February 17, 2017

By electronic submission to www.federalreserve.gov

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

Re: Comment Letter on the Notice of Proposed Rulemaking on Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments (Docket No. R-1547; RIN 7100 AE-58)

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**") and the Institute of International Bankers ("**IIB**") (collectively, the "**Associations**") welcome the opportunity to comment on the Notice of Proposed Rulemaking issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), entitled *Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments*, published in the Federal Register on September 30, 2016 (the "**Proposed Rule**").[1]

For the reasons stated below, we believe that the Proposed Rule is fundamentally flawed, does not consider the substantial benefits to the economy and jobs creation that would be lost by its implementation, is not supported by the law or empirical data, does not satisfy the well-established legal standards for agency rulemaking, and should be withdrawn and only re-proposed if the re-proposed version could and did meet those standards.

[1] Federal Reserve, *Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments*, 81 Fed. Reg. 67220 (Sept. 30, 2016).

I. Introduction

The Proposed Rule would impose punitive capital requirements and other restrictions on certain physical commodities activities of financial holding companies ("**FHCs**") conducted under the Bank Holding Company Act of 1956 (the "**BHC Act**").[2] The Proposed Rule would:

- impose punitive capital requirements on holdings by FHCs of specified physical commodities ("**Covered Physical Commodities**"), certain merchant banking investments in portfolio companies engaged in Covered Physical Commodities activities, including trading, storage, transportation and refining ("**Covered Commodity Merchant Banking Investments**"), and assets held pursuant to section 4(o) of the BHC Act other than physical commodities ("**Section 4(o) Infrastructure Assets**");

- impose additional restrictions on physical commodity activities conducted under the orders authorizing such activities as complementary to financial activities under section 4(k)(1)(B) of the BHC Act (the "**Complementary Powers Orders**")[3] and impose de facto parallel restrictions (through increased capital charges) on similar activities conducted under section 4(o) of the BHC Act; and

- establish new financial reporting requirements in connection with physical commodity activities.

The Proposed Rule would amend the risk-based capital rule applicable to FHCs to create three new categories of assets that would be subject to punitive capital requirements: Covered Physical Commodities, Covered Commodity Merchant Banking Investments and Section 4(o) Infrastructure Assets. Owning assets in each of these categories would be subject to a combination of additional and significantly increased capital charges, with risk weights under the U.S. Basel III capital rules ranging from 300 percent to 1,250 percent; the latter would require FHCs to hold more capital against an asset than the asset's value. These new capital charges are designed to address what the Federal Reserve has characterized as the tail (i.e., speculative or remote) risk of legal liability associated with engaging in certain activities with respect

[2] Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-1850).

[3] 12 U.S.C. § 1843(k)(1)(B). 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. 12 U.S.C. § 1843(j)(2).

to certain commodities,[4] notwithstanding that all of the largest U.S. and non-U.S. FHCs are already subject to existing capital charges for credit risk, market risk and operational risk, which are designed to address, among other risks, legal liability risk.

The Proposed Rule would also modify the activities counted toward the current cap of 5 percent of an FHC's Tier 1 capital on the market value of commodities held by an FHC under the Complementary Powers Orders (the "**5 Percent Cap**"). The Proposed Rule would count toward the 5 Percent Cap not only physical commodities held under Complementary Powers Orders, but also physical commodities held under certain other authorities, such as the authority of a bank holding company ("**BHC**") to acquire physical commodities under section 4(c)(8) of the BHC Act. The Federal Reserve explained that this would limit the ability of an FHC to expand its physical commodity activities based on the complementary authority of section 4(k)(1)(B) of the BHC Act if the FHC already engages in a substantial amount of physical commodity activities under other authorities.[5]

In addition, the Proposed Rule would re-classify copper as a non-precious metal, rescind the Federal Reserve's findings that energy management services and energy tolling are permissible complementary activities under section 4(k)(1)(B) of the BHC Act and impose new public reporting requirements on FHCs relating to their commodities activities.[6]

II. Executive Summary

The Proposed Rule fails to consider the benefits of FHCs' physical commodities activities, is not supported by the law or empirical data, does not satisfy the well-established legal standards for agency rulemaking and should be withdrawn and only re-proposed if the re-proposed version could and did satisfy those standards.

The proposed risk-based capital charges on a wide range of commodities activities – from holding Covered Physical Commodities positions and infrastructure assets to making investments in companies engaged in Covered Physical Commodities

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[4] Federal Reserve, *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities*, 79 Fed. Reg. 3329, 3331 (Jan. 21, 2014).

[5] *See* 81 Fed. Reg. at 67226.

[6] In addition, in the preamble to the Proposed Rule, the Federal Reserve states that it is "considering the appropriate risk-based capital treatment for *all* merchant banking investments." 81 Fed. Reg. at 67228 (emphasis added). Although this comment letter does not address this statement, the Associations support the comments of The Clearing House with respect to this issue, which are expected to be included in a separate comment letter dated on or about February 21, 2017. The Associations also support the comments of the Futures Industry Association with respect to the Proposed Rule.

activities – would be in addition to or a staggering increase (of up to twelve times) in the existing risk-based capital requirements for credit and investment risk (capturing the risk of, for example, the loss of the value of an equity investment), market risk (capturing price risk) and operational risk (capturing, among other risks, legal liability risk). These additional charges would in many cases result in FHCs having to maintain significantly more capital than the total value of the particular investments or commodity assets. The extent to which FHCs would have to overcapitalize for physical commodity assets is unprecedented and finds no basis in the international Basel III framework.[7] In fact, imposing these capital requirements would be so punitive as to make, whether intentionally or not, certain activities related to Covered Physical Commodities – including ordinary-course merchant banking investments in the equity of companies engaged in activities that extend beyond merely trading Covered Physical Commodities – effectively prohibited, a result that could only be justified by a finding that the assets held by FHCs are so unsafe and so unsound that they ought to be impermissible for FHCs to hold. Yet the Federal Reserve has made no such finding.

Indeed, the Proposed Rule fails to satisfy the well-established standards of rulemaking under the Administrative Procedure Act. As the Supreme Court reemphasized as recently as 2015, "[f]ederal administrative agencies are required to engage in reasoned decisionmaking."[8] An agency "must examine the relevant data and articulate a satisfactory explanation for its action, including a 'rational connection between the facts found and the choice made.'"[9] The Federal Reserve's explanation for the Proposed Rule is unsupported by the facts or the law, as both the case law and real-world examples of environmental liability demonstrate that FHCs engaged in the trading and ownership of physical commodities or investments in commodities companies do not pose a "substantial risk to the safety and soundness of depository institutions or the financial system generally"[10] associated with any potential environmental incidents. As Federal Reserve Chair Yellen candidly conceded in her testimony before the House Financial Services Committee on September 28, 2016, "[i]t's not a question of just going back through history to see what has happened in the

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[7] *See, e.g.*, Federal Reserve, *Regulatory Capital Rules: Implementation of Basel III*, 78 Fed. Reg. 62018 at 62021 (Oct. 11, 2013).

[8] *Michigan v. E.P.A.*, 135 S. Ct. 2699, 2706 (2015) (citing *Allentown Mack Sales & Service, Inc. v. NLRB*, 522 U.S. 359, 374 (1998) (internal quotation marks omitted)).

[9] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (citing *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)).

[10] The Board has proposed the rule pursuant to its authority under the GLB Act, which allows FHCs to engage in any activity that the Board determines "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." 12 U.S.C. § 1843(k)(1)(B).

past. It's [a] forward-looking concern that the *permissible* activities *could* pose risks."[11] Despite the fact that Congress and the Federal Reserve have allowed FHCs to engage in physical commodity activities for over 15 years, the Federal Reserve has failed to point to a single instance where an FHC incurred a significant loss arising from environmental liability related to these activities, which Ms. Yellen herself acknowledged are "permissible activities".[12] As a result, the Proposed Rule does not satisfy these well-established legal standards for rulemaking.

If implemented, the Proposed Rule inevitably would force domestic FHCs and the U.S. subsidiaries of foreign FHCs to significantly reduce or even terminate their commodities activities, causing adverse effects on competition, end users, the liquidity of commodities markets, small and medium-sized companies in the commodities sector, and thus the real economy.[13] Yet there is no denying the significant benefits that accrue to the end users and small and medium-sized companies that engage in commodities-related activities, and thus to the real economy, from FHCs' participation in these activities. As a majority of the specific comment letters on the advanced notice of proposed rulemaking published by the Federal Reserve in January 2014 (the "**2014 ANPR**") submitted by organizations, congressional representatives and law professors attested,[14] and as the Federal Reserve's own Complementary Powers Orders recognized,[15] numerous public benefits flow from the participation by FHCs in the commodities markets, including greater competition, increased liquidity in

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[11] *Hearing on Federal Reserve Supervision and Regulation of the Financial System Before the H. Fin. Serv. Comm.*, 114th Cong. 16-17 (2016) (statement of Janet Yellen, Chair, Board of Governors of the Federal Reserve System ("**Yellen Statement**")) (emphasis added).

[12] *See* 81 Fed. Reg. at 67224; *see also* Yellen Statement.

[13] *See, e.g., Barclays' Exit from Energy Trading Stirs Concerns Over Liquidity*, REUTERS (Dec. 6, 2016), *available at* http://www.reuters.com/article/us-usa-oil-barclays-bk-idUSKBN13U2MW.

[14] Sixty-two unique letters were submitted by organizations, congressional representatives and law professors. Of these letters, 40 support the view that the Federal Reserve should not curtail or eliminate the existing authority of FHCs to engage in physical commodities activities. Comment letters received on R-1479 a*vailable at* http://www.federalreserve.gov/apps/foia/ViewAllComments.aspx?doc_id=R-1479&doc_ver=1 (last accessed Oct. 11, 2016).

[15] See Citigroup Inc., 89 Fed. Res. Bull. 508 (2003); UBS AG, 90 Fed. Res. Bull. 215, 216 (2004); Barclays Bank plc, 90 Fed. Res. Bull. 511, 512 (2004); Deutsche Bank AG, 92 Fed. Res. Bull. C54, C56 (2006); Société Générale, 91 Fed. Res. Bull. C113, C115 (2006); JPMorgan Chase & Co., 92 Fed. Res. Bull. C57, C58 (2006); Fortis S.A./N.V., 94 Fed. Res. Bull. C22 (2008); The Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60 (2008); Letter to Mark Lenczowski, Esq., dated Apr. 20, 2009 (JP Morgan Chase & Co.); Letter to Andrew S. Baer, Esq., dated July 2, 2009 (Barclays PLC); Letter to Andrew S. Baer, Esq., dated Jan. 29, 2010 (Deutsche Bank); Letter to Kathryn V. McCulloch, Esq., dated June 30, 2010 (JPMorgan Chase & Co.); Letter to Robert L. Tortoriello, Esq., dated Sept. 21, 2010 (BNP Paribas); Letter to Andrew S. Baer, Esq., dated Feb. 17, 2011 (Bank of Nova Scotia).

commodities, increased price convergence between cash and derivatives markets and more economical financing for end users, among many others.

None of these benefits have changed since the passage of the GLB Act in 1999, the merchant banking regulations jointly adopted by the Federal Reserve and the U.S. Treasury in 2001[16] or the Complementary Powers Orders issued by the Federal Reserve from 2003 to 2011.[17]

Nor have the risks. The statutory sources of the environmental liabilities cited by the Federal Reserve in the Proposed Rule have been part of federal law since the 1980s or before.[18] There has been no meaningful change with respect to the general principle of limited liability for separate corporate entities absent the extraordinary circumstances that would warrant piercing the corporate veil since the foundational cases of the early 20th century,[19] nor has the veil-piercing risk in the specific context of environmental liabilities evolved substantially since 1998.[20] As the Federal Reserve is aware, none of the U.S. or foreign FHCs that are subject to the BHC Act have incurred *any* catastrophic legal liability or reputational harm arising from an environmental disaster of the scale the Federal Reserve purports to address in the Proposed Rule. What the Federal Reserve is left with is a speculative concern about hypothetical risks

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[16] 12 C.F.R. §§ 225.170 *et seq.* and 1500.1 *et seq.*

[17] *See supra* note 15.

[18] *See, e.g.*, Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("**CERCLA**").

[19] *Lowendahl v. Baltimore & Ohio R.R. Co.*, 287 N.Y.S. 62, 72, 247 A.D. 144, 164 (1st Dep't 1936), *aff'd*, 272 N.Y. 360 (1936) (articulating the bedrock principle of corporate law that stockholders are not liable for the obligations of a corporation); *U.S. v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 1 A.F.T.R (P-H) P 131 (C.C.E.D. Wis. 1905) (stating that veil-piercing is the exception, not the rule, and therefore the corporate form will be respected "until sufficient reason to the contrary appears"); Stephen B. Presser, Piercing the Corporate Veil § 1:4, 24-27, (2016) *citing Berkey v. Third Ave. Ry. Co.*, 244 N.Y. 84, 85, 155 N.E. 58 (1926) (Cardozo, J.) (noting that attempts to set aside any corporate entities must be approached with caution, and that one should be on guard against the tendency to find instances appropriate for veil-piercing).

[20] *United States v. Bestfoods*, 524 U.S. 51, 61–62 (1998) (holding that, under the "deeply ingrained" principle that a parent corporation is not liable for the acts of its subsidiaries, veil-piercing is the exception rather than the rule, and "nothing in CERCLA purports to reject this bedrock principle"); *United States v. Friedland*, 173 F. Supp. 2d 1077 (D. Colo. 2001) (applying the *Bestfoods* veil-piercing analysis in order to grant summary judgment for parent company, imposing no derivative liability under CERCLA); *United States v. Viking Resources, Inc.*, 607 F. Supp. 2d 808, 823 (S.D. Tex. 2009) (applying the *Bestfoods* veil-piercing analysis in the context of the Oil Pollution Act); *In re Appalachian Fuels, LLC*, 493 B.R. 1, 17 (6th Cir. BAP 2013) (applying the *Bestfoods* veil-piercing analysis to indirect liability claims under the Clean Water Act, Surface Mining Control and Reclamation Act and statutory claims under state law).

that have never yet materialized, and without any basis for assuming that they will materialize.

In addition to the unsupported and unsupportable punitive capital requirements, other elements of the Proposed Rule are similarly flawed. First, the proposed definition of Covered Physical Commodities is unworkably expansive as proposed. As currently written, the proposed definition would cover commodities that present no meaningful risk of environmental harm, including a number of substances found in common household goods, consumer products, and even drinking water and multi-vitamins, as well as a precious metal – silver – that is, specifically listed in the Federal Reserve's Regulation Y as a permissible financial asset underlying forward contracts, options, futures and similar contracts that FHCs may enter into as principal under certain conditions.[21] For example, substances covered by the proposed definition – which contains no *de minimis* exception – include the following:[22]

- Ammonia
- Chlorine
- Copper
- Iodine
- Iron
- Nickel
- Silver
- Silicon
- Sodium
- Vinegar
- Zinc

Because the proposed definition would also cover "any physical commodity… *a component of which* is" one of these substances, if the Federal Reserve insists on re-proposing a new version of the Proposed Rule, it must revise its definition to avoid subjecting FHCs' activities and investments that are related to drinking water, metals, consumer electronics, cleaning products, and other commodities, such as agricultural commodities, to the Proposed Rule's punitive capital requirements.[23] Second, there is

[21] *See* 12 C.F.R. § 225.28(b)(8)(ii)(B); *see also* 12 C.F.R. § 225.28(b)(8)(iii) (authorizing buying, selling and storing bars, rounds, bullion and coins of, among other metals, silver, as principal or agent).

[22] These substances are all included in the CERCLA list of hazardous substances. *See* 40 C.F.R. § 302.4. The Proposed Rule defines Covered Physical Commodity to include "any physical commodity that is, or a component of which is, specifically named (1) As a 'hazardous substance' under section 104 of the Comprehensive Environmental Response, Compensation, and Liability Act (42 U.S.C. 9601). 81 Fed. Reg. at 67236.

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

no basis for further restricting physical commodities trading activities under the Complementary Powers Orders and section 4(c)(8) of the BHC Act. Finally, there is no basis for the Federal Reserve to rescind the authority of some FHCs to engage in energy tolling and management services under Complementary Powers Orders.

In short, the Proposed Rule is fundamentally flawed and should be withdrawn and only re-proposed if the re-proposed version could and did satisfy the established standards for rulemaking. The Federal Reserve should review and assess the substantial benefits of FHCs' Covered Physical Commodities activities, the existing operational risk loss data showing insignificant losses from environmental accidents, and the existing case law on the very high legal threshold required to pierce the corporate veil (and the rare occasions on which veil-piercing has actually been allowed) before determining whether to make any new proposal to address the Covered Physical Commodities activities of FHCs.

The remainder of this comment letter is structured as follows: **Part III** explains why the benefits of continuing to permit FHCs to engage in physical commodities activities should continue to produce public benefits that outweigh their potential risks. **Part IV** discusses our comments on the proposed capital charges on Covered Physical Commodities and Covered Commodity Merchant Banking Investments. **Part V** discusses our comments on the scope of Covered Physical Commodities under the Proposed Rule. **Part VI** discusses our comments on the proposal to restrict physical commodities trading activities under the Complementary Powers Orders. **Part VII** discusses our comments on the proposal to rescind energy tolling and energy management services under the Complementary Powers Orders. **Part VIII** discusses our comments on the proposed removal of copper from the list of precious metals. Finally, **Part IX** identifies components of the Proposed Rule for which we request clarification or correction.

III. The Proposed Rule Does Not Take into Account the Public Benefits of FHCs' Physical Commodities Activities

The Proposed Rule is a one-way street and is based on incomplete information in that it focuses solely on the potential, and we believe highly speculative and remote, tail risks of ownership of and exposure to Covered Physical Commodities, regardless of the authority under which such activities are conducted. The Federal Reserve nowhere addresses or even acknowledges the substantial public benefits accruing from FHCs' participation in these activities, thus effectively ignoring, or rejecting without any stated justification, the 40 unique comment letters[24] in response to the 2014 ANPR from end users, commodity markets trade associations, financial services trade

[24] *See supra* note 14.

associations and other market participants that emphasized these benefits, as well as the Federal Reserve's own prior findings in issuing Complementary Powers Orders to FHCs and Congressional determinations that the benefits of certain physical commodities activities outweigh their potential risks.

The Federal Reserve's failure to take into account the public benefits of FHCs' physical commodities activities that would be lost if the requirements of the Proposed Rule were to become effective fails to satisfy its obligation under the Administrative Procedures Act to engage in reasoned decision-making in its rulemaking, as discussed in Part IV below.[25]

A. Prior Board and Congressional Determinations

The Federal Reserve expressly determined in the Complementary Power Orders[26] that the commodities activities under the Complementary Powers Orders could reasonably be expected to produce the following public benefits:

- **Greater Convenience** to customers by enhancing the ability of FHCs to provide a full range of commodity-related services;
- **Increased Competition** by enabling FHCs to improve their understanding of physical commodity and commodity derivative markets and their ability to serve as effective competitors in such markets; and
- **Gains in Efficiency** by allowing FHCs to compete in physical settled OTC derivative markets more economically and hedge risks more efficiently.[27]

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[26] *See supra* note 15. Starting in 2006, the Federal Reserve decided that Complementary Powers Orders determinations were sufficiently routine that they could be made by delegated authority to the Director of the Division of Banking Supervision and Regulation, unless a particular application raised novel issues that required direct Board action. *See* Letter to Elizabeth T. Davy, Esq., dated Apr. 13, 2006 (Wachovia Co.); Letter to David R. Sahr, Esq., dated Sept. 29, 2006 (Fortis S.A./N.V.); Letter to Paul E. Glotzer, Esq., dated Mar. 27, 2007 (Credit Suisse Group); Letter to Gregory A. Baer, Esq., dated Apr. 24, 2007 (Bank of America); Letter to Paul E. Glotzer, Esq., dated Aug. 31, 2007 (BNP Paribas); Letter to John Shrewsberry, dated Apr. 10, 2008 (Wells Fargo); Letter to David R. Sahr, Esq., dated May 21, 2008 (Fortis S.A./N.V.); Letter to Robert L. Tortoriello, Esq., dated Dec. 5, 2008 (BNP Paribas); Letter to Mark Lenczowski, Esq., dated Apr. 20, 2009 (JP Morgan Chase & Co.); Letter to Andrew S. Baer, Esq., July 2, 2009 (Barclays PLC); Letter to Andrew S. Baer, Esq., dated Jan. 29, 2010 (Deutsche Bank); Letter to Kathryn V. McCulloch, Esq., dated June 30, 2010 (JPMorgan Chase & Co.); Letter to Robert L. Tortoriello, Esq., dated Sept. 21, 2010 (BNP Paribas); Letter to Andrew S. Baer, Esq., dated Feb. 17, 2011 (Bank of Nova Scotia).

[27] *See, e.g.*, 2008 RBS Order, *supra* note 15, at C66; 2003 Citi Order, *supra* note 15, at 510.

Congress similarly determined in 1999 that commodities activities would produce substantial public benefits when it enacted the complementary activities authority under Section 4(k)(1)(B) of the BHC Act[28] and the grandfathering authority under section 4(o) of the BHC Act.[29]

B. Prior Board and Congressional Determinations of Public Benefit Were Correct When Made and Are Still Correct with Respect to All Permissible Physical Commodities Activities

The Federal Reserve's determinations as recently as 2011 and those by Congress in 1999 were correct when made and they remain correct today with respect to all permissible physical commodities activities, regardless of their source of legal authority. The Federal Reserve has not cited a single subsequent instance that is inconsistent with, much less repudiates, those findings.

1. Greater Convenience for Customers

Physical commodities activities by FHCs result in greater convenience for customers.[30] Among other things, customers enjoy a better and more diverse array of risk management and financing options, as FHCs and their non-bank affiliates enjoy more flexibility to make or take delivery of physical commodities upon the expiration of a commodity derivatives contract and to maintain inventories.

If FHCs were forced out of the physical commodities markets, businesses would be forced to turn to other types of counterparties: a limited number of commodity trading houses, energy merchant companies, oil companies with trading desks, or other types of traders that are not market-makers and are not subject to any prudential supervision. These firms do not seek to provide the types of customer-driven, integrated services long provided by FHCs. Rather, their businesses are focused on deploying assets for investment or proprietary trading purposes, not market

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[28] Statement by Senator Sarbanes, 145 Cong. Rec. S13783-01, at S13788 (Nov. 3, 1999).

[29] *See* Congress indicated that the grandfathered commodities activities should be "construed broadly," that they "*shall* include owning and operating properties and facilities required to extract, process, store and transport commodities," and that the purpose of the grandfathering provision was to allow qualified FHCs to continue engaging in physical commodities activities as long as certain conditions were satisfied. H.R. Rep. No. 104-127, Part 1, at 97 (May 18, 1995) (emphasis added); Amendment No. 9 by Senator Gramm (Mar. 4, 1999), *available at* http://banking.senate.gov/docs/reports/fsmod99/gramm9.htm.

[30] *See* 12 U.S.C. § 1873(j) (listing criteria Federal Reserve must consider for notices of non-banking activities, including for complementary activities under Section 4(k)(1)(B) of the BHC Act).

making.[31] Moreover, these firms are restricted in their ability to offer swap products to other market participants to the extent that they are not registered as swap dealers under Title VII of the Dodd-Frank Act.[32] These firms are less able to offer credit solutions to commodity businesses, and operating companies would be required to set aside more capital for transactions with nonbank counterparties. Unlike the commodity activities of FHCs, which are closely monitored by the Federal Reserve, and for registered swap dealers, by the Commodity Futures Trading Commission ("**CFTC**"), and are subject to prudential requirements, these commodities trading firms that are not affiliated with banks or broker-dealers are far less regulated or wholly unregulated and often based outside the United States.[33] Forcing end users into the shadow banking system creates greater risks for not only these customers, but for the financial system as a whole.

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[31] A recent article about the exit of Barclays Plc from the energy trading market emphasized the differences in the provision of commodities trading liquidity by banking organizations such as FHCs, on the one hand, and by independent commodity trading organizations unaffiliated with banks or FHCs, on the other hand. S*ee supra* note 13 (quoting a market analyst as observing that "[m]erchant books are physically oriented. They don't offer the same type of liquidity that the banks do . . . . When they're there, it's patchy and specific [and] ancillary . . . .").

[32] Of the 104 entities currently registered as swap dealers or major swap participants with the CFTC and National Futures Association, all except four are entities affiliated with FHCs, broker-dealer firms, or interdealer brokers (BP Energy Company, Cargill Incorporated, Shell Trading Risk Management LLC, MBIA Insurance Corporation). *See* NFA SD/MSP Registry, *available at* https://www.nfa.futures.org/NFA-swaps-information/regulatory-info-sd-and-msp/SD-MSP-registry.html. *See also* Comment letter on 2014 ANPR from Coalition of Physical Energy Companies (Apr. 15, 2014) (noting that many non-FHC commodities trading firms that previously traded and made markets in both the physical and derivatives markets have exited the derivatives markets out of concern of becoming a swap dealer, making FHCs' function in the market even more important).

[33] *See* Comment letters on the 2014 ANPR from Murray Energy Co. (Apr. 4, 2014) (emphasizing that less regulated and creditworthy entities may replace FHCs in commodities markets); Center for Capital Markets Competitiveness (Jan. 9, 2014) (same); United Parcel Service Inc. (Apr. 4, 2014) (same); Alon USA Energy, Inc. (Mar. 14, 2014) (same); American Gas Association, America's Natural Gas Alliance and American Exploration & Production Council (Mar. 31, 2014) (same); Futures Industry Association (Apr. 9, 2014) (same); Apache Corporation (Apr. 14, 2014) (same); Novelis Inc. (Apr. 14, 2014); Calpine Corporation (Apr. 15, 2014) (same); Central Plains Energy Project (Apr. 15, 2014) (same); Clark-Mobile Counties Gas District and The Black Belt Energy Gas District (Apr. 15, 2014) (same); Chelan County Public Utility District, Clark Public Utilities, Cowlitz County Public Utility District, Public Utility District #2 of Grant County, Eugene Water and Electric Board, Klickitat County Public Utility District, Lewis County Public Utility District, Pend Oreille County Public Utility District #1, Snohomish County Public Utility District and Tacoma Power (Apr. 16, 2014) (same); EP Energy LLC (Apr. 15, 2014) (same); Coalition of Physical Energy Companies (Apr. 15, 2014) (same); NRG Energy, Inc. (Apr. 15, 2014) (same); Talos Energy LLC (Apr. 15, 2016) (same); Tennessee Energy (Apr. 15, 2014) (same); CME Group (Apr. 16, 2014) (same); Delek US Holdings, Inc. (Apr. 16, 2014) (same); Denham Capital Management LP (Apr. 16, 2014) (same); Electric Power Supply Association (Apr. 16, 2014) (same); Noranda Aluminum, Inc. (Apr. 16, 2014) (same); U.S. Chamber of Commerce (Apr. 16, 2014) (same).

In contrast, FHCs are customer-driven and able to offer clients risk management solutions. They are able to provide clients "full service solutions with integrated risk management, financing, and customized" options, including "hedging, asset backed facilities, and working capital facilities."[34] FHCs have the balance sheet capacity, the ability to extend credit and the risk management expertise to price risk effectively. Moreover, FHCs' broad client coverage networks allow them to effectively distribute and transform risk.[35]

The value of this public benefit can be illustrated by the example of a customer that needs to hedge its exposure to the volatility of the price of some critical input, such as jet fuel, or to finance its inventory of such critical input. Its needs will be better met, and it will have more choice in counterparties and financial products, if FHCs are permitted to engage in physical commodities activities than if FHCs are forced to exit the market.[36] In particular, and as discussed in greater detail below, the customer is more likely to have access to customized, over-the-counter financial contracts because FHCs and their affiliates are more likely to provide them than other players in the market. These bespoke products allow customers to hedge their risks and finance their inventories more effectively than if they were only able to do so with standardized, exchange-traded futures contracts, or a narrower range of bespoke contracts.

Other products involve more customizations. For example, a refinery may enter into a transaction reflecting the spread between the prices of its input (crude oil)

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[34] IHS Global, Inc., Comments on Volcker Rule Regulations Regarding Energy Commodities Report, 17 (2012) ("**IHS Volcker Report**"). *See also* Comment letters on the 2014 ANPR from American Gas Association, America's Natural Gas Alliance and American Exploration & Production Council (Mar. 31, 2014) (noting that FHCs are the market participants most willing to enter customized trades); International Swaps and Derivatives Association, Inc. (Apr. 8, 2014) (noting the ability of FHCs to provide end users with a broad range of customized risk management solutions); Futures Industry Association (Apr. 9, 2014) (noting that end users rely on FHCs for a broad spectrum of significant commodity-related financial services); United Parcel Service Inc. (Apr. 4, 2014) (noting that FHCs are "particularly sophisticated in constructing hedging transactions and in identifying options to help manage our risks in ways that we otherwise would not have considered"); Apache Corporation (Apr. 14, 2014) (noting that given FHCs' size, sophistication and business model, FHCs are able to customize trades to each end user's specific needs, allowing end users to most effectively hedge their underlying risks); Talos Energy LLC (Apr. 15, 2016) (same); Delek US Holdings, Inc. (Apr. 16, 2014) (same); Morgan Stanley (Apr. 17, 2014) (noting that commodities businesses require tailored solutions involving complex combinations of commodity physically-settled forwards, options and over-the-counter and cleared derivatives to meet their needs and that FHCs are uniquely positioned to provide necessary specialized financings and risk management services).

[35] *See* IHS Volcker Report, *supra* note 34, at 17.

[36] Rudy Ruitenberg, *Bank Reform Seen by Schreiber Pushing Commodities into Opacity*, BLOOMBERG BUSINESSWEEK (April 8, 2014) (describing the view of a leading investor that Dodd-Frank rules have already pushed commodities trading away from banks and into unregulated entities).

and finished product (gasoline), allowing it to lock in profit margins and providing cash-flow predictability. For this transaction to be as effective as possible, the pricing is keyed off the crude grades that are actually used by the refiner. Certain crude grades, such as Louisiana light sweet crude, are not actively traded on a financially settled basis. Thus, an FHC that enters into a spread transaction with a refiner that uses these grades would seek to manage the market risk it assumes by entering into a fixed-price purchase transaction with a producer of the same crude grade referenced in the financial spread transaction. These transactions achieve the dual goals of providing revenue certainty to both the refinery and the producer.

These public benefits will be lost to a considerable degree if FHCs are forced to exit the market because other market participants do not have the balance sheets, business models or incentives to provide the same range of bespoke products to customers. FHCs have the size and expertise to intermediate the full range of transactions and services commodity customers require. FHCs also have the ability to provide credit capacity, which allows companies to free up cash that can be used for other investment purposes. Perhaps most importantly, the credit quality of FHCs, in combination with these other attributes, makes banking entities the preferred – and sometimes the only permitted – counterparty for many operating companies. FHCs can also be expected to remain active market-makers during a financial crisis, providing end users, producers and trading firms with more certainty regarding an uninterrupted supply of bespoke financial contracts. In its 2013 study on the role of banks in physical commodities, IHS Global, Inc. described the important role that FHCs play as reliable counterparties as follows:

> Banks have emerged as the credit worthy counterparty to tailor corporate hedging transactions. This customer-facing role is a natural extension to traditional banking services. This client-facing business model creates a primary impetus for being in the physical commodity markets – on behalf of or in support of client needs. There are many important reasons behind the need for these bank services in the commodities markets. For instance, exchange traded solutions frequently are not available, not sufficiently liquid, not available in sufficient size or not appropriately matching the desired period of time, *i.e.*, they create too much basis risk.[37]

[37] IHS Global, Inc., *The Role of Banks in Physical Commodities*, 10 (2013) ("**IHS Commodities Study**").

2. Increased Competition

The commodities markets will be more competitive, not less competitive, if banks and their non-bank affiliates are allowed to enter and remain in physical commodities markets, and are not forced to exit them, compared to a world in which their competitors in commodities markets are protected by regulatory barriers to entry that keep banks or their non-bank affiliates out of that market or by regulatory mandates that force them to exit.[38] Indeed, the very heart of our antitrust (pro-competition) laws is to break down barriers to entry or mandates to exit, prevent excessive concentrations of market share and otherwise foster free and robust competition from the greatest number of competitors.[39]

A consequence of making commodities markets more competitive is that market prices will be lower than if markets were less competitive as a result of regulatory barriers to entry or mandates to exit. It is well established that prices will be lower in a more competitive market compared to those in a less competitive market.[40] Another consequence of making commodities markets more competitive is that they will be more liquid and efficient. A more liquid commodities market means that the spread between bid and ask prices of a particular commodity will be lower, and it will

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[38] *See* Comment letters on the 2014 ANPR from American Gas Association, America's Natural Gas Alliance and American Exploration & Production Council (Mar. 31, 2014) (noting that eliminating, or substantially reducing, FHC participation would harm competition); American Gas Association, American Public Gas Association, Electric Power Supply Association, National Rural Electric Cooperative Association, U.S. Chamber of Commerce for Capital Markets Competitiveness and U.S. Chamber of Commerce Institute for 21st Century Energy (Apr. 3, 2014) (noting restrictions on FHCs' physical commodities activities could lead to greater systemic and commercial risk concentration); Converse and Company, Inc. (Apr. 15, 2014) (the physical commodities market is dominated by a small number of participants and accessing commodities markets will be more difficult and expensive without the presence of FHCs); EP Energy (Apr. 15, 2014) (additional restrictions on FHCs' physical commodities activities will increase costs for end users and their customers); Interstate Natural Gas Association of America (Apr. 16, 2014) (same); Talos Energy LLC (Apr. 15, 2014) (same); U.S. Chamber of Commerce (Apr. 16, 2014) (noting that restrictions that deter or eliminate FHC participation in physical commodity markets could cause these markets to unravel, leading to decreased competition, greater market illiquidity and inefficient pricing); Chelan County Public Utility District, Clark Public Utilities, Cowlitz County Public Utility District, Public Utility District #2 of Grant County, Eugene Water and Electric Board, Klickitat County Public Utility District, Lewis County Public Utility District, Pend Oreille County Public Utility District #1, Snohomish County Public Utility District and Tacoma Power (Apr. 16, 2014) (additional limitations on the participation of FHCs in physical energy markets could prompt their exit from the marketplace, leading to higher hedging costs for customers); *see also* Gregory Meyer, *A Ban on Banks Holding Physical Commodities Could Backfire*, FINANCIAL TIMES (July 26, 2013).

[39] *See, e.g.*, Robert H. Bork, THE ANTITRUST PARADOX (1978).

[40] *See, e.g.*, James R. Kearl, ECONOMICS AND PUBLIC POLICY: AN ANALYTICAL APPROACH 225 (Pearson, 6th ed. 2011).

be possible to buy and sell larger quantities of the commodity without affecting the market price of the commodity. Markets are generally considered to be more efficient the more liquid they are. Indeed, in the most idealized and efficient market model – the perfectly competitive market model – perfect liquidity is assumed when the market is in long-term equilibrium; i.e., there is no spread between bid and ask prices. All producers and consumers are considered to be "price takers" in such idealized markets.[41]

3. Gains in Efficiency

The involvement of banks and their non-bank affiliates in the physical commodities markets can also increase the efficiency of supply chains.[42] Specifically, FHCs' trading activities in commodity markets promote competitive pricing and the efficient allocation of commodities by creating links between regions and products.[43] For example, as explained in the IHS Commodities Study, an FHC may have electricity transmission capabilities between the Midwest and Georgia, which it can use to move power from an oversupplied, lower-priced area in the Midwest to an undersupplied, higher-priced location in Georgia. This activity, which is low risk for the FHC, greatly benefits U.S. end users and consumers by helping to eliminate price disparities, mitigate supply shortages and maintain price stability.[44]

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[41] *Id*. at 157.

[42] *See, e.g.*, Comment letters on 2014 ANPR from National Association of Corporate Treasurers (Apr. 16, 2014) (FHCs help end users efficiently transact in physical commodities markets); Apache Corporation (Apr. 14, 2016) (same); Central Plains Energy Project (Apr. 15, 2014) (same); Noranda Aluminum (Apr. 16, 2014) (same); PBF Energy Inc. (Apr. 14, 2014) (noting that because FHCs are large, liquid entities authorized to hold title to physical commodities, end users of physical commodities are able to use FHCs' services through the course of their day-to-day business activities, from sourcing raw materials to delivering refined materials to the point of sale without arranging for independent financing or engaging in additional risk mitigation); Delek US Holdings, Inc. (Apr. 16, 2014) (noting as uniquely favorable characteristics of FHCs their strong knowledge of commodities markets and the financial resources and credibility that FHCs alone offer).

[43] IHS Commodities Study, *supra* note 37, at 9 (citing Scott H. Irwin, Dwight R. Sanders and Robert P. Merrin, Devil or Angel? The Role of Speculation in the Recent Commodity Price Boom (and Bust), 41 J. Agricultural & Applied Economics); *see also* Comment letter on the Notice from International Swaps and Derivatives Association, Inc. (Apr. 8, 2014) (emphasizing the role of FHCs in promoting the efficient functioning of physical and financial markets, creating important "benefits for market participants, including reduced transaction costs, decreased market volatility, greater predictability and improved price discipline").

[44] IHS Commodities Study, *supra* note 37, at 9.

C. Additional Public Benefits

In addition to the public benefits determined by the Federal Reserve to be reasonably likely if the commodities activities under the Complementary Powers Orders are permitted, continuing to permit FHCs to engage in commodities activities can reasonably be expected to produce a variety of additional public benefits, including the benefits described below.

1. Increased Liquidity in the Commodities Markets

Permitting FHCs and their non-bank affiliates to make markets in physical commodities has increased and can reasonably be expected to continue to increase the liquidity of the commodities markets, reducing the spread in bid and ask prices and increasing the volume of commodities that can be bought and sold without affecting market prices.[45] As market makers, FHCs bear the price risk between the arrival of sellers and buyers, which can lead to temporary accumulations of inventory. By acting as counterparties in trades and by accumulating inventories in anticipation of customer demand in their role as market makers, FHCs therefore provide much needed liquidity.[46] Although FHCs acting as market makers in commodities are mostly known for their activities at the long-dated end of the forward oil and natural gas curves, they also "provide liquidity at the short-dated end of the curve by managing their own positions."[47] FHCs also finance other market participants, such as commodity traders and end users, through physical repurchase agreements. These FHCs, by dealing in physical commodities, thereby facilitate participation in the market by other entities, which further contribute to market liquidity.

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[45] *See* Comment letters on the 2014 ANPR from International Swaps and Derivatives Association, Inc. (Apr. 8, 2014) (emphasizing that FHCs provide liquidity in commodity markets through their market making activities); Murray Energy Corporation (Apr. 4, 2014) (same); Apache Corporation (Apr. 14, 2014) (same); Calpine Corporation (Apr. 15, 2014) (same); EP Energy LLC (Apr. 15, 2014) (same); Talos Energy LLC (Apr. 15, 2014) (same); Interstate Natural Gas Association of America (Apr. 16, 2014) (same); U.S. Chamber of Commerce (Apr. 16, 2014) (same); American Gas Association, et al. (Mar. 31, 2014) ("We are concerned that, especially in the markets for customized commodity derivatives, a retreat by FHC affiliates will lead to greater market illiquidity and inefficient pricing"); CME Group (Apr. 16, 2014) (noting that FHCs are a critical source of liquidity for bona fide hedgers that benefit from delivery optionality, which increases the hedging value of physical-delivery futures to end users and improves futures-cash market convergence); Denham Capital Management LP (Apr. 16, 2014) (noting that outside of FHCs, physical commodities and commodity-related derivatives markets are relatively illiquid).

[46] Ricardo Lagos, Guillaume Rocheteau and Pierre-Olivier Weill, "Crises and Liquidity in Over-the-Counter Markets," NBER Working Paper No. 15414 (Oct. 2009).

[47] IHS Volcker Report, *supra* note 34, at 18.

FHCs' market-making commodities activities provide significant liquidity to both exchanges and the OTC markets. Such provision of liquidity is beneficial to the public, as a reduction in liquidity would result in "increased price volatility for energy commodities, wider bid-ask spreads, reduced access to services, and increased basis risk for hedging strategies."[48]

2. Increased Price Convergence Between the Physical and Derivatives Markets

Allowing FHCs to engage in physical commodities activities in both the physical and derivatives markets has helped foster and will continue to foster convergence of prices in the physical and derivatives markets, resulting in more efficient commodities markets, with lower price volatility and increased certainty. Unlike other financial assets, commodity instruments are related to a physical product. Accordingly, financial markets should tie or "converge" to these physical markets at expiry, meaning that settlement prices of derivative contracts should meet the prices of the physical commodity.

Divergence between these prices may reflect an inefficiency of the financial instrument's use as a hedge of commodity prices. Such a divergence may result in end users having to absorb risks that they otherwise seek to shed through the purchase or sale of such financial instruments. When end users purchase a physical commodity for their businesses, the price they pay is the prevailing price in the market for the actual commodity. To the extent that an end user uses derivative instruments (such as futures contracts or swaps) to hedge against changes in that price, the end user is at risk if the settlement price of the hedge diverges from the price of the actual commodity. To the degree that the prices diverge, there will be arbitrage opportunities that market participants can mitigate by taking offsetting financial and physical positions until prices do converge.

FHCs improve price convergence by providing intermediation services that connect buyers and sellers across locations, time periods and products, as FHCs stand ready to deliver product or receive delivery of product in the various markets in which they intermediate. Because FHCs are in the markets for both commodity instruments

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[48] IHS Volcker Report, *supra* note 34, at 7. *See also* Comment letter on 2014 ANPR from Chelan County Public Utility District, Clark Public Utilities, Cowlitz County Public Utility District, Public Utility District #2 of Grant County, Eugene Water and Electric Board, Klickitat County Public Utility District, Lewis County Public Utility District, Pend Oreille County Public Utility District #1, Snohomish County Public Utility District and Tacoma Power (Apr. 16, 2014) (reductions in liquidity due to additional limitations on the participation of FHCs will cause utilities and their customers to suffer through higher hedging costs and may ultimately leave them unable to adequately hedge price and volumetric exposures without undue credit concentration risk).

and related physical products, they promote efficient markets and help to maintain pricing relationships – i.e., they improve price convergence in both physical and financial commodities markets. FHCs thus promote the efficiency of commodity markets, providing liquidity and helping drive more efficient price formation.[49]

3. More Publicly Transparent Commodities Markets

Because FHCs and their non-bank affiliates are subject to more comprehensive and transparent reporting and disclosure requirements than the privately held foreign commodity trading and investment firms that would almost certainly dominate the physical commodities trading markets if FHCs were forced to exit those markets, FHC participation in these markets provides the public and U.S. regulatory agencies, including the Financial Stability Oversight Council, with a better window into the U.S. physical commodities markets than they otherwise would have and fosters more publicly transparent commodities markets.[50]

4. More Economical Financing of Inventories by End Users

FHCs can play an important role in helping commodity producers to reduce their operating costs, efficiently manage their cash flow and reduce their working capital. By having the ability to take title to and the right to dispose of commodity inventories, an FHC is able to provide a larger amount of financing than would be possible if the transaction were structured as a secured loan.[51]

Consider the example of a crude oil refiner that wants to finance its inventory economically in order to manage cash flow and optimize working capital. The producer can do so by borrowing from an FHC intermediary and temporarily passing title to the inventory to the FHC. Because the FHC can hold title, it can significantly

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[49] IHS Commodities Study, *supra* note 37, at 9. *See also* comment letters on the Notice from International Swaps and Derivatives Association, Inc. (Apr. 8, 2014) (FHCs enhance price integrity by helping to bring about price convergence); CME Group (Apr. 16, 2014) (the physical-delivery mechanism ensures price convergence between derivatives and their underlying commodities).

[50] *See* Comment letters on 2014 ANPR from United Parcel Service Inc. (Apr. 4, 2014) (the risk profiles of FHC counterparties are transparent and well-known to the end user community); Calpine Corporation (Apr. 15, 2014) (noting that FHCs are important counterparties because, in part, they are transparent).

[51] *See* Comment letters on 2014 ANPR from PBF Energy Inc. (Apr. 14, 2014) (noting that because FHCs are authorized to take title to physical commodities, end users of physical commodities are able to use FHCs' services through the course of their day-to-day business activities, from sourcing raw materials to delivering refined materials to the point of sale without arranging for independent financing or engaging in additional risk mitigation); Apache Corporation (Apr. 14, 2014) (same); Talos Energy LLC (Apr. 15, 2014) (same).

reduce its credit risk to the refiner arising from the transaction, and this in turn allows it to offer better terms to the refiner in the form of lower borrowing costs or a reduced (or no) haircut on the inventory. As a result, the refiner has less debt on its balance sheet, pays less for this alternative form of financing and is thereby able to invest in its business more efficiently, such as in capital expenditure investments including safety improvements and additional hiring, and it receives a return of the title to its inventory when the secured transaction expires.

In fact, many if not most physical commodities transactions have a financing component that is clearly within an FHC's traditional activity of providing financing, which supports our view that physical commodities activities are complementary to financial activities. Physical hedging provides less basis risk than futures markets, but also allows customers to finance the margin they otherwise would have to post to the exchange through a credit line offered by the bank (which may or may not be secured by the lender's collateral pool). Inventory management transactions, such as the jet fuel example discussed under "Reliable Supplies, Steady Prices and Specified Inputs Through Customized Hedging" below, physical commodity repurchase agreements, and metal lending and consignment agreements are alternative forms of secured inventory finance that could also be accomplished through an asset-backed or unsecured loan. Many companies therefore prefer to use inventory management transactions with FHCs because: (i) they are lower cost, (ii) they can result in commodities being removed from or not being added to their balance sheets and (iii) the end user retains operational care custody and control over the commodity, even though the FHC may own it.

5. Reliable Supplies, Steady Prices and Specified Inputs Through Customized Hedging

Many commodities consumers and producers require customized OTC contracts with specialized terms in order to meet their risk management needs.[52] Specialized contracts typically include terms such as non-standard locations for delivery, unusual maturity dates or commodities of a specific grade or quality. Without these customized contracts, producers and consumers would face higher basis risk – the risk that the hedge does not perfectly offset the physical position being hedged.

An FHC's ability to hold physical commodities supports its ability to offer its clients customized hedges to meet their risk management needs, and to offset the risk the FHC assumes through a mixture of financial contracts and physical holdings. FHCs cannot safely provide these customized OTC contracts to producers and

[52] *See* Comment letters on 2014 ANPR, *supra* note 33.

consumers unless they can dynamically hedge their risks by buying and selling physical commodities.[53]

The following examples illustrate the use of customized hedging to secure supply or price for consumers and producers:

- A widget producer routinely purchases commodities as inputs in its business. Standardized futures contracts provide only a partially effective hedge because the settlement price underlying the financial contract is set ahead of time as of a specified future date, while the widget producer buys its inputs every day and at different prices each day. Because it can hold physical commodities as well as trade financial contracts, an FHC can create a custom hedge for the producer that uses a daily average price rather than the price on a specific date. This better covers the producer's exposure to price changes and reduces the variability of its input costs and thus of its earnings.

- An airline needs to have a reliable source of jet fuel with deliveries every day, in variable quantities and in various locations. The airline can both reduce its operating costs and enhance the reliability of its supply by arranging for a long-term contract with an FHC. While a standardized contract would offer a set amount at a set location on a specific date, the FHC can deliver the quantity needed, in the appropriate locations, on the necessary days. To do so, the FHC needs to be able to take physical delivery from standardized contracts, as well as to hedge its market risk using financial contracts. Ultimately the cost to the airline is lower, because with lower basis risk it does not need to maintain its own outsized inventory in order to smooth supply.[54]

- A utility company may need to take physical delivery of a commodity when the heating season begins in late October, meaning that a standardized financial contract maturing at the end of September or the end of December will not provide an effective hedge. A customized contract can alleviate this risk. The FHC must be able to take physical delivery in order to provide the customer with the commodity on the specified date.

- A wire manufacturer may need copper delivered to the hub that is closest to its factory in the U.S. Midwest in order to avoid additional transportation costs and potential delays. The financial contract for copper, however, may

[53] IHS Commodities Study, *supra* note 34.

[54] IHS Volcker Report, *supra* note 34, at 25-26.

> not assure delivery in that specific location, and the Midwest customer relying on a financial contract could find itself taking delivery of the commodity in Singapore. A customized contract with an FHC can ensure delivery at the specified location. At a minimum, this ensures that the consumer pays the local cost, without additional transport fees; the contract likely reduces timing uncertainty for delivery as well. This lowers the cost for the FHC's customer and ultimately the end-user consumer.[55]

In short, end users rely on FHC intermediaries to obtain hedge products that provide a degree of customization that is not available in standardized contracts, such as those offered by futures exchanges and swap execution facilities. This is important not only from the standpoint of obtaining products that more closely offset the risks of a business, but also to enable the company to achieve "hedge" accounting treatment under generally accepted accounting principles. This accounting treatment requires a degree of measurable correlation between the company's financial risk and the contractual offset. Having this treatment allows companies to reflect in their financial statements the offset of risk exposure to hedge instruments that avoids the appearance of unnecessary volatility that would be created by the reporting of changes in the value of the hedge contracts in isolation.

6. Help Small and Mid-Sized Businesses Expand Their Scale and Geographic Reach

FHCs can use their scale and global reach to achieve better terms for end users than the clients could obtain on their own. For example, small and medium-sized producers have driven much of the investment in shale gas in recent years. They have been able to do so even as the price of natural gas fell by more than two thirds between 2008 and 2015, [56] thanks to hedging agreements with FHC counterparties. Locking in higher prices through hedging helped these firms to make significant investments in development, helping to expand the diversity of the U.S. energy supply and create jobs for U.S. workers.

Consider also a mid-sized U.S. steel company that uses coal at a plant in the United States. Its larger competitors can obtain coal less expensively because they have access to global sources of supply that the mid-sized U.S. firm lacks. But the steel company could enter into a contract with an FHC, whereby the FHC agrees to

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[55] *Id*. at 10.

[56] U.S. Energy Info. Admin., NYMEX Henry Hub Gas Spot Price *available at* http://www.eia.gov/dnav/ng/hist/rngwhhdA.htm (last updated Dec. 14, 2016); *see also* U.S. Energy Info. Admin., NYMEX Contract 1 Futures Prices, *available at* http://www.eia.gov/dnav/ng/ng_pri_fut_s1_d.htm (last updated Dec. 14, 2016).

purchase the coal directly from the overseas producer, arrange for third-party transportation, ensure its delivery to the company's plant and finally own the coal up until the point it is processed into steel. Because of this arrangement, the steel company is able to take advantage of the FHC's large scale and to avoid significant exposure to foreign counterparties. The FHC can be a lower-cost provider of this service because it has existing relationships with overseas producers and because it can more cheaply hedge the residual risk.

7. Merchant Banking Financing to Small and Mid-Size Companies, Including Start-ups

In addition, as recognized by Congress in passing the GLB Act, merchant banking investments can play an important role as a source of finance for small and mid-size companies, including start-ups. Senator John Kerry specifically commented on this role of the merchant banking authority in the discussion of the Conference Report on the proposed GLB Act:

> I am also glad that the conference report will permit financial institutions to engage in merchant banking activities. This will allow banks to invest in small companies for the purpose of appreciating and ultimately reselling the investment. The merchant banking provisions limit the day-to-day management of companies by financial institutions and the duration of the investment. I am hopeful that these new powers will allow banks to provide more capital for small businesses, which have been leading contributors to the economic growth of our country.[57]

The Conference Report for the GLB Act recognized the "essential role that [merchant banking] activities play in modern finance."[58] Between 1983 and 2009, 30 percent of all U.S. private equity investments were sponsored by the private equity arm of a large bank.[59] FHCs engage in merchant banking investments across a wide variety of industries throughout the economy.[60]

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[57] Statement of Senator John Kerry, *Discussion of Financial Services Modernization Act of 1999, Conference Report*, 145 Cong. Rec. S. 13883, 13904 (Nov. 4, 1999).

[58] H.R. Conf. Rep. No. 106-434 to Accompany S. 900, Gramm-Leach-Bliley Act, at 154 (Nov. 2, 1999); *see also* S. Rep. No. 106-44 to Accompany S. 900, Financial Services Modernization Act of 1999, at 9 (Apr. 28, 1999); H.R. Rep. 106-74 Part 1 to Accompany H.R. 10, Financial Services Act of 1999, at 122 (Mar. 23, 1999).

[59] Lily Fang, Victoria Ivanshina and Josh Lerner, *Combining Banking with Private Equity Investing*, Review of Financial Studies 26, 9, at 2139 (2013).

[60] *See* IBISWorld Industry Report OD6088, "Merchant Banking Services in the US," at 15 (Feb. 2014).

FHCs make merchant banking investments in a wide range of small to mid-sized companies, but often seek out start-up companies with economic potential and sound management teams capable of developing and expanding businesses. Equity financing to start-ups is a driver of new jobs and innovation. Successful start-ups such as Facebook,[61] Twitter,[62] Uber,[63] LinkedIn,[64] PayPal,[65] Pinterest,[66] Dropbox,[67] Jet.com[68] and Square[69] have all been financed at least in part by bank equity investments, including investments made under the merchant banking authority of the BHC Act. In making these investments in start-up and small, privately held companies, FHCs provide an alternative form of financing to traditional bank loans and the issuance of capital markets debt, which can be more expensive for companies that are in the early stages of development. FHCs also provide an alternative to venture capital and private equity firms as a source of this type of financing, thus increasing competition for these investment activities to the benefit of the investee companies and their employees.[70]

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[61] *See* Brian Womack and Douglas MacMillan, *Goldman Sachs Said to Invest $450 Million in Facebook*, BLOOMBERG NEWS (Jan. 3, 2011), *available at* http://www.bloomberg.com/news/2011-01-03/facebook-valued-at-50-billion-as-goldman-is-said-to-invest-450-million.html.

[62] *See* Tim McLaughlin & Ross Kerber, T. Rowe, *Morgan Stanley Funds Sitting on Whopper Twitter Gains*, REUTERS (Nov. 6, 2013), *available at* http://www.reuters.com/article/2013/11/06/funds-twitter-ipo-idUSL2N0IR10I20131106.

[63] *See* Alexia Tsotsis, *Uber Gets $32M From Menlo Ventures, Jeff Bezos And Goldman Sachs*, TECHCRUNCH (Dec. 7, 2011), *available at* https://techcrunch.com/2011/12/07/uber-announces-32-million-in-funding/.

[64] *See LinkedIn Raises $22.7 Million from Goldman Sachs, The McGraw-Hill Companies, SAP Ventures and Bessemer Venture Partners*, BLOOMBERG BUSINESS WIRE (Oct. 23, 2008), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVSVDeQL4y6c.

[65] *See X.com Announces $100 Million Financing Round: Leader in Email Payments Will Continue Rapid Customer Growth* (Apr. 5, 2000), *available at* https://www.paypalobjects.com/html/pr-040500.html.

[66] *See* Alexei Oreskovic, *Pinterest Has Now Raised More Than Half a Billion Dollars in Its Latest Financing Round*, BUSINESS INSIDER (May 8, 2015), *available at* http://www.businessinsider.com/pinterest-series-g-crosses-500-million-2015-5.

[67] *See Dropbox Snags $250 Million Funding at $10 Billion Valuation: Sources*, REUTERS (Jan. 17, 2014), *available at* http://www.reuters.com/article/us-dropbox-funding-idUSBREA0G1OS20140118.

[68] *See Jet.com Raises $500 Million led by Fidelity*, FORTUNE (Nov. 4, 2015), *available at* http://fortune.com/2015/11/04/jet-fundraising-fidelity/.

[69] *See Square Closes $150 Million Round at $6 Billion Valuation*, TECHCRUNCH (Oct. 5, 2014), *available at* https://techcrunch.com/2014/10/05/square-closes-150-round-at-6-billion-valuation/.

[70] FHCs are particularly robust competitors to venture capital and private equity firms due to their ability to seek out investment opportunities that venture capital and private equity firms have more difficulty identifying. IBISWorld Industry Report OD6088, "Merchant Banking Services in the US," at

FHCs are particularly well suited to provide ready capital access to businesses engaged in physical commodities activities. Because of their diverse financial activities, FHCs have the ability to make capital available in different layers of a company's capital structure, including senior secured debt, mezzanine debt, subordinated debt, preferred equity or common equity, based on a portfolio company's needs and the circumstances of the transaction, and are well suited to understanding those needs and circumstances as a result of their own participation in physical commodities activities. In addition, FHCs can provide portfolio companies with access to more traditional banking services and banking relationships, including providing loans, investment advisory, brokerage and other banking and financial services. This creates potential information synergies that can lead to a better-informed basis for making credit decisions and providing other more effective services to portfolio companies.[71] In short, merchant banking investments by FHCs can lay the foundation for longer-term, traditional banking relationships for portfolio companies engaged in physical commodities activities.[72]

8. Increased Resiliency of FHCs by Providing Greater Diversification of Revenue Streams

Allowing FHCs to engage in physical commodities activities will increase their resiliency by diversifying their consolidated assets and revenue streams to include a source of assets and revenue that may not be as correlated with the asset values and revenues from their other financial activities. It has long been well established that, all things being equal, increased diversification of investments or activities reduces risk.[73] Such a reduction in risk should result in lower net losses, as the losses from one activity are offset by gains in another activity. This, in turn, should help diversified institutions protect and even improve their financial condition over time.

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20 (Dec. 2015) ("Merchant banks compete for investment opportunities with venture capitalists, private equity firms and investment banks based on their access to sufficient funding and their cost of raising capital. However, merchant banks that have strong relationships with other financial institutions are in a better position to be informed of investment opportunities and grow their investment portfolio.").

[71] Fang, *supra* note 59.

[72] *See, e.g.*, Comment letter on 2014 ANPR from Goldman Sachs (Apr. 16, 2014) (merchant banking investments have facilitated the transformation of many businesses and promoted broader economic growth).

[73] *See, e.g.*, Harry M. Markowitz, Portfolio Selection: Efficient Diversification of Investments (Wiley 1959); Paul Samuelson, General Proof that Diversification Pays, Journal of Finance and Quantitative Analysis (Mar. 1967).

We urge the Federal Reserve to consider these benefits and the negative impact the Proposed Rule would have on economic growth, jobs creation and the markets for Covered Physical Commodities and merchant banking investments, including on end users of commodities, companies relying on merchant banking investments by FHCs, and other market participants. The Federal Reserve should withdraw the Proposed Rule, specifically assess these benefits and weigh them against actual empirical evidence as opposed to pure speculation of the risks posed by these activities before determining whether there is any justification for any restriction or increased capital charges on these activities.

IV. The Proposed Capital Requirements Are Unwarranted, Unsupported and Contrary to FHCs' History and Practice of Prudently Managing the Related Risks

The Proposed Rule would impose new, punitive, and in some cases prohibitive, risk-based capital requirements on a wide range of commodities activities – from holding Covered Physical Commodities positions and infrastructure assets to making merchant banking investments in companies engaged in Covered Physical Commodities activities, including trading, storage, transportation or refining. These proposed capital requirements would inevitably force domestic FHCs and the U.S. subsidiaries of foreign FHCs to significantly reduce or even terminate their Covered Physical Commodities activities. The Federal Reserve candidly acknowledges this: "[I]f FHCs consider their physical commodity trading on a standalone basis, the proposed increases in capital requirements could make this activity significantly less attractive based on its return on capital, and could result in decreased activity."[74] For the reasons discussed in Part III above, reducing these activities would result in a loss of substantial public benefits including losses in economic growth and jobs creation, competition, hedging by end users, liquidity of commodities markets, and the provision of liquidity to small and medium-sized companies in the commodities sector. FHCs would also lose risk and revenue diversification benefits.

The Proposed Rule is not the first time the Federal Reserve has weighed in on FHCs' commodities activities. The Federal Reserve first published its ANPR foreshadowing many aspects of the Proposed Pule in January 2014.[75] Then, in September 2016, the Federal Reserve and the other federal banking agencies published their Dodd-Frank Act section 620 report in which the Federal Reserve recommended that Congress amend the BHC Act to repeal certain authorities under which FHCs

[74] 81 Fed. Reg. at 67229.

[75] FEDERAL RESERVE, Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 12414 (Mar. 5, 2014).

engage in commodities activities, including all merchant banking authority under section 4(k)(4)(H) of the BHC Act.[76] As of the date of this letter, Congress has not acted on the Federal Reserve's recommendations and the U.S. Treasury has not agreed to any amendments to the regulations relating to merchant banking activities (over which Congress explicitly granted joint authority to the U.S. Treasury). Nevertheless the Federal Reserve is effectively proposing to preempt both Congress and the U.S. Treasury by amending its own capital regulations to impose punitive capital charges on commodities activities without providing any credible justification for such punitive treatment and reversing course on aspects of its prior Complementary Powers Orders. Neither amending the Federal Reserve's own capital regulations nor reversing course on its prior orders requires Congress or the U.S. Treasury to act, but either of these actions would frustrate the congressional purpose of authorizing complementary and commodities activities under the BHC Act. Seen in this context, the proposed capital requirements are an unjustified and unilateral attempt by the Federal Reserve to use its authority over capital rules to impose punitive costs on congressionally authorized commodities and merchant banking activities that would effectively supplant that authorization.

The proposed capital requirements are unjustified for several reasons. First, they are empirically flawed, having been proposed on the basis of mere speculation about potential, and we believe highly remote, legal liability or reputational risks, without any attempt to support these theories with empirical data. Second, both the empirical data and the applicable law show that the Federal Reserve's concern about environmental tail risk – i.e., the joint risk both of an underlying environmental hazard materializing *and* that such an event would result in legal liability or reputational harm for an FHC – is unfounded. Third, there is no reason to duplicate existing capital requirements designed to address the same risks. Finally, the proposed capital requirements would have illogical results, requiring for some activities that FHCs maintain more capital than the amount of their investment in the activity when there is no reasonable possibility that they could lose more than the value of their investment.

A. The Federal Reserve Did Not Provide Support for the Proposed Capital Requirements Beyond Concerns About Merely Speculative Risks

Congress and the courts have imposed specific requirements on the decision-making process that agencies undertake when promulgating rules. In adopting the Administrative Procedure Act, Congress expressly required agencies such as the Federal Reserve to compile a record supporting the proposal and "intended that agency findings under the Act would be supported by '*substantial evidence on the record*

[76] FEDERAL RESERVE, FDIC AND OCC, Report Pursuant to Section 620 of the Dodd-Frank Act, 28–31 (Sept. 9, 2016).

considered as a whole.'"[77] Thus, a federal court will set aside a rule when an agency has "offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise."[78]

As the Supreme Court reiterated just last year, "[f]ederal administrative agencies are required to engage in reasoned decisionmaking. . . . Not only must an agency's decreed result be within the scope of its lawful authority, but the process by which it reaches that result must be logical and rational."[79] An agency "must examine the relevant data and articulate a satisfactory explanation for its action, including a 'rational connection between the facts found and the choice made.'"[80] The Federal Reserve did not provide any objective data to support the proposed increased capital requirements. Instead, the Federal Reserve's stated justifications for the proposed capital requirements are based on speculative theories of legal liability and reputational risks that are contradicted by the facts.

Moreover, under administrative law, when an agency changes policy, it should "provide a more detailed justification than what would suffice for a new policy created on a blank slate."[81] While an agency does not have to prove the reasons for the new policy are better than the reasons for the old one, if a "new policy rests upon factual findings that contradict those which underlay [an agency's] prior policy, the agency

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[77] *Id.* at 44 (emphasis added).

[78] *State Farm*, 463 U.S. at 43. *See also* 12 U.S.C. § 1848. These same rules apply even when the substantial evidence standard of Regulation Y is implicated. *See Ass'n of Data Processing Serv. Orgs., Inc. v. Bd. of Governors of Fed. Reserve Sys.*, 745 F.2d 677, 684 (D.C. Cir. 1984) ("The 'scope of review' provisions of the APA, 5 U.S.C. § 706(2), are cumulative. Thus, an agency action which is supported by the required substantial evidence may in another regard be 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law'. . . . We have noted on several occasions that the distinction between the substantial evidence test and the arbitrary or capricious test is 'largely semantic.'"). The Supreme Court has instructed that "[t]he reviewing court should not attempt itself to make up for such deficiencies: 'We may not supply a reasoned basis for the agency's action that the agency itself has not given.'"[78] Likewise, "the courts may not accept appellate counsel's post hoc rationalizations for agency action. It is well-established that an agency's action must be upheld, if at all, on the basis articulated by the agency itself." *See State Farm* (citing *Burlington Truck Lines*, 371 U.S. at 168).

[79] *See Michigan v. E.P.A.*, 135 S. Ct. 2699, 2706 (2015) (citing *Allentown Mack Sales & Service, Inc. v. NLRB*, 522 U.S. 359, 374 (1998) (internal quotation marks omitted)).

[80] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (citing *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)).

[81] *Mingo Logan Coal Co. v. Envtl. Prot. Agency*, 829 F.3d 710, 718–19 (D.C. Cir. 2016) (citing *FCC v. Fox Television Stations, Inc*., 556 U.S. 502, 515 (2009)).

must provide a more detailed justification for its action."[82] Here, the Federal Reserve is not writing on a blank slate. FHCs have long been engaged in the covered commodities activities for which the Proposed Rule would apply new punitive capital requirements, and have been doing so with the Federal Reserve's approval for the past 15 years.[83] Therefore, under the applicable administrative law standard, the Federal Reserve must provide a sufficient justification to explain why it has determined that the long-approved commodity activities of FHCs now pose a significant risk to the safety and soundness of depository institutions or the financial system generally such that they justify the proposed prohibitive capital requirements.[84]

In an attempt to justify the proposed punitive capital charges on Covered Physical Commodities and commodities infrastructure assets, the Federal Reserve cited the risk that FHCs might be subject to legal liability in an amount greater than the value of their investment as a result of an environmental catastrophe.[85] The Federal Reserve also cited the risk that an FHC and its affiliates might temporarily suffer limited access to funding markets in the event of an environmental catastrophe "linked to" the FHC's physical commodities activities.[86] In an attempt to justify the proposed punitive capital charges for Covered Commodity Merchant Banking Investments, the Federal Reserve cited the risk associated with merchant banking investments generally, potential reputational risks, and the possibility that the corporate veil might be pierced and that the FHC might be held liable for environmental damage caused by the portfolio company.[87] The Federal Reserve did not, however, provide a single example of an FHC actually suffering either legal liability or loss of funding following reputational harm as a result of its physical commodities activities, whether conducted directly by the FHC or through a merchant banking portfolio company. Consequently, the Federal Reserve is left with a speculative concern about hypothetical risks that have never materialized.

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[82] *Id.* at 719 (citing *Fox Television Stations*, 556 U.S. at 515 (internal quotation marks omitted)).

[83] *See* 81 Fed. Reg. at 67222.

[84] The Board has proposed the Proposed Rule pursuant to its authority under the GLB Act, which allows FHCs to engage in any activity that the Board determines "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." 12 U.S.C. § 1843(k)(1)(B). Accordingly, and in light of the well-settled standard of review, the key question is whether the Board has provided a logical and rational basis for its conclusion that an FHC's mere ownership of a physical commodity poses a "substantial risk to the safety and soundness of depository institutions or the financial system generally."

[85] 81 Fed. Reg. at 67227.

[86] *Id*.

[87] 81 Fed. Reg. at 67228.

Federal Reserve Chair Yellen candidly conceded that the justification for the proposed capital requirements was speculative in her testimony before the House Financial Services Committee on September 28, 2016. In response to a question on the Proposed Rule by Rep. Neugebauer, Chair Yellen responded, "[i]t's not a question of just going back through history to see what has happened in the past. It's [a] forward-looking concern that the *permissible* activities could pose risks."[88] This concern certainly justifies requiring prudential controls and a robust risk management framework – such as the limitations and conditions currently applicable to merchant banking investments, the effectiveness of which the Federal Reserve has neither acknowledged nor contested – to manage the genuine risks associated with these activities. But speculation about hypothetical risks that are divorced from empirical loss data is a fundamentally inappropriate basis on which to substantially increase capital requirements on commodities activities and investments. This is particularly inappropriate where the result would be to unilaterally impose, on congressionally authorized activities, punitive capital requirements that, by the Federal Reserve's own admission, would risk increasing the capital costs for these activities so dramatically as to effectively regulate them out of existence.[89] As a result, the Proposed Rule does not satisfy the well-established legal standards for rulemaking.

B. Empirical Data on Operational Risk Events Show That the Federal Reserve's Concerns About Environmental Tail Risks for FHCs Are Unsupported and Exaggerated

The Federal Reserve gives the impression that there is no empirical data to measure the legal liability and reputational risks associated with physical commodity activities. For example, in reiterating its concern about the hypothetical tail risk of an environmental disaster to an FHC, the Federal Reserve cited the "inherent uncertainty in valuing the potential damages associated with a catastrophe" and the risk that "the full amount of legal liability and reputational harm that might result from a catastrophic event . . . can vary significantly depending on the nature and extent of the environmental disaster and could be extremely large."[90]

Contrary to the Federal Reserve's assertions, there is in fact extensive empirical data available about the commodities-related losses actually incurred by FHCs. These data show that none of the legal liability or reputational risks feared by the Federal Reserve has materialized since data collection for assessing operational risk capital

[88] Yellen Statement (emphasis added).

[89] *See supra* n.74 and accompanying text.

[90] 81 Fed. Reg. at 67227.

charges began in 2002, just shortly after the enactment of the GLB Act in November 1999.

Since the introduction of the Basel II capital framework and the commencement of the largest U.S. FHCs' "parallel run" process of transitioning from the former Basel I risk-based capital rules to first the Basel II and subsequently the Basel III advanced approaches risk-based capital rules, the advanced approaches FHCs have had to calculate an amount of risk-weighted assets for operational risk, which includes the risk of, among other things, legal liability arising from any of their activities, including trading in physical commodities, investing in infrastructure assets and making merchant banking investments in commodities companies.[91] The same has been true for foreign banking organizations that are FHCs under their home-country Basel II and subsequently Basel III risk-based capital rules.[92] As the Federal Reserve is aware, none of the U.S. or foreign FHCs that are subject to the BHC Act has incurred *any* catastrophic legal liability or reputational harm, over at least a 14-year period, arising from an environmental disaster of the scale the Federal Reserve purports to address in the Proposed Rule.

Since 2002, ORX has acted as an operational risk data consortium that provides for the reporting and anonymous exchange of operational risk loss data among its 93 member financial institutions, which include major U.S. and foreign banking organizations and seven of the eight U.S. G-SIBs.[93] At the time of the comment letter in response to the 2014 ANPR, the then current 2012 ORX Report on Operational Risk Loss Data showed that, for the six-year period from 2006 through 2011, there were a total of 2,313 operational loss events under the ORX level 1 category of "Disasters & Public Safety" (a category that includes slip and fall accidents on bank premises as well as natural disasters, acts of terrorism and environmental accidents) and that ORX members incurred aggregate losses of EUR 337 million, or an average loss of EUR 145,700 per loss event.[94]

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[91] *See* 12 C.F.R. § 217.101 (defining "operational risk").

[92] Basel Committee on Banking Supervision, "Basel II: International Convergence of Capital Measurement and Capital Standards – Comprehensive Version)" (June 2006), *available at* http://www.bis.org/publ/bcbs128.pdf; Basel Committee on Banking Supervision, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems – Revised Version" (June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.

[93] ORX Members by Region and Joining Order (September 2016) *available at* https://www.orx.org/Lists/PublicDocuments/ORX%20Members%20by%20Region%20and%20Joining%20Order%20(September%202016%20-%2093%20members).pdf.

[94] The 2012 ORX Report on Operational Risk Loss Data, is available at http://www.orx.org/Pages/Contact.aspx?Type=ORR.

The most recent ORX report, dated as of 2015, shows that there were a total of 2,992 operational loss events under this category from 2009 through 2014, with ORX members incurring aggregate losses of EUR 550 million, or an average loss of EUR 183,824 per loss event.[95] To place these figures in their proper context, these operational losses represented 0.3 percent of the aggregate losses of EUR 167.1 billion reported by ORX members from operational loss events for all level 1 categories. Because of the inclusion of slip and fall accidents, natural disasters and acts of terrorism in the same category of environmental accidents, it is clear that the actual incurred losses from environmental accidents are lower than the aggregate losses reported for "Disasters & Public Safety."[96]

Given that ORX has been collecting operational risk loss data since 2002 and there have been environmental accidents since then, the fact that no FHC has actually incurred a catastrophic loss resulting from an environmental accident confirms that FHCs do not face significant risks from environmental liability. This is the case, first and foremost, because entities that passively own commodities do not face any material risk of liability under environmental laws and regulations.[97] These statistics also demonstrate that FHCs have prudently managed their exposures to Covered Physical Commodities and Covered Commodity Merchant Banking Investments. FHCs have either avoided exposures to assets or companies implicated in environmental accidents, or, to the extent any such assets or companies have been implicated in any environmental accidents, they have not suffered any losses beyond the value of their investments or any consequential losses of any material scale.

In short, the Federal Reserve's analysis is flawed, not only because it is speculative, but because there is ample empirical data relating to liability for environmental accidents that directly contradicts the Federal Reserve's analysis. Much of this data is publicly available, and there is also more granular data available to ORX members and thus to their respective banking supervisors, including the Federal Reserve. This data contradicts the Federal Reserve's contention as to the risks of activities or investments related to Covered Physical Commodities.

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[95] 2015 ORX Report on Banking Operational Risk Loss Data, *available upon request at* https://www.orx.org/Pages/ORXData.aspx.

[96] ORX, Operational Risk Reporting Standards (ORRS), version 1.2 (Jul. 12, 2012), *available upon request at* https://www.orx.org/Pages/ORXStandards.aspx.

[97] *See infra* Part IV.C and Appendix A.

C. The Proposed Capital Requirements Effectively Ignore the High Hurdles to Imposing Legal Liability Under Long-Standing Legal Precedent

The Federal Reserve justifies the proposed capital requirements in part based on the potential for an FHC to face legal liability for its commodities activities in excess of the amount of its investment.[98] This justification overstates the risk of legal liability in cases where the FHC merely owns physical commodities, such as when an FHC engages in physical commodities trading activities.[99] The Proposed Rule also overstates the risk in cases where the FHC's activity is limited to an investment in a subsidiary (such as a merchant banking portfolio company) that itself owns the commodity or conducts related activities, because it ignores the degree to which corporate separateness and related controls act as highly effective mitigants to this risk. This Part IV.C summarizes the high hurdles to imposing liability on an FHC for commodities activities, which are more fully explained in the joint memorandum of law attached to this comment letter as Appendix A.

In cases where an FHC's activity is limited to mere ownership of the Covered Physical Commodity, as is the case with Covered Physical Commodities trading activities, the Federal Reserve overstates the risk of legal liability. The Proposed Rule makes statements about the potential to incur significant environmental liabilities under a number of statutes and legal doctrines that simply do not apply to a mere commodity owner, such as an FHC. In fact, the very federal environmental laws cited in the Proposed Rule (CERCLA, the Oil Pollution Act, and the Clean Water Act) do not impose liability on the mere owner of a released commodity. Theories of liability under state common law (such as nuisance, trespass, negligent entrustment and strict liability) likewise do not apply to an FHC's mere ownership of Covered Physical Commodities, so long as the FHC:

- In the case of potential liability for nuisance, does not engage in behavior that is either (i) "intentional and unreasonable" or (ii) otherwise actionable as a tort;

- In the case of potential liability for trespass, does not form the intent necessary to be held liable;

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[98] *See* 81 Fed. Reg. at 67227 (stating that "FHCs may be subject to legal liability in an amount much greater than the value of the physical commodities they own").

[99] Throughout this letter, we refer to a "passive" or "mere" commodity owner, which is an entity that owns the physical commodity but does not otherwise engage in activities to manage the commodity. As detailed in the memoranda attached as Appendix A, commodity owners that take the proper steps to insulate themselves from liability can avoid liability under the legal regimes discussed below.

- In the case of potential liability for negligent entrustment, conducts adequate due diligence on companies hired to transport and store the commodities; and

- In the case of strict liability, limits its physical commodities activities to mere ownership and implements controls to ensure that it does not engage directly in handling, transportation or storage activities.[100]

As a result, the risks of environmental liability are not ordinarily borne by commodity owners under common law unless they engage in certain actions beyond mere ownership.[101]

Although a very limited number of state statutes do allow for a mere commodity owner to be held liable for damages resulting from a release, the Federal Reserve cannot point to a single FHC that has incurred liability under these laws.[102] Despite these statutes, regulators in the relevant jurisdictions still ordinarily pursue the *facility* owner or operator for remediation costs, not a commodity owner whose involvement was merely passive ownership. In fact, under these state statutes, there have only been two cases in which a court held that a commodity owner could be held liable for damages.[103] Both cases were decided more than ten years ago and in neither of the two cases was the commodity owner an FHC. As a result, the administrative record does not and cannot support the Proposed Rule's assumptions as to the legal risks faced by FHCs in their capacity as owners of Covered Physical Commodities.

To the extent FHCs are involved in commodities-related activities other than mere ownership of commodities, the FHCs' involvement in such activities is principally limited to investments in operating companies. These investments are generally made under the merchant banking authority of section 4(k)(4)(H) of the BHC Act. Merchant banking investments are required by law to be made in legally separate companies that are not routinely managed or operated by the FHC, pursuant to joint

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[100] See Appendix A, Part I.B.2 at 25–31.

[101] For a more thorough discussion, *see* Appendix A.

[102] It is worth noting that clean-up and remediation costs for environmental incidents are rarely significant. The primary driver of liability costs from an environmental catastrophe stem from damages, rather than clean up and remediation costs. As a result, state statutes under which a commodity owner could be held liable for remediation and clean-up costs, but not damages, do not pose a meaningful risk to FHCs. *See, e.g.*, Restrepo & Associates for the Bureau of Land Management, IXTOC I Oil Spill Economic Impact Study 13 (1982–83) (reporting that the damage claim suits pending in U.S. courts were almost ten times the reported cost of clean-up operations for the IXTOC I oil spill).

[103] These state statutes include explicit defenses that make it unlikely that a mere commodity owner would incur such liability. *See* Appendix A, Part I.B.1 at 24.

Federal Reserve and U.S. Treasury regulations.[104] With respect to Covered Commodity Merchant Banking Investments, there is simply no basis on which the Federal Reserve can justify a concern that the amount at risk of loss to the FHC exceeds the carrying value of its equity investment in the portfolio company, yet this is what the Proposed Rule would require.

For an FHC to suffer anything more than a loss of the value of the investment in these cases, there must effectively be a "double default" – not only would an environmental disaster have to occur that results in liability to the company held responsible for the disaster so great as to render it insolvent, but a court would also have to find a basis for piercing the corporate veil and assigning liability directly to the FHC as a shareholder of the company. Courts – including the U.S. Supreme Court – have set a high threshold for piercing the corporate veil, including in cases involving environmental accidents.[105] This standard simply cannot be satisfied under the limitations and conditions under which FHCs are permitted to make such merchant banking investments in the first place. Without piercing the corporate veil, the maximum risk of loss to which the FHC is exposed is the loss of the value of its investment – not multiples of the value of the investment as the Proposed Rule unjustifiably assumes.

This double-default risk is mitigated by legal risk management with respect to corporate separateness, a risk that is in fact already covered by the existing regulations of FHCs' merchant banking activities. The Federal Reserve and the U.S. Treasury's regulations already prescribe certain corporate formalities that limit any risk of piercing the corporate veil between an FHC or any of its non-IDI affiliates and any of its portfolio companies. Indeed, the regulations require that FHCs "[e]nsure the maintenance of corporate separateness between the [FHC] and each company in which the [FHC] holds an interest under this subpart and protect the [FHC] and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of each such company."[106] The Federal Reserve conducts examinations of

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[104] *See* 12 U.S.C. § 1841(k)(4)(H) and 12 C.F.R. § 225.170 *et seq*.

[105] *United States v. Bestfoods*, 524 U.S. 51, 61–62 (1998) (holding under the "deeply ingrained" principle that a parent corporation is not liable for the acts of its subsidiaries, veil-piercing is the exception rather than the rule, and "nothing in CERCLA purports to reject this bedrock principle"); *United States v. Friedland*, 173 F. Supp. 2d 1077 (D. Colo. 2001) (applying the *Bestfoods* veil-piercing analysis in order to grant summary judgment for parent company, imposing no derivative liability under CERCLA); *United States v. Viking Resources, Inc.*, 607 F. Supp. 2d 808, 823 (S.D. Tex. 2009) (applying the *Bestfoods* veil-piercing analysis in the context of the Oil Pollution Act); *In re Appalachian Fuels, LLC*, 493 B.R. 1, 17 (6th Cir. BAP 2013) (applying the *Bestfoods* veil-piercing analysis to indirect liability claims under the Clean Water Act, Surface Mining Control and Reclamation Act and statutory claims under state law).

[106] 12 C.F.R. § 225.175(a)(iv).

FHCs to ensure that they maintain corporate separateness through policies, procedures, records and systems.[107]

Other requirements further mitigate this risk. For example, section 4(k)(4)(H) of the BHC Act and its implementing regulations set forth in Subpart J of Regulation Y impose limitations on participation by the FHC or its other subsidiaries in routinely managing or operating portfolio companies.[108] This is a fundamental mitigant to the risk of blurring the legal and corporate separateness between an FHC and a merchant banking portfolio company. Absent the ability to become involved in the management and operations of such a company (except in exceptional circumstances in which a creditor would need to take steps to preserve the value of its investment), it follows that the risk of an FHC inadvertently engaging in the sorts of management and other activities that would blur the legal and corporate separateness between it and the portfolio company would be remote – and thus so would the risk of piercing the corporate veil. In addition, merchant banking investments may be held by an FHC or its non-IDI affiliates only for a period of time that enables the sale or disposition of the investment on a reasonable basis consistent with the financial viability of merchant banking investment activities.[109] These limitations on merchant banking activities limit the possibility of an FHC being held responsible for the liabilities of an investee under a veil-piercing theory to a level consistent with each FHC's risk tolerance, as established by its board of directors, and its risk management framework, each of which is subject to the Federal Reserve's supervision and examination, and safety and soundness standards.

D. The Magnitude of the Environmental, Legal Liability and Reputational Risks Has Remained Low Since FHCs Gained the Relevant Authorities in 1999

There have been no changes since the passage of the GLB Act in 1999 in either the circumstances or the relevant law that would heighten either the environmental risks of the underlying commodities activities or the legal or reputational risks.

First, the actual environmental risks to FHCs engaged in commodity-related activities have decreased since the Federal Reserve first determined that these entities should be allowed to participate in such activities. With respect to the environmental risks, the occurrence of environmental catastrophes involving physical commodities

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[107] *See* Bank Holding Company Supervision Manual § 3907.0.7.1; *see also* Supervision and Regulation Letter 00-9, "Supervisory Guidance on Equity Investment and Merchant Banking Activities" (June 22, 2000).

[108] 12 C.F.R. § 225.171.

[109] 12 C.F.R. § 225.172(a).

remains rare, despite occasional high-profile events that do not involve FHCs. In fact, the incidence rate and severity of environmentally sensitive commodities-related events has decreased in recent years. For example, pipeline, railroad, vessel and toxic chemical release incidents have all been on the decline.[110] This trend coincides with improved risk management of the underlying environmental risks. Federal and state environmental laws and regulations are becoming ever more comprehensive and protective. Each time an environmental catastrophe occurs, significant agency resources and expertise are brought to bear to prevent similar events.[111] As a result, these strengthened environmental regulations provide additional reason to believe that

[110] *See, e.g.*, Press Release, Ass'n of Am. R.R., Federal Safety Statistics Confirm Freight Rail Safety Advancements (Apr. 13, 2015) (noting that 2014 was the safest year on record for freight train operations in the United States, and that since 2000, the train accident rate is down 45 percent, a new low); Int'l Tanker Owners Pollution Fed'n Ltd., Oil Tanker Spill Statistics 2015, *available at* http://www.itopf.com/information-services/data-and-statistics/statistics/; Toxic Release Inventory (TRI) National Analysis, EPA (last updated on Mar. 1, 2016), *available at* https://www.epa.gov/trinationalanalysis (noting that from 2013 to 2014, releases decreased by 6 percent); Releases of Chemicals in the 2014 TRI National Analysis, EPA (Jan. 2016), *available at* https://www.epa.gov/trinationalanalysis/releases-chemicals-2014-tri-national-analysis (noting that releases of TRI chemicals decreased from 2003 to 2014 by 13 percent).

[111] Multiple federal agencies have recently issued proposed or final rules, or implemented new policies, that may be pertinent to FHC commodity activities. *See, e.g.*, Bureau of Ocean Energy Management, NTL No. 2016-N01, Notice to Lessees and Operators of Federal Oil and Gas, and Sulfur Leases, and Holders of Pipeline Right-of-way and Right-of-use Easement Grants in the Outer Continental Shelf (July 14, 2016) (increasing the financial assurance requirements for lessees and operators to cover future potential decommissioning obligations); Bureau of Safety and Environmental Enforcement, Oil and Gas and Sulfur Operations in the Outer Continental Shelf – Blowout Preventer Systems and Well Control, 81 Fed. Reg. 25887 (Apr. 29, 2016) (adopting industry standards in the areas of well design, well control, casing, and implementing recommendations from various investigations of the Deepwater Horizon incident); Environmental Protection Agency, Proposed Rule: Accidental Release Prevention Requirements: Risk Management Programs Under the Clean Air Act, 81 Fed. Reg. 13637 (Mar. 24, 2016) (proposing to amend existing Risk Management Program regulations proposed to improve chemical process safety, assist local emergency authorities, and improve public awareness of chemical hazards at regulated sources); Pipeline and Hazardous Materials Safety Administration, Proposed Rule: Pipeline Safety: Safety of Hazardous Liquid Pipelines, 80 Fed. Reg. 61609 (Oct. 13, 2015) (proposing changes to the hazardous liquid pipeline safety regulations); Pipeline and Hazardous Materials Safety Administration, Hazardous Materials: Enhanced Tank Car Standards and Operational Controls for High-Hazard Flammable Trains, 80 Fed. Reg. 26644 (May 8, 2015) (adopting requirements designed to reduce the consequences and, in some instances, reduce the probability of accidents involving trains transporting large quantities of flammable liquids); Pipeline and Hazardous Materials Safety Administration, Proposed Rule: Pipeline Safety: Safety of Gas Transmission and Gathering Pipelines, 81 Fed. Reg. 20721 (Apr. 8, 2016) (proposing the adoption and expansion of risk-based safety practices to pipelines not currently covered under existing regulations).

an FHC will not face a substantial risk of an environmental incident because of the reduced likelihood of such incidents occurring in the first place.[112]

Second, with respect to the legal liability risks, the statutes cited by the Federal Reserve in the Proposed Rule, as explained above and in Appendix A, can impose liability on facility owners and operators. They do not, however, impose liability on commodity *owners* (unless they also engage in certain actions beyond mere ownership). As described in greater detail in Appendix A, an FHC's status as a commodity owner simply is not a basis for liability under any federal environmental law.[113] These federal laws have been on the books since the 1980s or before,[114] and their liability regimes have not meaningfully changed in decades. Moreover, there has been no change to the general principle of limited liability and respect for corporate separateness since the foundational cases of the early 20th century,[115] nor has the veil-piercing risk in the specific context of environmental liabilities evolved substantially since 1998.[116] Because these legal regimes have remained unchanged since the Federal Reserve's previous determinations that FHCs could safely participate in physical commodity activities, they cannot serve as a justification for the Federal Reserve's shift in policy – and the Federal Reserve has never suggested that the original analysis of the laws as they then existed was incorrect.

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[112] Importantly, each new environmental regulation continues in the longstanding environmental-law tradition of placing responsibility for regulatory compliance first and foremost on facility owners and operators. For example, none of the new or proposed regulations cited in footnote 111, *supra*, is likely to have the effect of imposing liability on mere owners of physical commodities. As a result, these new rules do not create additional regulatory risks for FHCs as passive commodity owners and are consistent with existing liability regimes that place liability on owners and operators and not mere commodity owners.

[113] The Federal Reserve acknowledges this in its Proposed Rule, stating that these laws "generally impose liability on owners and operators of facilities and vessels for the release of physical commodities." 81 Fed. Reg. at 67221. While "a company that directly owns an oil tanker or petroleum refinery that releases crude oil in a navigable waterway" may be liable for damages that result from a spill, the owner of the commodity will not.

[114] *See, e.g.*, Comprehensive Environmental Response, Compensation, and Liability Act of 1980 U.S.C. § 9601 *et seq.*

[115] *Lowendahl*, 287 N.Y.S. at 72 (articulating the bedrock principle of corporate law that stockholders are not liable for the obligations of a corporation); *Milwaukee Refrigerator Transit Co.*, 142 F. at 255 (stating that veil-piercing is the exception, not the rule, and therefore the corporate form will be respected "until sufficient reason to the contrary appears"); Stephen B. Presser, Piercing the Corporate Veil § 1:4, 24–27, (2016), *citing Berkey v. Third Ave. Ry. Co.*, 244 N.Y. 84, 85, 155 N.E. 58 (1926) (Cardozo, J.) (noting that attempts to set aside any corporate entities must be approached with caution, and that one should be on guard against the tendency to find instances appropriate for veil-piercing).

[116] *See* Appendix A, Part II.A–II.D at 37–49.

Third, with respect to reputational risks, there is no evidence to support the Federal Reserve's speculation that an FHC engaged in currently approved commodity activities faces a serious risk of reputational harm, and consequent loss of funding, as a result of those activities. The Deepwater Horizon example cited by the Federal Reserve, which involved activities of subsidiaries sharing a similar name with their parent that were actively participating in the same integrated oil and gas exploration and production business as their parent, provides no such evidence. As discussed above, several existing safeguards significantly limit the exposure of FHCs to both direct and indirect liability arising from currently approved commodity activities. For example, section 4(k)(4)(H) of the BHC Act and its implementing regulations set forth in Subpart J of Regulation Y impose limitations on participation by the FHC or its other subsidiaries in routinely managing or operating merchant banking portfolio companies.[117] In the case of Deepwater Horizon, the subsidiaries of BP p.l.c. ("**BP**") were actively involved in oil and gas production activities. As the Federal Reserve notes in the Proposed Rule, it *already* prohibits FHCs from engaging in the types of activities under Complementary Powers Orders that *can* give rise to federal environmental liabilities, such as "owning, operating, or investing in facilities that extract, transport, store, or alter commodities," and requires that FHCs "ensure that the third-party contractors hired to store, transport, and otherwise handle the physical commodities of the FHC are reputable."[118] In addition, with respect to a merchant banking or other investment in a portfolio company or operating company that itself engages in extractions, transportation, storage or refining activities, an FHC can – just like any other shareholder – further mitigate its risk of liability by engaging in a level of corporate governance oversight appropriate for a shareholder.

FHCs in any event do take reputational risks seriously in connection with any investment, and in particular with investments in portfolio companies that are engaged in activities that can result in significant environmental or other safety-related liabilities. While the degree of reputational risk may indeed be difficult to measure quantitatively, FHCs generally take a binary approach to addressing the level of reputational risk they are willing to accept: if the risk is relatively remote, it will not be an obstacle to making the investment; otherwise, the investment will not be made.

Especially when viewed in light of these existing safeguards, the concern over potential reputational harm to an FHC is overstated. There is a meaningful difference between the public's perception of a scenario, such as Deepwater Horizon, where the parent company and the subsidiary operating facility share a similar name and operate in a common industry, and one where they do not (i.e., an FHC's commodities business may share a name with the FHC itself, but not with a portfolio company in

[117] 12 C.F.R. § 225.171.

[118] 81 Fed. Reg. at 67223.

which it makes a merchant banking investment). It was understandably difficult for the public to distinguish between three oil and gas companies in the same corporate family, all of which were operating companies engaged in BP's core business of oil and gas exploration and extraction. However, while news reports of pipeline spills or explosions frequently name the company operating the pipeline, they rarely identify the companies that own the commodities shipped through the pipeline and spilled by the pipeline operator.[119]

In sum, Deepwater Horizon cannot supply the missing evidence needed to support the Federal Reserve's assertion that reputational risk would justify the increased and additional capital charges under the Proposed Rule. First, the parent company, BP, that provided support to affiliates in that scenario was not an FHC and was not subject to the limitations already imposed on FHCs by law. Second, there is no evidence that BP employed appropriate measures – like those discussed above and in Appendix A – designed to help its subsidiaries or portfolio companies limit the risk of environmental incidents without subjecting themselves to increased risks of indirect liability under piercing theories. On the contrary, BP actively managed subsidiaries engaged in an ongoing petroleum extraction business. Third, the parent and the subsidiaries all included "BP" in their names, and all – including the parent – are well-known companies engaged in oil and gas exploration, extraction and production activities. The resulting potential for the parent to suffer reputational harm due to the misconduct of a subsidiary simply does not exist when FHCs engage in currently approved commodity activities. Indeed, in view of these multiple and crucial distinctions, if the Federal Reserve seeks to rely principally on Deepwater Horizon to support the Proposed Rule, that reliance demonstrates how truly speculative the Federal Reserve's analysis is. [120]

In addition, to the extent the Federal Reserve is relying on the potential for reputational harm to an FHC related to investments the FHC makes in companies

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[119] *See, e.g.*, David R. Baker, *Gov. Brown Signs Utility-Oversight Reform Bills*, SFgate.com (Sept. 29, 2016); Dennis Pillion, *Alabama Pipeline Leak: Cleanup, Investigation Continue in Colonial Pipeline spill*, AL.com (Sept. 22, 2016); Fritz Klug, *Oil Spills into Calhoun County Creek That Leads to Kalamazoo River*, KALAMAZOO GAZETTE (July 27, 2010).

[120] It is also inconceivable that an FHC could own the amount of oil in a single location that could result in a catastrophe on the scale of the Deepwater Horizon incident. In Deepwater Horizon, an estimated 4 million barrels (168 million gallons) of oil spilled into the ocean over an 87-day period. *See* EPA, Deepwater Horizon – BP Gulf of Mexico Oil Spill, *available at* https://www.epa.gov/enforcement/deepwater-horizon-bp-gulf-mexico-oil-spill. These figures once again show that the Federal Reserve's use of an outlier incident does not support the Proposed Rule. The Federal Reserve has not presented any data suggesting that any FHC owns this amount of oil, let alone that any FHC stores this amount of oil in a single location from which the entire quantity could be released in a single environmental event.

engaged in physical commodities activities, this rationale is inconsistent with the Federal Reserve's own implicit view that loans and other extensions of credit made to businesses engaged in such activities do not give rise to similar reputational risks justifying similarly punitive capital requirements. The Proposed Rule – in our view, sensibly – would not require any of the heightened capital requirements for engaging in Covered Physical Commodities activities or making equity investments in companies engaged in such activities to be applied to loans, other extensions of credit or other credit exposures to any such companies. We believe that it would be illogical to impose punitive capital requirements on lending activities because of a concern over speculative reputational risks. If the potential for reputational harm related to a banking organization's assets were sufficient to justify heightened capital requirements on investments in such companies, it would stand to reason that this rationale would apply equally to traditional extensions of credit. Yet the Federal Reserve has evidently taken the view that there is no reputational risk sufficient to justify heightened capital requirements on loans to such companies. If that is the case, we do not believe there is any basis for distinguishing between reputational risks arising from lending activities and those arising from equity investments. In short, the Federal Reserve's concern about reputational risks arising from equity investments proves too much and is unjustified.

Finally, reputational risks are by their nature speculative and difficult to quantify, and are therefore a poor fit to be addressed through risk-based capital requirements. House Financial Services Committee Chairman Jeb Hensarling raised a similar concern about the use of reputational risk to justify prudential policy, stating in the context of CAMELs ratings that "it would be an abuse of regulatory discretion to use vague, subjective and unquantifiable indicators like a firm's reputation to justify regulatory outcomes that could not otherwise be justified under an objective CAMELS analysis . . . . The introduction of subjective criteria like 'reputation risk' into prudential bank supervision can all too easily become a pretext for the advancement of political objectives, which can potentially subvert both safety and soundness and the rule of law."[121]

E. The Proposed Capital Requirements Would Double-Count Risks Already Addressed by Existing Capital Requirements

The proposed capital requirements for trading in Covered Physical Commodities and investing in infrastructure assets would be *in addition to* the existing risk-based capital requirements for these activities. For both of these activities, advanced approaches banking organizations are already subject to risk-based capital

[121] Rep. Jeb Hensarling, Letter to Janet Yellen at 3 (May 22, 2014), *available at* http://financialservices.house.gov/uploadedfiles/5-22-14_letters.pdf.

requirements for credit risk, market risk and operational risk.[122] Credit risk capital requirements are intended to cover, among other risks, the bankruptcy risk of a company in which an FHC has made an equity investment and the consequent risk of the loss of the entire value of the investment. Operational risk capital requirements are intended to reflect, among other risks, the risks of legal liability related to the banking organization's activities. Given that legal liability risk is also one of the principal stated justifications for the proposed capital requirements on these activities, these requirements would be duplicative of the existing capital requirements for operational risk.

This duplication is at odds with the overall structure of the calculation of risk-weighted asset ("**RWA**") amounts under the risk-based capital rules, under which each risk type generally is addressed only once.[123] RWA amounts for Covered Physical Commodities are already calculated under the Basel III market risk rule to cover price risk. RWA amounts for Covered Physical Commodities and infrastructure assets are already addressed under the Basel III operational risk rules to cover, among other things, the risk of legal liability. RWA amounts for Covered Commodity Merchant Banking Investments are already calculated under the Basel III rules for credit risk, as equity exposures. These existing capital treatments are part of a comprehensive and cohesive risk-based capital framework that avoids redundant RWA calculations and the resulting capital requirements.[124]

The proposed capital requirements would deviate from this principle by requiring the calculation of additional RWA amounts for Covered Physical Commodities and infrastructure assets – on top of the RWA amounts already calculated for the market risk and operational risk posed by these exposures – to cover the hypothetical risk of legal liability beyond the value of the exposures, notwithstanding that the very same risk is captured in the calculation of operational risk RWA amounts. There is no justification for this duplicative calculation.

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[122] Physical commodities positions, including Covered Physical Commodities, are also subject to existing risk-based capital requirements for market risk, which are designed to reflect a banking organization's exposure to price risk related to the underlying commodity.

[123] For example, a corporate bond held in an FHC's banking book would be risk-weighted under Subparts D or E (each addressing risk-weighted assets for credit risk), whereas the same bond held in the FHC's trading book would be risk-weighted under Subpart F (addressing risk-weighted assets for market risk). However, the capital rules would not require the FHC to recognize risk-weighted asset amounts for *both* credit risk and market risk on the same position. *Compare* 12 C.F.R. §§ 217.30 *et seq.* and 217.100 *et seq. with* 12 C.F.R. § 217.201 *et seq.*

[124] In contrast, capital "add-ons" such as the G-SIB surcharge or the countercyclical capital buffer are not based on an additional RWA calculation, but increase the amount of required Common Equity Tier 1 capital to address such factors as an FHC's complexity and interconnectedness, and changing macroeconomic conditions, respectively.

At a minimum, the Federal Reserve should either reflect the calculation of RWA amounts for legal liability risk in the existing operational risk rules or completely carve out Covered Physical Commodities and infrastructure assets from the existing operational risk rules to avoid double-counting RWA amounts for the same risk. The Federal Reserve acknowledges this potential for double-counting, but only with respect to covered merchant banking investments, for which it proposes to *replace* the existing equity exposure rules with new equity exposure rules, rather than require *additional* RWA amounts for such exposures. If the Federal Reserve persists with the punitive capital requirements it has proposed, it should at least revise its approach to adhere consistently to this replacement-treatment principle for all exposures covered by the Proposed Rule.

F. The Proposed Heightened Risk Weights Are Punitive and Unsupported, and Would Lead to Illogical Results

The proposed capital requirements would in many cases result in FHCs having to maintain significantly more capital than the total value of their investments or exposures. For example, an FHC would have to hold more capital for a merchant banking equity investment in a company processing or storing Covered Physical Commodities – such as oil – than the amount of the investment. This illogical result is an outcome of the 1,250 percent risk weight that would apply to such a merchant banking investment under the Proposed Rule.

By way of example, the effect of the 1,250 percent risk weight would be to attribute a $125 million exposure amount to a $10 million Covered Commodity Merchant Banking Investment (other than a narrow carve-out for commodity trading portfolio companies). For an FHC managing itself to a 12 percent total risk-based capital ratio (the illustrative ratio used by the Federal Reserve in the Proposed Rule), this FHC would be required to maintain $15 million of capital against this $10 million investment just to cover the hypothetical legal liability or reputational risk the Federal Reserve is concerned about. This amount would represent an increase of anywhere from four to twelve times the amount of capital already maintained by the FHC under the current U.S. Basel III capital rules to cover credit risk – and thus the bankruptcy risk of the company, leading to a loss of the value of the investment – and would be *on top of* the amount of capital already maintained by the FHC to cover operational risk – and thus the legal liability risk – of this investment. Assuming, hypothetically, that the RWA amount for operational risk was equal to 20 percent of the amount of the exposure, an FHC would calculate total RWAs of $145 million and would be required to maintain total capital of $17.4 million for this $10 million investment.

The selection of a 1,250 percent risk weight is purely arbitrary. The Federal Reserve justifies it for Covered Commodity Merchant Banking Investments that are not investments in commodity trading portfolio companies by citing the risks

associated with merchant banking investments generally (as if they were somehow different from other equity exposures), "potential" reputational risks and the "possibility" that the corporate veil may be pierced and the FHC may be held liable for environmental damage caused by the portfolio company.[125] For an FHC to suffer anything more than a loss of the value of the investment, a "double default" is necessary – not just the occurrence of an environmental accident that renders the company insolvent, but also a court decision to pierce the corporate veil and find the FHC as a shareholder of the company liable for the accident. In addition, merchant banking investments are generally made for less than 100 percent of the equity of the portfolio company. In these cases, veil piercing would be particularly unlikely, because it would require a court to pierce the veil with respect to a majority, but not the sole, owner, leaving open the issue of whether the minority owner(s) should also be liable. As discussed in Part IV.C above, the Federal Reserve exaggerates this risk and fails even to acknowledge the effectiveness of controls and regulatory requirements – including its own requirements in Regulation Y – in place to mitigate the risk that legal separateness would not be respected.

The Federal Reserve also justifies higher risk weights under the Proposed Rule on the basis that the extent of losses related to environmental tail risks are difficult to measure.[126] Beyond the obvious point that the absence of losses by FHCs does not, at least in this context, make losses difficult to measure, this argument proves too much. Under the existing Basel III capital rules, there are other types of exposures – such as OTC derivative exposures – for which the current fair value of the exposure does not represent the maximum amount at risk. However, for OTC derivatives and other exposures of this type, the existing Basel III capital rules do not automatically apply the highest risk weight available under the capital rules to the current exposure in order to reflect the off-balance sheet portion of the exposure (e.g., in the case of OTC derivatives exposures, the current exposure is increased by a potential future exposure amount based on the notional amount of the contract). The contrast between the approach taken for OTC derivatives under the existing capital rules and the approach taken by the Federal Reserve under the Proposed Rule – in the face of existing and measurable operational loss data – reveals how arbitrary the proposed capital requirements are.

In any event, there is no basis for the Proposed Rule to assign exponentially higher risk weights to Covered Physical Commodities trading activities. The Federal Reserve's only cited justification for increasing the risk weight of Covered Physical Commodities trading activities is to "help ensure that FHCs engaged in commodities trading have a level of capitalization for such activities that is roughly comparable to

[125] 81 Fed. Reg. 67221, 67229.

[126] 81 Fed. Reg. 67227, n.51.

that of nonbank commodities trading firms." The Federal Reserve does not support this assertion about the level of capitalization at nonbank commodities trading firms – firms that do not face robust existing regulatory capital requirements such as those applicable to FHCs. Moreover, the Federal Reserve does not explain why the Basel III risk-based capital rules to which FHCs are subject – which require FHCs to calculate RWAs for credit risk, market risk and operational risk and to hold a capital conservation buffer – as well as the other capital requirements to which FHCs are subject, such as the well-capitalized standards and the Federal Reserve's capital planning and stress testing rules, which result in FHCs holding substantially more capital in baseline economic conditions than is necessary under the Basel III capital rules, are not sufficient and must be supplemented by unspecified and unsubstantiated requirements applicable to nonbank commodities trading firms.

In short, there is no empirical evidence to justify the Federal Reserve's uniquely heightened risk weights. The extent to which FHCs would have to overcapitalize certain commodities exposures under the Proposed Rule is unprecedented and finds no basis in the international Basel III standard. On the contrary, the empirical data for operational risk losses confirms that FHCs have not suffered any catastrophic loss of the scale hypothesized by the Federal Reserve.[127]

[127] *See supra* Part IV.B. In any event, we note that the Proposed Rule is also flawed in that it assumes there is a direct relationship between the value of a Covered Physical Commodity and the potential environmental liability to an FHC. There is no logical connection between the market value of a Covered Physical Commodity and the potential environmental liability that could stem from its release. For example, bars of silver–which are included in the Federal Reserve's current proposed definition of a Covered Physical Commodity–could be "cleaned up" at very little expense if they happened to spill out of the vault where they were being stored. In contrast, a comparatively inexpensive Covered Physical Commodity such as crude oil could result in far greater clean-up costs if the release occurred in a wetlands area. The factors that contribute to potential liabilities associated with environmental incidents are complex, and include cost-drivers such as the spill amount, location and proximity to high-density populations or sensitive natural resources, whether it occurs on land or offshore, the type of substance, and weather. *See, e.g.*, Dagmar Schmidt Etkin, *Estimating Cleanup Costs for Oil Spills* (1999). The extent of the potential liability is also affected by the physical state that the commodity is in when it is released; many commodities can be stored as solids, liquids, or gases. As a result, the same Covered Physical Commodity can pose very different liability risks depending on the circumstances in which a release occurs. While we are confident that a mere commodity owner would not be subject to liability under any of these scenarios, this issue highlights an additional reason why the Federal Reserve needs to reconsider its current Proposed Rule. Given the complete lack of correlation between the value of a Covered Physical Commodity and potential environmental liability to an FHC, the Federal Reserve simply cannot demonstrate that its Proposed Rule is the result of a logical and rational process, as required under administrative law. *See also State Farm*, 463 U.S. at 43.

V. The Scope of Covered Physical Commodities Is Overbroad

If the Federal Reserve persists with higher capital requirements notwithstanding the substantive and procedural infirmities discussed in Part IV above, we urge the Federal Reserve to limit the scope of commodities activities covered by these requirements. The definition of Covered Physical Commodities as proposed is so potentially broad as to be unworkable, as it would cover a wide range of substances including metals such as magnesium, iron, copper, nickel, manganese, phosphorus, and zinc, which can be found in normal household items, food, drinking water, vitamins, and other items meant to be used or ingested by the public.[128] The proposed definition would also cover silver, a previous metal that is specifically listed in the Federal Reserve's Regulation Y as a permissible financial asset underlying forward contracts, options, futures and similar contracts that FHCs may enter into as principal under certain conditions, or which FHCs are specifically authorized to buy, sell and store in bars, rounds, bullion and coins as principal or agent.[129] It would be an illogical result for such substances to be treated as Covered Physical Commodities unless, by virtue of their quantity and composition, they truly pose a material risk of significant environmental danger and liability. Consequently, if the Federal Reserve insists on re-proposing a new version of the Proposed Rule, at a minimum it must narrow the definition of Covered Physical Commodities to focus on the tail risks discussed in the Proposed Rule – in short, commodities with the potential to cause clean-up costs out of proportion to their value. Although it may be facially logical to incorporate a broad definition of "hazardous" from another statute, a rational analysis for liability risk and capital purposes must take into account the various types of hazards involved. For example, substances that are by themselves relatively benign can become hazardous if mixed with other benign substances, and substances that are innocuous if consumed in small quantities can become toxic if consumed in large quantities. It is the use of and exposure to the substance that gives rise to the hazard, rather than the characteristics of the substance itself.

We therefore propose a more focused definition that would include only those substances that the U.S. Environmental Protection Agency ("**EPA**") has determined have a greater potential to create meaningful liability when released. Specifically, the definition would cover: (1) Extremely Hazardous Substances ("**EHS**"), as defined

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[128] Each of these substances is included in the list of CERCLA hazardous substances, which is incorporated by reference into the definition of a Covered Physical Commodity under the Proposed Rule. *See* 40 C.F.R. § 302.4; 81 Fed. Reg. at 67236 (specifically including (1) As a 'hazardous substance' under section 104 of the Comprehensive Environmental Response, Compensation, and Liability Act (42 U.S.C. 9601)). .

[129] 12 C.F.R. 225.28(b)(8)(ii)(B), (b)(8)(iii). The proposed definition could also cover base metals, such as aluminum, lead and zinc, regardless of their quantities and whether or not they are used as a component in a potentially hazardous substance.

under the Emergency Planning and Community Right-to-Know Act of 1986 ("**EPCRA**") regulations, when more than the threshold planning quantity of an EHS is held in a single facility,[130] and (2) crude oil and refined petroleum products when transported or stored above certain thresholds.

This definition would better align with the Federal Reserve's stated goals underlying the Proposed Rule by targeting only those commodities in quantities likely to pose a significant risk in the event of a release and would provide a finite list of substances to avoid confusion and facilitate efficient administration by the Federal Reserve. In addition, this definition draws on the EPA's decades of experience and expertise – as the federal agency responsible for protecting the environment – in identifying the substances that, in specific quantities, are unique in the potential liability they could create.

A. Rather Than Covering All Substances Deemed Hazardous Under Environmental Law, the Federal Reserve Should Focus on a Subset of Extremely Hazardous Substances if It Moves Forward with the Proposed Rule

As currently drafted, the Federal Reserve's proposed definition would cover a number of everyday items and substances – including silver, copper and nickel – that do not pose a meaningful risk to the environment when released. The proposed definition incorporates all of the substances that fall within one of several terms defined under a list of environmental statutes.[131] But this approach fails to appreciate

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[130] *See* 40 C.F.R. pt 355, app. A –The List of Extremely Hazardous Substances and Their Threshold Planning Quantities.; *see also* 42 U.S.C. § 11002. *See also* Appendix B.

[131] The Proposed Rule defines Covered Physical Commodity to include "any physical commodity that is, or a component of which is, specifically named:

(1) As a 'hazardous substance' under section 104 of the Comprehensive Environmental Response, Compensation, and Liability Act (42 U.S.C. 9601);

(2) As 'oil' under section 1001 of the Oil Pollution Act of 1990 (33 U.S.C. 2701) or section 311 of the Clean Water Act (33 U.S.C. 1321);

(3) As a 'hazardous air pollutant' under section 112 of the Clean Air Act (42 U.S.C. 7412);

(4) In regulations interpreting the foregoing terms under the corresponding statute; or

(5) In a state statute, or regulation promulgated thereunder, that makes a party other than a governmental entity or fund responsible for removal or remediation efforts related to the unauthorized release of the substance or for costs incurred as a result of the unauthorized release; provided that, with respect to paragraph (5) of this definition, the Federal Reserve-regulated institution owned the commodity in the state that promulgated the law imposing such liability during the last reporting period."

81 Fed. Reg. at 67236. We note that the statutes cited in the Federal Reserve's proposed definition correspond to the statutes discussed in Appendix A to this letter, which further illustrates why FHCs

the differing purposes behind these various statutes, and assumes incorrectly that any regulated substance could create the kind of catastrophic environmental incident and liability that the Federal Reserve has stated as the justification for the Proposed Rule. Here, the Federal Reserve's concern is to limit activities that could pose a substantial safety and soundness risk, whether from the costs of legal liability or the resulting reputational harm.[132] In contrast, the EPA's mission is to protect human health and welfare, even when the harm poses little in the way of costs or reputational risk.[133] As a result, environmental statutes cover a wide variety of substances and activities that could harm the environment under certain circumstances, but where the costs of remedying the harm would be immaterial to the safety and soundness of an FHC or its depository institution(s).

There are three primary reasons why the Federal Reserve should limit its proposed definition if it finalizes or re-proposes the Proposed Rule. First, just because a substance is deemed "hazardous" under a statutory provision, it does not follow that the commodity could pose a monetarily or reputationally meaningful threat if released, particularly in small quantities. For example, the definition of a "hazardous substance" under CERCLA is incredibly broad and incorporates substances from a number of other environmental statutes, including metals such as copper, lead, nickel, silver and zinc, which can be found in normal household items.[134] Each and every one of these substances is covered by the Federal Reserve's proposed definition. Far from being "catastrophic," the "release" of one of these commodities could be resolved with a shovel.

That is why the EPA, which administers the federal statutes cited in the proposed definition, does not require all of these substances to face the same levels of regulatory control. Instead, the EPA created a narrower list of EHSs, each with an applicable minimum reportable quantity.[135] Only when more than the threshold quantity of an EHS is held in a single location is the facility required to notify State Emergency Response Commissions and Local Emergency Planning Committees for any area likely to be affected by a release in order to limit any potential risk to the

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would not bear significant environmental liability under these laws for merely owning commodities regulated under these various statutes.

[132] *See supra* note 84.

[133] *See, e.g.*, EPA, Our Mission and What We Do, *available at* https://www.epa.gov/aboutepa/our-mission-and-what-we-do.

[134] *See* 42 U.S.C. § 9601(14); 40 C.F.R. § 401.15

[135] *See* 40 C.F.R. pt 355, app. A – The List of Extremely Hazardous Substances and Their Threshold Planning Quantities.

public.[136] This list reflects decades of thought and expertise that the EPA has put into determining which substances and quantities could truly pose a material risk to the public or the environment if released.

The quantity thresholds are as important to the list as the specific substances the EPA chose to include. For example, chlorine is commonly used in household cleaners, bleach and disinfectants.[137] It is also an EHS with a threshold planning quantity of 100 pounds.[138] This threshold quantity reflects EPA's experienced judgment that 100 pounds or more of chlorine in a single location could pose a meaningful threat if released, while the lesser amounts found in the average home could not. For each of the EHSs, EPA's regulations include a substance-specific threshold amount that resulted from the agency's analysis of the specific risks posed by each of these individual substances. As a result, both the substances and threshold qualities of EHSs developed by EPA should serve as the basis of the definition of a Covered Physical Commodity in any further rulemaking on this topic.

There is no reason, and no basis in the BHC Act, for the Federal Reserve to regulate the ownership of permissible physical commodities that are inexpensive to clean up and would not cause high-figure damages to property or natural resources if spilled or released. The EPA's comprehensive list of the EHSs that pose the most meaningful threat to the public and the environment is far better suited for meeting the Federal Reserve's goal of targeting the commodities that could give rise to significant environmental liabilities, and would allow the Federal Reserve to administer the rule with greater ease, consistency and true relationship to safety and soundness. In order to further the goal of the Proposed Rule and avoid overstepping its statutory mandate, the Federal Reserve should rely on this EPA classification of substances and quantities that pose the most meaningful environmental risk. Accordingly, we recommend altering the proposed definition for any final rule that would cover only EHSs held at a single facility in a quantity at or above the threshold planning quantity under EPCRA.[139] These substances and their threshold planning quantities are already publicly available and provided in a single table, codified in the EPCRA regulations.[140] Use of this definition will also reduce the administrative burden imposed by the

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[136] *See* 42 U.S.C. § 11002. If an accidental release of a hazardous substance listed under CERCLA occurs, the facility must also notify the National Response Center.

[137] EPA, Chlorine (Jan. 2000), *available at* https://www.epa.gov/sites/production/files/2016-09/documents/chlorine.pdf.

[138] 40 C.F.R. pt 355, app. A.

[139] *See* 40 C.F.R. pt. 355, app. A.

[140] *Id.*

Proposed Rule because the tracking and reporting of the presence of EHSs is already required under federal law.[141]

Another major reason why limiting the definition to EHSs would be much easier for the Federal Reserve to administer is that it provides a closed list with a finite number of substances. By contrast, CERCLA is an open-ended list, and incorporates not only a litany of substances specifically listed in other statutes, but also includes "characteristic wastes" under the Resource Conservation and Recovery Act ("**RCRA**"). Under RCRA, a waste is considered "hazardous" if it exhibits characteristics of ignitability, corrosivity, reactivity or toxicity under the complex regulatory scheme and guidance created by the EPA.[142] The Federal Reserve's current proposed definition would therefore put Federal Reserve personnel in the unenviable position – without having the necessary expertise – of trying to evaluate these technical and scientific decisions in order to determine whether a substance is a "characteristic waste," and thus a Covered Physical Commodity. In contrast, using the EHS list would allow for readily ascertainable evaluations of an FHC's Covered Physical Commodities.

Second, the proposed definition includes "any physical commodity that is, *or a component of which* is," listed under one of the enumerated statutes.[143] This portion of the definition is unworkable because hazardous substances are *components* of a great many common items that pose no meaningful threat to the environment when they are merely a component of a commodity, for example:

- potassium, magnesium, iron, copper, manganese, phosphorus, and zinc are all found in tap water;[144]
- "[s]odium is the sixth most abundant element on Earth and is widely distributed in soils, plants, water, and foods;"[145]

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[141] We note that EPCRA places the emergency planning and reporting requirements on the owner or operator of the facility where the EHSs are located, rather than on the owner of the substance. *See* 40 C.F.R. § 355.2. This is in keeping with the basic regulatory scheme established by environmental law, which holds *facility* owners and operators liable for illegal releases of substances. *See* Appendix A.

[142] 40 C.F.R. § 261.20–24.

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

[144] *See* Pamela Pehrsson, Kristine Patterson, and Charles Perry, The Mineral Content of US Drinking and Municipal Water, *available at* https://www.ars.usda.gov/ARSUserFiles/80400525/Articles/NDBC32_WaterMin.pdf.

[145] *See, e.g.*, 40 C.F.R. § 302.4(a), Table 302; *see also* EPA, Coal Cleaning, *available at* https://www3.epa.gov/ttnchie1/ap42/ch11/final/c11s10.pdf (Nov. 1995); EPA, Drinking Water Advisory: Consumer Acceptability Advice and Health Effects Analysis on Sodium 1 (Feb. 2003), *available at* https://www.epa.gov/sites/production/files/2014-09/documents/support_cc1_sodium_dwreport.pdf.

- many of the components of the average multi-vitamin are also hazardous substances under CERCLA;[146]

- mineral impurities such as chromium, copper and nickel are components of coal;

- pigments and solvents are components of paint; and

- toxic metals are components of laptops, smart phones, and other electronic devices.

The CERCLA list also includes acetic acid, which we know in its diluted form as vinegar, and creosote, which is used as a wood preservative on telephone poles and fences. The release of one of these commodities simply could not create the kind of significant liability risks that the Federal Reserve aims to limit through this Proposed Rule, and the administrative record will therefore not support such a broad definition.[147] As a result, the definition of any final rule should be revised to avoid the unintended consequence of imposing punitive capital charges on FHCs' activities and investments related to these everyday commodities or products.

Third, it is unnecessary for the definition to include substances covered by state, but not federal, environmental statutes.[148] This proposed provision would require an FHC – and by extension the Federal Reserve as its supervisor – to review all of the environmental laws and regulations in all of the states where it operates to determine whether any of the commodities it owns in or are being transported through each individual state might give rise to liability in that state, and then cross-reference those lists with the substances enumerated under federal laws. Because state statutes sometimes contain vague terms such as "pollutant," the FHC would also need to

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[146] For example, the Centrum multivitamin contains iron, phosphorus, iodine, magnesium, zinc, selenium, copper, chromium, potassium, and nickel. *Cf.* 40 C.F.R. 302.4

[147] *See State Farm*, 463 U.S. at 43–44; *see also supra* Section IV.

[148] In the fifth prong of its definition, the Federal Reserve proposes including substances that could give rise to removal or remediation obligations under state law for FHCs operating in that particular state. The Federal Reserve explains that "the proposed definition does not name individual state environmental laws. Rather, an FHC would be required to identify on a state-by-state basis the physical commodities it owns that are not covered substances under the enumerated Federal laws. It would then be required to determine whether the physical commodities it owns in a particular state are subject to liability under that state's environmental laws. This approach is intended to limit an FHC's compliance burden to only those commodities and jurisdictions relevant to the activities actually conducted by the FHC, while helping to ensure the FHC understands the range of its riskiest physical commodity activities and the breadth of state environmental laws to which the FHC may be subject." 81 Fed. Reg. at 67237.

review court and administrative decisions and exercise its judgment as to whether its commodities might meet the definition. These decisions, and thus the scope of the definitions, can change over time. Moreover, different FHCs or Federal Reserve personnel could come to different judgments about the same commodities, leading to inconsistent application of the Proposed Rule. These same practical problems would make this part of the definition difficult for the Federal Reserve to administer, and risk creating situations where different Federal Reserve personnel reach different conclusions. Therefore, the inclusion of this provision would create additional problems of inconsistent application to different FHCs, and would unnecessarily tie up agency resources in resolving these issues.

In addition to these practical problems, the state law prong in the definition of Covered Physical Commodity is unnecessary, and the Federal Reserve can point to no substance that would be covered by the state law prong that is not otherwise covered by the federal law prongs of the definition.[149] The Federal Reserve has not identified a single commodity owner, let alone an FHC, that has incurred liability from owning a commodity listed under a state statute that was not already regulated under one of the federal environmental statutes. Therefore, the inclusion of the state law prong would be unlikely to meaningfully expand the scope of Covered Physical Commodities while nevertheless imposing significant incremental compliance costs on FHCs.

Courts will defer to an agency when it exercises its expertise in reasoned decision-making, but they will not do so when there are no findings or analysis to justify the agency's choice, and no indication of the basis on which the agency exercised its discretion.[150] As the Supreme Court has said: "Expert discretion is the lifeblood of the administrative process, but 'unless we make the requirements for administrative action strict and demanding, expertise, the strength of modern government, can become a monster which rules with no practical limits on its discretion.'"[151] Because the Federal Reserve does not have expertise in matters of environmental law, it should instead adopt the approach taken by the EPA and limit the

[149] For example, the Federal Reserve cited *State v. Montayne*, 604 N.Y.S. 2d 978 (N.Y. App. Div. 1993) for the proposition that states may impose liability based on a causal connection between a party's actions and the prohibited release. *See* 81 Fed. Reg. at 67222 at n. 12. The substance at issue in that case was oil, which would be covered in our proposed definition of Covered Physical Commodity by reference to the relevant federal statute and regulations.

[150] *State Farm*, 463 U.S. at 48 (citing *New York v. United States*, 342 U.S. 882, 884 (Douglas, J., dissenting) (footnote omitted)).

[151] *Id.*

hazardous substances considered Covered Physical Commodities to the list of EHSs held at a single facility in a quantity at or above the threshold planning quantity.[152]

B. If the Federal Reserve Moves Forward with Its Proposed Rule, the Proposed Definition Should Include Oil and Refined Petroleum Products Only to the Extent They Are Held Above *De Minimis* Thresholds

While we do not believe that either oil or refined petroleum products pose a meaningful financial risk to FHCs who merely own these products, we recognize that these products can give rise to environmental obligations for *other* parties in certain circumstances. If the Federal Reserve decides to include these substances in the definition of Covered Physical Commodity, it is important that the substances that would fall in such categories are clearly defined in order to provide clarity to FHCs and ease of administration for the Federal Reserve. For this purpose, we agree with the Federal Reserve's use of the Oil Pollution Act's ("**OPA**") definition of oil as the baseline definition.[153]

As with the definition of covered hazardous substances, it is important that the Federal Reserve exempt these substances when they are in quantities that could not give rise to meaningful environmental liability. With regard to oil and refined petroleum products, the greatest liabilities stem from spills that reach water. These spills tend to be more costly to clean up, and can result in greater fines and penalties than spills that only reach land. In contrast, spills that only impact soil can be resolved by scooping up the affected dirt, sending it to a proper waste treatment facility, and then replacing it with clean soil. This is why a number of federal and state environmental statutes that cover oil and refined petroleum products apply only in instances where the substance reaches water.[154]

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[152] *See* 40 C.F.R. pt 355, app. A.

[153] However, this definition does not encompass certain refined petroleum products that could also give rise to environmental liability. In order to provide greater certainty about which specific substances meet the definition, we recommend adopting the list of crude oil and refined petroleum products used by the United States Coast Guard, which is the agency tasked with implementing certain aspects of the OPA. We have included this list as Appendix C to this comment letter. Alternatively, the Federal Reserve could incorporate the Department of the Interior's regulatory definition, which defines refined petroleum products as "gasoline, kerosene, distillates (including Number 2 fuel oil), refined lubricating oils, or diesel fuel." 30 C.F.R. § 1208.2. As with the EHSs, adopting these specific definitions would allow the Federal Reserve to target only those substances that could create a significant risk of environmental liability if released.

[154] *See, e.g.*, 33 U.S.C. § 2702(a).

The EPA has already developed a regulatory scheme designed to address oil spill prevention and preparation that could pose a risk to water. The EPA's Spill Prevention, Control and Countermeasure ("**SPCC**") Rule requires facilities that store more than a threshold amount of oil to prepare plans and comply with certain procedures, methods and equipment requirements.[155] This Rule already has reasonable exceptions built into it for facilities where the stored commodities do not pose a significant environmental risk.[156] We recommend limiting the definition of Covered Physical Commodities to only cover oil and refined petroleum products that are stored at facilities that are required to comply with the SPCC Rule.

Although the SPCC Rule does not apply to transportation-related facilities, we propose that the Federal Reserve's definition expand to cover these commodities while they are in transit, using the same threshold qualities and exceptions already included in the SPCC Rule. This would provide additional protection when these commodities are transported in significant qualities on vessels, rail cars, or other forms of transportation. The definition should not, however, include commodities while they are transported in commingled product pipelines.

When oil and petroleum products are transported, it is standard industry practice to use a pipeline owned by a third party – often a common carrier – to ship the products of multiple owners simultaneously. When petroleum products are transported in these pipelines, they are most often comingled with similar products owned by a variety of different shippers, and it is not possible to distinguish between the specific products of different owners.[157] While there are some chemical "markers" that can identify oil from a particular field and distinguish it from oil from another producing area, most crude oil transmission pipeline operators specify that a shipper must be willing to receive a specified range of crude oil grades because the operator cannot guarantee that the particular grade of crude oil introduced by the shipper into the pipeline will be the same grade that the shipper received at the point of delivery. In other words, the shippers receive a designated quantity of the product at their designated point of delivery, with the understanding that some of the precise molecules of the product that they owned at the beginning of transit may be delivered to other shippers before or after their point of delivery. This is why, for instance, the gasoline

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[155] *See* 40 C.F.R., Part 112.

[156] *See* 40 C.F.R. § 112.1(d).

[157] *See* Angela Wallace, Title Troubles – Commingled and Blended Petroleum (June 2015), *available at* https://www.andrewskurth.com/insights-1229.html. In addition, the EPA has designed an entire regulatory regime to address products that are comingled in pipelines, which applies to the pipeline operators and processors of these fuels. *See, e.g.*, 40 CFR 80.84(a)(1) (defining "interface" as a volume of petroleum product generated in a pipeline between two adjacent volumes of non-identical petroleum product that consists of a mixture of the two adjacent products.).

shipped by pipeline is "generic" gasoline that meets standards adopted by the EPA, and why the brand-specific additives that distinguish one company's product from another (e.g., "Techroline") are not added until the product reaches the pipeline delivery terminal, and before the gasoline is placed in tanker trucks for delivery to retail gasoline service station facilities.

As we have noted above, the pipeline owner or operator (rather than commodity owner) would bear the liability if some of the product were to be released while in transit. Even if the law allowed for commodity owners to be held liable for a product release from a pipeline owned and operated by another entity, there would be no way to distinguish between the products of the various shippers. This, in turn, means that there would be no way to identify the specific owner of the product that had spilled, which in and of itself makes it difficult to see how any individual commodity owner could face any material liability or reputational risk.[158] In fact, it is a misdemeanor under the statute governing federal regulation of oil and petroleum product pipelines for a common carrier pipeline to release certain information about their customers' products without customer consent when that information could be used to the detriment of the shipper.[159] It is also worth noting that oil pipelines are already carefully regulated by federal and state agencies that impose a complex set of safety requirements on the pipeline operators.[160] The definition of Covered Physical Commodity should therefore exclude commodities shipped through multi-customer pipelines.

C. Proposed Revision to the Definition of a Covered Physical Commodity

If the Federal Reserve does not withdraw the Proposed Rule, we would recommend the following revised definition for a Covered Physical Commodity:

A Covered Physical Commodity:

(1) is any physical commodity that is:

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[158] This is why news media reports of pipeline spills and releases refer to the pipeline owner/operator and almost never to the owner of the crude oil or natural gas spilled or released: no one can reasonably identify who owned the spilled commodity.

[159] *See* Interstate Commerce Act (ICA) § 15(13). *See also* Order Adopting Protective Order and Compelling disclosure, 139 FERC ¶ 61,174, n.2 (June 1, 2012) ("Section 15(13) prohibits the disclosure of any information concerning the nature, kind, quantity, destination, consignee, or routing of any property tendered to an oil pipeline for interstate transportation, which information may improperly disclose its business transactions to a competitor."). The ICA does allow the information to be obtained by government officials through legal process and for other specific business purposes.

[160] These agencies include Pipeline and Hazardous Materials Safety Administration in the Department of Transportation, and its state counterparts.

(A) an "extremely hazardous substance" under the Emergency Planning and Community Right-to-Know Act of 1986 regulations, 40 C.F.R. pt 355, app. A, that the Board-regulated institution holds in a single facility in excess of the threshold planning quantity for the substance under such regulations; or

(B) "oil" under section 1001 of the Oil Pollution Act of 1990 (33 U.S.C. 2701) or a refined petroleum product that the Board-regulated institution stores at a facility that is subject to the Spill Prevention, Control and Countermeasure Rule, 40 C.F.R., pt 112. This clause (B) shall also apply to crude oil and refined petroleum products in transportation-related facilities that would otherwise be subject to the Spill Prevention, Control and Countermeasure Rule if they were non-transportation-related facilities under 40 C.F.R. § 112.1; and

(2) does not include any physical commodity that would otherwise meet the definition of sub-paragraph (1) or (2) above that the Board-regulated institution has in an "open access" or "common carrier" pipeline that provides service to multiple shippers.

VI. There Is No Basis for Further Restricting Physical Commodities Trading Activities Under the Complementary Powers Orders and Section 4(c)(8) of the BHC Act

The Proposed Rule would modify the activity subject to the 5 Percent Cap to include not only physical commodities held under the Complementary Powers Orders, but also physical commodities held under certain other authorities, such as the authority of a BHC to acquire physical commodities under section 4(c)(8) of the BHC Act or of a national bank to hold physical commodities as hedges for its permissible derivatives activities under the National Bank Act. Thus, under the Proposed Rule, an FHC engaged in physical commodities trading as a complementary activity would need to include the market value of *all* physical commodities – not just the Covered Physical Commodities – owned by the FHC on a consolidated basis under these other authorities (which include any authority other than those described below in Section V.B), for purposes of calculating compliance with the 5 Percent Cap.

A. The Federal Reserve Does Not Explain the Basis for Counting Physical Commodities Owned Pursuant to These Other Authorities Towards the 5 Percent Cap

The Federal Reserve does not explain on what basis an FHC's ability to purchase, sell or deliver physical commodities pursuant to its authority to engage in physical commodities trading activities under Complementary Powers Orders or section 4(c)(8) should be further restricted. Under this tightened restriction, all

physical commodities, not just Covered Physical Commodities, would count toward the 5 Percent Cap. For the same reasons cited in Section IV above with respect to the Proposed Rule's increased capital requirements for Covered Physical Commodities, the Federal Reserve has not shown why the current RWA amounts – namely, the RWA amounts for market risk and operational risk – are not sufficient to cover the risks relating to these activities. While the Federal Reserve states that "[t]he proposed tighter limit would better account for the risks that activities involving physical commodities pose to the consolidated organization,"[161] it offers no analytical justifications or empirical data to support, and we see no basis or support for, the Federal Reserve's concern about the hypothetical risk arising from Covered Physical Commodities, much less from physical commodities that are not Covered Physical Commodities.

B. Section 4(c)(6) of the BHC Act Should Be Added to the List of Authorities Carved Out from the Calculation of the 5 Percent Cap

The Proposed Rule would exclude from calculation towards the 5 Percent Cap physical commodities held in satisfaction of a debt previously contracted under section 4(c)(2) of the BHC Act, as well as physical commodity interests or activities of portfolio companies held by an FHC under the merchant banking authority of section 4(k)(4)(H) of the BHC Act or the insurance company investment authority of section 4(k)(4)(I) of the BHC Act. The Federal Reserve states that the Proposed Rule would exclude physical commodities activities of portfolio companies held under merchant banking authority or related to satisfaction of debts previously contracted because, among other reasons, it may be difficult for an FHC to monitor and control.[162]

For similar reasons, investments held pursuant to section 4(c)(6) of the BHC Act[163] should also be excluded from the calculation of the 5 Percent Cap. Under Board interpretations of this provision, a BHC may invest in a nonbanking company under section 4(c)(6) only if the investment: (i) represents 5 percent or less of each class of voting securities of the nonbanking company; (ii) represents less than 25 percent of the total equity of the nonbanking company; and (iii) is otherwise noncontrolling.[164] Section 4(c)(6) is thus used by FHCs to invest their surplus funds and to diversify in equity securities of a wide range of companies rather than to make strategic investments in controlled subsidiaries. Because these investments are by definition non-controlling, an FHC lacks the practical ability to monitor and direct the physical

[161] 81 Fed. Reg. at 67226.

[162] 81 Fed. Reg. at 67225.

[163] 12. U.S.C. § 1843(c)(6) (". . . (6) shares of any company which do not include more than 5 per centum of the outstanding voting shares of such company").

[164] *See, e.g.*, Federal Reserve Regulatory Service 4-189.

commodities activities of these portfolio companies in order to maintain compliance with the 5 Percent Cap. In addition, the likelihood of occurrence of a "double-default," as discussed above, would be even more remote in the context of a passive investment. Consequently, investments held pursuant to section 4(c)(6) should also be excluded from the calculation of the 5 Percent Cap.

VII. There Is No Basis for the Federal Reserve to Rescind Energy Tolling and Management Services Under Complementary Powers Orders

The Federal Reserve stated that it is reconsidering whether energy management services and energy tolling activities are complementary to a financial activity, and so would rescind its Complementary Powers Orders granting certain FHCs the authority to engage in those activities.[165] It has not, however, cited any risk arising from energy tolling or energy management services that would justify rescinding the authority to conduct such activities under complementary orders.

The Federal Reserve does not make any finding of any increased risk arising from these activities.[166] Instead, it merely notes that, because these activities do not appear to be as directly or meaningfully connected to a financial activity as, e.g., physical commodities trading, because all but one FHC have terminated or scaled back their energy tolling or energy management services, the Federal Reserve no longer believes these services to be complementary to a financial activity.[167]

The number of FHCs involved in energy tolling or management activities under Complementary Powers Orders – as opposed to under any other authority, such as section 4(o) of the BHC Act – should not be the criterion for determining whether an activity is complementary. Indeed, if that were the criterion, there would be no justification for the Wellpoint order authorizing certain disease management and mail-order pharmacy services as complementary to the financial activity of underwriting and selling health insurance, since Wellpoint was not even a BHC and no FHC has a similar Complementary Powers Order.[168]

The Federal Reserve is in any event not required by the relevant provision of the BHC Act to consider whether other FHCs are engaging in an activity as a factor in determining whether an activity is financial in nature or incidental to a financial

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[165] 81 Fed. Reg. at 67226.

[166] While U.S. federal law attaches liability for catastrophic environmental events to owners and operators, energy tolling arrangements and management services do not pose a comparable risk of liability for catastrophic environmental events.

[167] 81 Fed. Reg. at 67231.

[168] Wellpoint, Inc., 93 Fed. Reg. Bull. C133 (2007).

activity.[169] If that was a factor, no Complementary Powers Orders would ever be issued because FHCs would not be engaging in activities for which they did not otherwise have authority.

The fact that some FHCs have announced that they plan to sell or scale back some of their physical commodities businesses does not alter the fact that it is irrelevant whether or how many FHCs currently engage in these activities.[170] Moreover, the FHCs cited in the Proposed Rule are not necessarily selling their entire physical commodities businesses, but may be scaling them back for a variety of reasons, such as new regulatory and political risks, capital requirements or the reduced profitability of some of these businesses for the time being. FHCs routinely enter or exit businesses based on a variety of factors. For instance, many of them have recently sold or scaled back their bond trading, mortgage servicing and credit card businesses without raising any concerns about whether these businesses are no longer financial activities.

VIII. The Federal Reserve Should Follow the OCC's More Tailored Approach with Respect to Removing Copper from the List of Precious Metals

The Proposed Rule would reclassify copper as a non-precious metal, thereby making the purchase or sale of physical copper under the BHC Act an activity permissible only to FHCs that have received Complementary Powers orders to trade physical commodities, and subject to the limitations imposed on that authority, or are grandfathered under section 4(o). The rationale provided by the Federal Reserve for this action is that copper is most commonly used as a base or industrial metal rather than as a store of value. The OCC, adopting an identical rationale, recently issued a final rule limiting the ability of national banks to deal and invest in industrial and commercial metals, but adopted a more narrowly tailored restriction with respect to copper, prohibiting national banks from dealing or investing in copper only if that metal is in a physical form primarily suited for industrial or commercial use, such as copper cathodes.[171] The Federal Reserve should follow the OCC's more tailored approach rather treating copper as an industrial metal regardless of its form.[172]

The Federal Reserve should prohibit dealing or investing in copper only if the metal is in physical form primarily suited for industrial or commercial use. The Federal Reserve should follow the more tailored approach proposed by the OCC,

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[169] *See* 12 U.S.C. 1843(k)(3).

[170] 81 Fed. Reg. at 67231–67232.

[171] 81 Fed. Reg. 96353 (Dec. 30, 2016).

[172] For example, there is no reason to prohibit FHCs from purchasing or selling copper coins.

which only prohibits national banks from dealing or investing in copper if the metal is in physical form primarily suited for industrial or commercial use, such as copper cathodes.

IX. Clarifications and Corrections to the Proposed Rule

A. The 5 Percent Cap on Physical Commodities Trading Activities Under the Complementary Powers Orders and Section 4(c)(8)

As noted above in Section V.B., the Proposed Rule would exclude from calculation towards the 5 Percent Cap physical commodities held in satisfaction of debt previously contracted under section 4(c)(2) because activities under that authority are temporary and, because of other restrictions, may be difficult for an FHC to monitor and control. Parallel authorities exist for national banks[173] and for state member banks[174] that are also temporary and may be difficult for an FHC to monitor and control. Consequently, physical commodities held in satisfaction of debt previously contracted under these other authorities should also be excluded from calculation towards the 5 Percent Cap.

B. Scope of 4(k) Cap Parity Amount

The Federal Reserve should make conforming changes, consistent with the technical corrections discussed in Part VIII.A above, to the scope of the commodities activities the aggregate market value of which (the "**Section 4(k) Cap Parity Amount**") would be subject to a 5 percent of tier 1 capital threshold, above which any Covered Physical Commodities of an FHC with grandfathered commodities authority under section 4(o) would be subject to a 1,250 percent risk weight. Since the Federal Reserve stated that the reasons for the Section 4(k) Cap Parity Amount are the same as the reasons for the proposal to tighten the 5 Percent Cap,[175] if the Federal Reserve makes any changes to the exclusions from the amounts counted toward the 5 Percent Cap, it should make conforming changes to the Section 4(k) Cap Parity Amount.

C. Technical Correction to Definition of Section 4(o) Infrastructure Assets

The Federal Reserve should correct the definition of a Section 4(o) Infrastructure Asset to limit the scope of commodities to which such assets relate to Covered Physical Commodities. As proposed, a Section 4(o) Infrastructure Asset is

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[173] Staff Op. of Oct. 10, 1975, 2 Fed. Res. Reg. Serv. 4-290; OCC Interpretative Letter No. 397 (Sept. 15, 1987), printed in 1988–1989 Transfer Binder Fed. Banking L. Rep. (CCH) ¶ 85,62.

[174] 12 C.F.R. § 225.22(e)(2)(ii) (Regulation Y).

[175] 81 Fed. Reg. at 67227–28.

defined as an "on-balance sheet exposure owned pursuant to section 4(o) of the Bank Holding Company Act that is not a physical commodity."[176] This definition is over-inclusive relative to the stated purpose of the proposed capital requirements for such assets. The Federal Reserve stated in the preamble that the proposed capital treatment of Section 4(o) Infrastructure Assets "is intended to address the risk of legal liability resulting from the unauthorized discharge of a covered substance in connection with the infrastructure asset."[177] However, the proposed definition would include assets unrelated to Covered Physical Commodities – for example, assets related to wind farms, solar energy projects or grain silos – that pose no risk of an environmental discharge or similar event. Since the rationale stated in the preamble would not apply to assets used for physical commodities that are not Covered Physical Commodities, the Federal Reserve should amend the definition of Section 4(o) Infrastructure Assets to include only assets owned pursuant to section 4(o) that are not physical commodities and that directly involve the transportation, storage, distribution, extraction or processing of Covered Physical Commodities.

Even if, contrary to the scope of the Proposed Rule, which in all other cases is limited to activities relating to Covered Physical Commodities, the Federal Reserve intended the definition of Section 4(o) Infrastructure Asset to cover infrastructure assets used for any kind of physical commodities, we believe that the scope of the proposed new capital requirements for such assets be tailored to their intended purpose. For example, if the rationale for including infrastructure assets that are unrelated to Covered Physical Commodities is that a grandfathered FHC would be permitted under section 4(o) of the BHC Act to actively manage and operate such assets, the proposed capital requirements for such unrelated infrastructure assets should be limited to assets that the FHC in fact actively manages and operates, as opposed to extending to assets that are held through an operating company that is not actively managed or operated by an FHC. That is, if the Federal Reserve's concern is that active management and operation heightens liability and reputational risks, then the resulting higher capital requirements should apply only where, and for so long as, the assets are actively managed and operated.

D. Amendments to the Definitions of Commodity Trading Portfolio Company and Approved Physical Commodity

The Federal Reserve should amend the proposed definition of a "**Commodity Trading Portfolio Company**" to more appropriately tailor the requirement that such companies be engaged exclusively in activities that would be permitted for FHCs under Complementary Powers Orders for commodities trading activities. Under the

[176] 81 Fed. Reg. 67220 §217.39(f)(2).

[177] 81 Fed. Reg. at 67227 (emphasis added).

Proposed Rule, to qualify for 300 percent and 400 percent risk weights applicable to publicly traded and non-publicly traded commodity trading portfolio companies, to the extent such a portfolio company is engaged in Covered Physical Commodity activities, it must be engaged only in activities that would be permitted for FHCs under Complementary Powers Orders for commodities trading activities.[178] Since the merchant banking authority is only available for investments in companies that are not engaged exclusively in financial activities,[179] this requirement would effectively prevent a merchant banking investment from being made in a company that was exclusively engaged in commodities trading activities. Moreover, the Federal Reserve has identified no reason why these lower risk weights should apply solely to portfolio companies that are engaged exclusively in such activities. A relatively small volume of activities other than commodities trading activities should not disqualify the company from being allocated risk weights that are designed to generally reflect the types of risks inherent in the activities of such a company. Companies that are predominantly engaged in commodities trading activities should qualify for the same capital treatment.

The Federal Reserve should therefore revise the proposed definition to introduce the concept of the company being "predominantly engaged" in such permitted complementary trading activities. For example, the Federal Reserve could use a test based on 85 percent of assets and 85 percent of revenues, similar to the "substantially engaged" test in Regulation Y for the acquisition of companies engaged in limited non-financial activities,[180] and the predominance tests used in the definition of "financial company" under the existing capital rules[181] and to identify nonbank financial companies under Title I of the Dodd-Frank Act.[182] In the alternative, the Federal Reserve could introduce a *de minimis* exemption for non-trading activities conditioned on the FHC not even being temporarily engaged in day-to-day management activities under merchant banking authority.

The Federal Reserve should also make technical corrections to the definition of "approved physical commodity" to better reflect the CFTC post-Dodd-Frank derivatives regulation regime. As proposed, "approved physical commodity" means "a physical commodity for which a derivative contract has been authorized for trading on a U.S. futures exchange by the Commodity Futures Trading Commission (unless specifically excluded by the Board) or other commodities that have been specifically

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[178] 81 Fed. Reg. 67220 §217.40(a)(2).

[179] 12 C.F.R. § 225.170.

[180] 12 C.F.R. § 225.85(a)(3).

[181] 12 C.F.R. § 217.2.

[182] 12 U.S.C. §5381(b).

authorized by the Board under section 4(k)(1)(B) of the Bank Holding Company Act 12 (12 U.S.C. 1843(k)(1)(B)).”[183] The language used in this definition is used in the Federal Reserve’s Complementary Powers Orders from 2003 to 2009, but should now be made more precise to reflect the creation of swap execution facilities (“**SEFs**”), which were created by the Dodd-Frank Act and which operate under the regulatory oversight of the CFTC. In addition, because products can be listed on a U.S. futures exchange both via an approval process and by operation of CFTC rules through a certification process, the term “authorized for trading” should be modified to reflect each of the ways the CFTC might sanction an approved physical commodity. Therefore, the Federal Reserve should modify the definition as follows:

> *Approved physical commodity* means a **covered** physical commodity for which a derivative contract ~~has been authorized for trading on a U.S. futures exchange by the Commodity Futures Trading Commission~~ **is listed or made available to trade on a designated contract market, foreign board of trade or swap execution facility** (unless specifically excluded by the Board) or other commodities that have been specifically authorized by the Board under section 4(k)(1)(B) of the Bank Holding Company Act 12 (12 U.S.C. 1843(k)(1)(B)).

E. Removing Copper from the List of Precious Metals

The Federal Reserve should clarify that it does not intend to prevent FHCs from buying, selling and storing copper as agent for its clients pursuant to section 225.28(b)(iii) of Regulation Y. The preamble to the Proposed Rule makes it clear that copper would be removed from section 225.28(b)(8)(ii)(B) of Regulation Y and makes no specific references to section 225.28(b)(8)(iii).[184] The Proposed Rule text, however, simply provides that all references to copper would be removed from section 225.28 of Regulation Y, which would have the effect of preventing FHCs from buying, selling and storing copper as agent. Since it cannot be the Federal Reserve’s intention to prevent FHCs from engaging in agency activities for their clients, the Proposed Rule should be amended to refer specifically to Section 225.28(b)(8)(ii)(B) of Regulation Y.

F. Clarification of the Principle for Recognizing the Quantity of a Covered Physical Commodity

Lastly, the Federal Reserve should clarify the principle for recognizing the quantity of a Covered Physical Commodity for purposes of applying the relevant capital requirements under the Proposed Rule. Under section 217.39(d) of the

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[183] 81 Fed. Reg. at 67236.

[184] 81 Fed. Reg. at 67233.

Proposed Rule, an FHC would recognize the quantity of each Covered Physical Commodity that the FHC "owns pursuant to section 4(k)(1)(B) or section 4(o)" of the BHC Act. The Proposed Rule does not indicate whether "ownership" for this purpose turns on the FHC or one of its consolidated subsidiaries having *legal title* to the Covered Physical Commodity, or in the alternative on another recognition principle such as *accounting recognition* of the commodity as an on-balance sheet asset of the FHC on a consolidated basis.

We believe that a recognition principle based on legal title is more consistent with the purposes of the Proposed Rule than one based on accounting recognition, and request that the Federal Reserve clarify this ambiguity in any final rulemaking.[185] A commodity may be recognized on an FHC's balance sheet under U.S. generally accepted accounting principles even where neither the FHC nor any of its consolidated subsidiaries has legal title to the commodity. Yet if an FHC and its subsidiaries lack legal title to a commodity, it is difficult to imagine any basis under which the FHC could be liable for cleanup costs or damages caused by the release of that commodity.[186] As discussed in Part IV.C above, the Federal Reserve's justification for the proposed capital requirements for Covered Physical Commodities hinges in significant part on its claim that mere ownership of such commodities could expose the FHC to legal liability.[187] Therefore, we believe that a recognition principle based on legal title is more appropriately tailored to the purposes of the Proposed Rule.

* * * * *

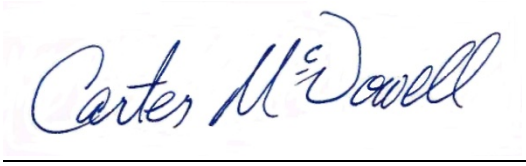
[185] We also request that the Federal Reserve clarify that, for consistency, the recognition principle applicable to Covered Physical Commodities should also apply to determining whether a merchant banking portfolio company is engaged in a covered commodity activity for the purpose of identifying Covered Commodity Merchant Banking Investments. In addition, a similar principle could apply to Section 4(o) Infrastructure Assets, subject on a case-by-case basis to additional safeguards based on other indicia of potential liability that are unique to non-commodity assets, such as active management and operation of the relevant assets.

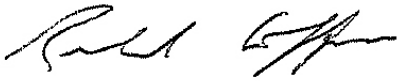
[186] As discussed in Part IV.C and Appendix A, even where an FHC or its subsidiary *has* legal title to a commodity, we believe the risk that the FHC could face legal liability or reputational risks for such a commodity is too small to justify the proposed capital requirements. In any event, the liability and reputational risks do not exist where an FHC *lacks* legal title to the commodity.

[187] 81 Fed. Reg. at 67227.

The Associations thank the Federal Reserve for its consideration of our comments. If you have any questions, please do not hesitate to contact any of the undersigned.

Sincerely,





Carter McDowell
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Securities Industry and Financial Markets Association

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APPENDIX A

JOINT MEMORANDUM OF LAW
PREPARED FOR SIFMA
IN RESPONSE TO THE NOTICE OF PROPOSED RULEMAKING
ON RISK-BASED CAPITAL AND OTHER REGULATORY REQUIREMENTS FOR ACTIVITIES OF FINANCIAL HOLDING COMPANIES RELATED TO PHYSICAL COMMODITIES AND RISK-BASED CAPITAL REQUIREMENTS FOR MERCHANT BANKING INVESTMENTS

(DOCKET NO. R-11547; RIN 7100AE-58)

COVINGTON & BURLING LLP
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SULLIVAN & CROMWELL LLP
VINSON & ELKINS LLP

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This memorandum discusses potential liabilities of financial holding companies ("FHCs"), their insured depository institution ("IDI") subsidiaries, non-IDI subsidiaries, broker-dealer subsidiaries, portfolio companies, and other affiliates (collectively, "FHC groups") arising from physical-commodity activities and from merchant-banking activities involving companies that are involved in businesses exposed to potential environmental liabilities. This memorandum is submitted on behalf of the Securities Industry and Financial Markets Association (SIFMA)[1] in response to the proposal issued by the Board of Governors of the Federal Reserve System (the "Board") and published in the Federal Register on September 30, 2016 (the "Proposed Rule").[2] This memorandum discusses the direct and indirect environmental liability schemes addressed in the Proposed Rule associated with the physical-commodities activities of FHCs and their non-IDI affiliates.

Executive Summary

- An extensive body of environmental statutes and regulations exists to prevent environmental incidents in the first instance and to allocate liability when such incidents occur.
- Under most federal and state laws, the parties responsible for damages resulting from the release of an environmentally sensitive commodity include the owner and operator of the facility from which the release occurred, as well as parties that directly handle the commodity or arrange for its treatment or disposal. Liability typically does not attach to an entity that merely owns a commodity that is released, or that enters into ordinary-course contracts for transportation or storage of a commodity. Nor does liability typically attach to an entity that merely invests in a business that is engaged in the activity that gives rise to the release.

[1] This memorandum is being provided to SIFMA in connection with its comment letter to the Board regarding the Proposed Rule and is solely for use by SIFMA in that context. It may not be relied upon by SIFMA for any other purpose, and may not be relied upon by any party other than SIFMA for any purpose. This memorandum is provided to SIFMA jointly by the four law firms. The substantive legal analysis with respect to environmental liability has been primarily contributed by [Covington & Burling LLP and] Vinson & Elkins LLP. The legal analysis with regard to the other subjects addressed by the memorandum reflects the contributions of each of the four firms.

[2] Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments, 81 Fed. Reg. 67,220 (Sept. 30, 2016) [hereinafter "Proposed Rule"].

- Although a commodity owner could potentially be held liable for damages resulting from the release of a commodity under a limited set of state laws, we have found only two instances where mere ownership of a commodity resulted in liability for any party under state law. Moreover, no FHC has ever incurred liability under any of these state laws. In addition, these state laws provide defenses that make it unlikely that a mere commodity owner would incur significant liability from the release of an environmentally sensitive product.

- An investor in an operating company is not liable for the environmental obligations of the operating company unless it becomes involved in the environmental affairs of the operating company, particularly as they relate to potentially polluting activities, or so dominates and controls the operating company that the two can be characterized as "alter egos" under common-law principles. Investors in entities that own or operate facilities that handle environmentally sensitive commodities are generally protected from indirect, derivative liability by well-established principles of corporate separateness, so long as they abide by appropriate guidelines.

Introduction

FHC groups that trade or invest in physical commodities, or that engage in commodities-related activities, face manageable liability risk for losses that might arise from such activities undertaken pursuant to the complementary merchant banking, or grandfather authorities under Sections 4(k) and 4(o) of the Bank Holding Company Act. As set out in this memorandum, an extensive statutory and regulatory framework governs these activities for the purpose of promoting their safe conduct and minimizing the occurrence and scale of adverse incidents. Further, the legal framework governing such activities permits an FHC group to conduct them without presenting an undue risk to the FHC's safety and soundness.

This governing legal framework affords FHC groups significant legal safeguards that limit their risk of being held liable for losses resulting from the release of environmentally sensitive commodities. Some of these safeguards may be appropriate to apply in every situation;

others may be appropriate with respect to certain higher-risk investments or lines of business.[3] These safeguards include measures to limit the risk and magnitude of any environmental liability that may be imposed on owners of physical commodities or owners and operators of facilities for the extraction, generation, transportation, storage, or processing of physical commodities. They also include measures designed to ensure that the corporate separateness of an FHC and its IDI and non-IDI subsidiaries is respected when one or more of the FHC's other subsidiaries, portfolio companies, or investees engages in commodity-related activities or contracts with an unaffiliated enterprise engaged in such activities.

FHCs and their affiliates have powerful financial and regulatory incentives to adopt safeguards appropriate to their business practices. So long as they are properly followed, these safeguards should protect the safety and soundness of FHCs and their IDI and non-IDI affiliates against risks resulting from their physical-commodity activities. Coupled with the wide array of protections built into the regulatory system to promote the safe conduct of activities in the first instance, these safeguards allow for the effective management of any liability risks from FHC groups' engagement in such activities.

Part I discusses the allocation of liability under laws and doctrines relevant to the ownership, transportation, and storage of environmentally sensitive commodities, including the fundamental principle that an entity that merely owns commodities and contracts for their storage and transportation typically faces limited liability risks. Further, Part I describes practices and procedures that, if followed in whole or in part, depending on the relevant legal and operational risks associated with the particular activity, can serve to further limit the liability risks associated with the release of environmentally sensitive commodities.

[3] For example, an FHC might determine that it is not necessary to be as rigorous with respect to the practices adopted in connection with the shipment of iron as compared to oil.

Part II discusses potential sources of indirect liability, such as corporate "veil piercing." It begins with a brief review of the foundational principle that an investor in a separate legal entity, such as a corporation or limited liability company, generally has no responsibility for the debts, torts, or wrongs of that entity. Part II then discusses the limited exceptions to that basic principle under veil-piercing theories, as well as the steps that can be taken to minimize the risk of veil-piercing liability.

Exhibit 1 of this Appendix A describes the safeguards that, if implemented appropriately in light of the relevant legal and operational risks, limit exposure to environmental liability and enhance corporate separateness, thereby reducing the risk to the safety, soundness, and financial stability of FHC groups that engage in commodities activities and commodity-related merchant banking activities to a level consistent with each FHC's risk tolerance, as established by its board of directors and its risk management framework, each of which is subject to the Board's supervision and examination and safety and soundness standards.

I. Appropriately Limited Investment and Trading Activities Relating to Environmentally Sensitive Commodities Present Limited Environmental Liability Risk to FHC Groups.

Trading or investing in physical commodities, including environmentally sensitive commodities, or engaging in related activities such as extraction, generation, transportation, storage, or processing, may, in certain circumstances, give rise to liability for damages resulting from the release of environmentally sensitive commodities. However, entities that own such commodities or contract with or invest in entities that engage in these activities generally face limited liability risk, provided that they do not themselves engage in additional activities that can be a basis for environmental liability under relevant statutes and regulations. Further, FHCs and their affiliates can employ appropriate safeguards to limit their direct liability risk.

A. Federal Environmental Statutes

Several federal environmental statutes regulate environmentally sensitive commodities or activities related to them, including extraction, generation, transportation, storage, processing, and disposal of such commodities. The broadest of these laws is the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"). Others include the Oil Pollution Act of 1990 ("OPA") and the Clean Water Act ("CWA"). The Pipeline Safety Act, the Natural Gas Act, the Hazardous Materials Transportation Act, Federal Railroad Administration statutes and regulations, and the Federal Motor Carrier Safety Administration statutes and regulations may also apply to the shipping and storage of some physical commodities.[4] These regulations are frequently updated to adapt to new or heightened environmental risks.[5] Both the frequency and size of environmental losses incurred by FHCs and their affiliates due to releases of environmentally sensitive commodities have been relatively small, at least since 2006.

1. CERCLA

CERCLA, also known as the "Superfund" law, imposes joint and several liability on certain classes of persons for remedial costs and natural resource damages associated with the release of hazardous substances from a facility or vessel.[6] CERCLA only applies to "hazardous

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[4] Pipeline Safety, Regulatory Certainty, and Job Creation Act of 2011, 49 U.S.C. §§ 60101–60140; Natural Gas Act, 15 U.S.C. §§ 717–717z; Hazardous Materials Transportation Act, 49 U.S.C. §§ 5101–5128; Rail Safety Improvement Act of 2008, 49 U.S.C. §§ 20101–21311; Federal Railroad Administration regulations, 49 C.F.R. §§ 200–69; the various motor carrier safety acts, codified at 49 U.S.C. §§ 501–526, 30101–30183, 30301–30308, and 31501–31504; and the Federal Motor Carrier Safety Administration regulations, 49 C.F.R. §§ 350–399.

[5] For example, the U.S. Department of Transportation ("DOT") recently finalized a new rule designed to prevent accidents and mitigate consequences in the event of an accident involving the shipment of flammable materials by rail. 80 Fed. Reg. 26,644 (May 8, 2015). Additionally, the Pipeline and Hazardous Materials Safety Administration ("PHMSA") has published proposed regulations that aim to address the emerging needs of the natural gas pipeline system and adapt and expand risk-based safety practices to include pipelines not currently covered under existing regulations. 81 Fed. Reg. 20,721 (Apr. 8, 2016).

[6] 42 U.S.C. §§ 9601–9675.

substances," which, by statutory definition, specifically exclude petroleum, crude oil or any fraction thereof, natural gas, natural gas liquids, liquefied natural gas, and synthetic gas usable for fuel (or mixtures of natural gas and such synthetic gas).[7] Thus, CERCLA does not apply to activities involving those excluded substances, and could not create liability for a commodity owner based on the release of only those substances. An assessment of potential liabilities under CERCLA is nonetheless relevant because CERCLA generally imposes the most onerous liability scheme under federal environmental law, and there has been substantially more litigation under CERCLA than under any other federal or state environmental law. As a result, courts interpreting other environmental statutes often look to CERCLA cases as persuasive authority.[8]

A party can only be held liable under CERCLA if it falls into one of four categories of "persons responsible" for releases of hazardous substances: (i) current owners and operators of a facility or vessel from which hazardous substances have been released; (ii) past owners and operators of a facility from which hazardous substances were released during their period of ownership; (iii) any person who arranged for disposal or treatment (or transportation for disposal or treatment) of hazardous substances; and (iv) transporters of hazardous substances to a disposal or treatment facility.[9] Under CERCLA, any and all of these "responsible parties" may be held liable for remedial costs associated with the cleanup of sites contaminated by hazardous

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[7] *Id.* § § 9601(14); *see also Organic Chem. Site PRP Grp. v. Total Petrol. Inc.*, 58 F. Supp. 2d 755, 763 (W.D. Mich. 1999) ("Th[e] petroleum exclusion applies to both used and unused petroleum products and includes hazardous substances inherent in unused petroleum products or added to unused petroleum products in the refining process; it does not apply to hazardous substances which are added to petroleum products during use."). Coal, metals, agricultural products, and other non-petroleum commodities may constitute hazardous substances under CERCLA if they exhibit certain hazardous characteristics. 42 U.S.C. § 9601(14)(C).

[8] *See, e.g., United States v. Viking Res., Inc.*, 607 F. Supp. 2d 808, 822 nn.46–47, 823 (S.D. Tex. 2009) (applying CERCLA principles with respect to corporate separateness and operator liability in the OPA context); *Harris v. Oil Reclaiming Co.*, 94 F. Supp. 2d 1210, 1213 (D. Kan. 2000) (applying Supreme Court's analysis of operator liability under CERCLA to OPA); *United States v. Dell'Aquilla*, 150 F.3d 329, 334 (3d Cir. 1998) (stating that the Supreme Court's analysis of operator liability under CERCLA is relevant under the Clean Air Act).

[9] 42 U.S.C. § 9607(a).

substances, for natural resource damages, and for the cost of certain health studies.[10] Because a "hazardous substance owner" is *not* one of these four categories, a commodity owner cannot be held liable under CERCLA for merely owning the released substance. To incur liability under CERCLA, the commodity owner must engage in additional activity that would place it in one of the four "responsible party" categories.

a. Contracting for the Transportation or Storage of Physical Commodities Does Not Create CERCLA Liability for Commodity Owners.

Mere ownership of physical commodities, together with ordinary-course contracting for associated transport and storage, is not a basis for liability under CERCLA. Although "transporters" can be held liable under CERCLA, commodity owners that merely contract with third parties for the transportation of physical commodities are insulated from liability by specific statutory provisions.[11] As a result, an FHC or its affiliate that trades or invests in physical commodities would not face liability for remediation costs associated with a release of the commodity to the environment from a facility merely because it was the owner of a released commodity or merely because it contracted with a third party for the commodity's transportation or storage, if for purposes other than disposal.

CERCLA includes a "shipper defense" that protects an owner of physical commodities that are released during shipment by a common or contract carrier. The statute provides that, with respect to releases during transportation for a purpose other than disposal or treatment, the carrier is considered the "owner or operator" that is subject to liability, and the shipper "shall not

[10] 42 U.S.C. § 9607(a).

[11] 42 U.S.C. § 9601(20)(B).

be considered to have caused or contributed to any release during . . . transportation which resulted solely from circumstances or conditions beyond his control."[12]

An owner of commodities that entrusts the commodities to a qualified, responsible third party for shipment, and does not become directly involved in the details of *how* the commodities will be shipped (apart from specifying their pickup point and destination), should be protected from any claim of having "contributed" to a release for purposes of CERCLA.[13] This analysis is supported by the United States Supreme Court's decision in *United States v. Bestfoods*,[14] which held that a parent of a subsidiary that owns or operates a facility may be directly liable as an "operator" of the facility only if the parent "manage[s], direct[s], or conduct[s] operations specifically related to pollution, that is, operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations."[15] On remand in *Bestfoods*, the district court held that a parent company was not an operator, notwithstanding evidence of some oversight of the subsidiary's environmental practices.[16] In particular, a lawyer employed by the parent company gave advice to the subsidiary regarding environmental compliance.[17] However, his advice was generally disregarded, and the subsidiary had its own policies for day-to-day environmental compliance.[18] The parent also planned to expand production at the facility and assisted in developing products manufactured at the facility, and a

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[12] *Id.* § 9601(20)(B).

[13] *See E. S. Robbins Corp. v. Eastman Chem. Co.*, 912 F. Supp. 1476, 1484–85 (N.D. Ala. 1995) (holding that the owner of a hazardous chemical was not liable as an owner or operator, despite providing certain instructions to the carrier regarding certain "equipment requirements and driver procedures").

[14] 524 U.S. 51 (1998).

[15] *Id.* at 66–67.

[16] *Bestfoods v. Aerojet-Gen. Corp.*, 173 F. Supp. 2d 729, 749 (W.D. Mich. 2001).

[17] *Id.* at 741–45.

[18] *Id.*

chemist employed by the parent advised subsidiary employees on how to conduct manufacturing procedures, such as pressure and temperature settings.[19] Notwithstanding these connections, the court concluded that the parent's involvement did not "demonstrate the requisite control over the facility to render [the parent] liable as an operator of the facility."[20] It follows that an entity that merely contracts for transportation or storage and does not own the facilities in question or exercise control over their operations faces an even more remote risk of liability.

Other cases demonstrate that a commodity owner must exercise some level of control over the transportation of the commodity before it can be held liable. For example, in *APL Co. Pte. Ltd v. Kemira Water Solutions, Inc.*, the district court refused to grant summary judgment in favor of a defendant chemical company, Kemira, that invoked the shipper defense under CERCLA for a release of ferrous chloride that Kemira had contracted to buy.[21] The record included evidence that Kemira had provided detailed specifications as to how the released ferrous chloride would be packaged, how it would be stowed, and how it would be unloaded onto a vessel and at its final destination.[22] Kemira's purchase agreement with the seller also specified the kind of containers in which the chemicals would be stored and how they would be loaded.[23] On this record, the court denied Kemira's motion for summary judgment on the shipper defense, holding that (i) the seller—not Kemira—was the "shipper," and (ii) even if Kemira had been the "shipper," the company's involvement in determining the packaging of the hazardous cargo

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19 *Id.* at 753.

20 *Id*. at 755.

21 890 F. Supp. 2d 360, 371–72 (S.D.N.Y. 2012).

22 *Id*.

23 *Id*. at 752–54.

created a factual question as to whether the release of chemicals had resulted solely from events beyond Kemira's control.[24]

Likewise, a mere owner of a physical commodity that contracts with a third party for the shipment of the commodity would not be liable as an "arranger" under CERCLA. Arranger liability can attach to "any person who by contract, agreement, or otherwise arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity."[25] In *Burlington Northern & Santa Fe Railway Co. v. United States*, the Supreme Court held that this section gives rise to liability for an arrangement to dispose of a hazardous substance only where an entity "takes intentional steps to dispose of a hazardous substance."[26] In that case, Shell sold pesticides to a third-party distributor, which transferred the pesticides into various tanks and vessels, often resulting in spills.[27] Shell was aware of these spills and took steps to encourage its distributors to adopt practices to minimize them.[28] The Court held that these facts did not give rise to arranger liability because Shell lacked the requisite intent to dispose of the spilled pesticides.[29] The Court held that a seller's knowledge that a hazardous substance "will be leaked, spilled, dumped, or otherwise discarded" by the purchaser "is insufficient to prove that [the seller] 'planned for' the disposal, particularly when the disposal occurs as a peripheral result of the legitimate sale of an

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[24] *Id*. at 755.

[25] 42 U.S.C. § 9607(a)(3). Under this provision, "treatment . . . of hazardous substances" is a limited concept that "refers to a party arranging for the processing of discarded hazardous substance or processing resulting in the discard of hazardous substances." *Pneumo Abex Corp. v. High Point, Thomasville & Denton R.R. Co.*, 142 F.3d 769, 774 (4th Cir. 1998) (holding that the sellers of hazardous metals were not liable under an arrangement for treatment theory under CERCLA, even though the buyer processed the metals, because the parties did not intend that the metals would be discarded).

[26] 556 U.S. 599, 611 (2009).

[27] *Id*. at 602–04.

[28] *Id*. at 604.

[29] *Id*. at 612–13.

unused, useful product," unless the seller actually intended the disposal of the substance.[30] In other words, the courts have distinguished between a party that is trying to get rid of a product, and thus arranging for its disposal, and those who intend to sell the product for some future use. While a court will "look beyond the parties' characterization of the transaction" in determining a seller's intent,[31] an FHC or its affiliate that invests in a useful commodity and arranges for its sale or transportation would typically lack any intent to dispose of the substance and thus would not be liable for any release as an arranger under CERCLA.[32]

In sum, cases decided under CERCLA provide guidance for entities that own or trade physical commodities and engage in appropriately limited contracting for transportation or storage. Under the case law, such entities should not be at material risk under CERCLA so long

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[30] *Id*. at 612. *Burlington Northern*'s focus on the need to show intentional steps to dispose of a hazardous substance appears likely to limit earlier appellate decisions that had imposed arranger liability on parties involved in a manufacturing process that generated hazardous waste based on the party's general obligation to control the disposal of the hazardous waste generated by the process. *See, e.g.*, *United States v. Aceto Agr. Chem. Corp.*, 872 F.2d 1373, 1381–82 (8th Cir. 1989). Further, it is our understanding that FHCs and their affiliates do not engage in manufacturing activities as in *Aceto* and, accordingly, they should be shielded from this type of arranger liability based on manufacturing.

[31] *Id*. at 610 (noting that this can be a "fact-intensive inquiry"); *cf. Carolina Power & Light Co. v. Alcan Aluminum Corp.*, 921 F. Supp. 2d 488, 496 (E.D.N.C. 2013) (noting that factors relevant to determination of intent for purposes of arranger liability include "the value of the materials sold, the usefulness of the materials in the condition in which they were sold, and the state of the product at the time of transferral" (quoting *Pneumo Abex Corp.*, 142 F.3d at 775)).

[32] *See Consolidated Coal Co. v. Georgia Power Co.*, 781 F.3d 129 (4th Cir. 2015) (even where sale of PCB laden transformers was in part for recycling, the seller was not arranging for disposal); *United States v. Vertac Chem. Corp.*, 966 F. Supp. 1491, 1507–08 (E.D. Ark. 1997) (holding that the commodity owner was not liable for arranging disposal when the evidence did not show that the sale of the hazardous but useful substance was "really a sham for disposal"); *Amcast Indus. Corp. v. Detrex Corp.*, 2 F.3d 746, 751 (7th Cir. 1993) (holding that a shipper was not liable as a party that "arranged . . . for transport for disposal or treatment" of the chemical when the shipper merely arranged for delivery of the useful chemical to a third party). Additionally, because a useful substance is not considered "waste," the sale of such a substance does not give rise to arranger liability under CERCLA. *See Team Enters., LLC v. W. Inv. Real Estate Tr.*, 647 F.3d 901, 908 (9th Cir. 2011) ("persons selling useful products do so for legitimate business purposes," not to dispose of such products); *Freeman v. Glaxo Wellcome, Inc.*, 189 F.3d 160, 164 (2d Cir. 1999) (finding that the sale of new, useful chemicals could not give rise to arranger liability because the chemicals were "not waste at the time that" they were purchased); *A & W Smelter & Refiners, Inc. v. Clinton*, 146 F.3d 1107, 1112–13 (9th Cir. 1998) (explaining that gold and silver ore may not be waste, even if mixed with some slag containing lead, and noting that "[i]f the ore was a useful product, then it was not waste and not subject to CERCLA"); *AM Int'l, Inc. v. Int'l Forging Equip. Corp.*, 982 F.2d 989, 999 (6th Cir. 1993) (sale of useful chemicals does not give rise to arranger liability); *Pakootas v. Teck Cominco Metals, Ltd.*, No. 04-256-AAM, 2012 WL 370105, at *3–4 (E.D. Wash. Feb. 3, 2012) (analogizing to the useful-product defense to reject the argument that the government arranged for the disposal of "naturally occurring in-ground ore deposits").

as they avoid (i) involvement in the operational aspects of the transportation or storage of a hazardous substance and the setting of environmental compliance policies, and (ii) arranging for the treatment or disposal of a hazardous substance.

b. Ownership and Operation of Facilities that Extract, Generate, Transport, Store, or Process Hazardous Materials

CERCLA does not create liability based on an entity's ownership of a hazardous substance. Instead, CERCLA provides potential liability for entities that own or operate the *facilities* that extract, generate, transport, store, or process the hazardous substances released.[33] In addition, entities that contract for services with owners or operators of such facilities can, under certain circumstances, be deemed to be operators of the facilities themselves, with liability under CERCLA. Similarly, parents and affiliates of entities that own or operate facilities may be deemed operators based on their conduct. Legal doctrines have developed, however, that insulate these contracting entities and corporate parents and affiliates from operator liability, provided they do not assert control over the day-to-day operations or environmental-compliance duties of the facilities. Within this framework, contracting parties and corporate affiliates may engage in due diligence or ordinary-course parental oversight to help ensure generally safe operations without incurring liability. Accordingly, FHCs and their IDI and non-IDI subsidiaries should be insulated from any liability with respect to facilities owned and operated by others, including by affiliates, provided that they employ appropriate safeguards.

The Supreme Court articulated the standards for parent entity liability under CERCLA in the *Bestfoods* decision discussed above.[34] In that decision, the Court recognized two ways that a parent entity can be liable for releases of hazardous substances from a facility owned or operated

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[33] *See* 42. U.S.C. § 9607(a).

[34] 524 U.S. 51 (1998).

by its subsidiary. First, under certain circumstances, a parent entity may be directly liable under CERCLA as an owner or operator of a facility based on its own actions or conduct, where those actions or conduct are connected to environmental affairs at the site.[35] Second, as with other types of liability, a parent entity may be held derivatively liable for the obligations of its subsidiary on a "veil-piercing" theory when the parent acts in a manner inconsistent with the separate corporate status of the subsidiary.[36] This section discusses the potential for direct operator liability under CERCLA; Part II discusses the potential for "veil-piercing" liability.

In *Bestfoods*, the Supreme Court held that a parent of a subsidiary that owns or operates a facility is not itself an "owner" under CERCLA (absent veil piercing), and may be directly liable as an "operator" only if the parent "manage[s], direct[s], or conduct[s] operations specifically related to pollution, that is, operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations."[37] The Supreme Court explained that, in determining whether to classify a parent company as an operator, courts must distinguish a parent's direct participation in or control over operations relating to pollution activities at the facility—which may trigger liability—from oversight of the subsidiary necessary to protect the parent's investment, which does *not* trigger liability.[38] Involvement in a facility's general operations is not enough to create liability as a CERCLA operator. Instead, the conduct

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[35] *Id*. at 64.

[36] *Id*. at 62–64.

[37] *Id*. at 66–67.

[38] *Id*. at 67–68 ("The question is not whether the parent operates the subsidiary, but rather whether it operates the facility, and that operation is evidenced by participation in the activities of the facility, not the subsidiary.") (emphasis added) (internal quotation marks omitted). In this respect, the CERCLA analysis is considerably narrower than the alter ego/veil-piercing analysis discussed in Part II.

of the parent must specifically relate to the polluting activities or environmental compliance of the facility in question.[39]

The Supreme Court also indicated in *Bestfoods* that a dual employee of both the parent and the subsidiary, while legitimately acting in his or her capacity as an employee of a subsidiary, may engage in such activities without exposing the parent to direct liability.[40] In order for the actions of such dual employees to create liability for the parent, a plaintiff must show that, "despite the general presumption to the contrary," such employees were acting on behalf of the parent, rather than the subsidiary.[41]

Following *Bestfoods*, courts have confirmed that activities commonly undertaken by a parent company, such as general monitoring of the subsidiary's performance, supervising its financing and budget decisions, and establishing general policies and procedures, are appropriate under accepted norms of parental oversight and not a basis for operator liability. For example, as discussed above, the district court in *Bestfoods* held on remand that even though the parent had exercised some oversight of the subsidiary's environmental practices, such oversight did not result in CERCLA liability.[42] Similarly, in *Atlanta Gas Light Co. v. UGI Utilities, Inc.*, the Eleventh Circuit Court of Appeals held that a parent company was not liable as an operator even though (i) the parent had provided general operating, construction, and financial advice to the subsidiary, and (ii) most of the subsidiary's officers and directors were employees of the parent company.[43] Because the parent's involvement was advisory in nature and did not extend to

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[39] *Id*. at 66–67.

[40] *Id*. at 69–70.

[41] *Id*. (citing P. Blumberg, *Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations* § 1.02.1 (1983)).

[42] *See Bestfoods v. Aerojet-Gen. Corp.*, 173 F. Supp. 2d 729 (W.D. Mich. 2001).

[43] 463 F.3d 1201, 1205 (11th Cir. 2006).

managing, directing, or conducting operations of the facility specifically related to pollution, leakage, or disposal, the court held that the parent was not liable under CERCLA as an "operator" of the facility.[44]

By contrast, in cases where courts have determined that parent entities were liable under CERCLA for releases at a facility operated by a subsidiary, the parents were found to have controlled the subsidiary's day-to-day, routine, or ordinary-course operations at facilities that contained hazardous substances, including by establishing policies specifically governing environmental compliance at such facilities. In *United States v. Kayser-Roth Corp.*, for instance, the court affirmed that the parent company could be held liable because it exercised substantial control over the subsidiary's environmental-compliance activities as they related to the polluting facility.[45] The parent company had both (i) required the subsidiary to conduct a cost-benefit study of the installation of the system at the subsidiary's facility that used the hazardous substances at issue and (ii) approved the installation of that system.[46] In holding that the parent could be liable, the First Circuit relied on the trial court's findings that the parent "essentially was in charge in practically all of [the subsidiary's] operational decisions, including those involving environmental concerns" and that "[t]he only autonomy given the officers of [the subsidiary] was that absolutely necessary to operate the facility on-site from day to day such as hiring and firing hourly employees and ordering inventory."[47]

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[44] *Id*. at 1206.

[45] 272 F.3d 89, 104 (1st Cir. 2001) (holding that the intervening *Bestfoods* decision did not render inequitable the continued application of the trial court's judgment imposing liability on the parent).

[46] *Id*. at 102. The parent also required the subsidiary to notify it of any regulatory-agency contact regarding environmental matters, and made the decision to settle a pollution-related case brought by the federal government against the subsidiary. *Id*. at 102, 104.

[47] *Id*. at 102–03 (quoting trial court decision). Indeed, the trial court concluded that the subsidiary "was in fact and effect the serf of [the parent]." *Id*. at 103.

These cases provide useful guidance to members of FHC groups that invest in physical commodity facilities, as well as those that contract with owners and operators of such facilities. FHCs and their affiliates that do not control the polluting activities, or environmental compliance, of such facilities should not face a material risk of liability under CERCLA for any discharge.[48]

In at least one instance, Congress and the U.S. Environmental Protection Agency ("EPA") resisted a judicial attempt to expand CERCLA liability. In response to a judicial decision[49] that potentially limited the scope of the safe harbor that CERCLA provides for secured creditors,[50] EPA issued rules under which secured lenders could undertake a broad range of routine and prudent activities while still qualifying for the exemption.[51] After a judicial ruling that EPA lacked authority to restrict CERCLA's statutory private right of action by regulation,[52] Congress amended CERCLA to codify the EPA rules.[53] Under this amendment, a lender only "participate[s] in management," and thus does not qualify for the statutory exemption, if it (i)

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[48] Courts have also applied these principles to outline CERCLA liability in the context of limited-partner structures. *See Redwing Carriers, Inc. v. Saraland Apartments*, 94 F.3d 1489, 1499–1505 (11th Cir. 1996) (finding that limited partners can be held directly liable as operators under CERCLA if they either (i) actually participated in operating the site or in the activities resulting in the disposal of hazardous substances; or (ii) actually exercised control over or were otherwise intimately involved in the operations of the partnership).

[49] *United States v. Fleet Factors Corp.*, 901 F.2d 1550, 1557–58 (11th Cir. 1990) (adopting a standard of liability for secured creditors under which a secured creditor would be liable under CERCLA if its involvement with the financial management of the facility is "sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose").

[50] 42 U.S.C. § 9601(20)(A)(iii) (providing that an "owner or operator" under CERCLA "does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility").

[51] National Oil and Hazardous Substances Pollution Contingency Plan; Lender Liability Under CERCLA, 57 Fed. Reg. 18,344 (Apr. 29, 1992) (to be codified at 40 C.F.R. pt. 300).

[52] *Kelley v. EPA*, 15 F.3d 1100, 1107 (D.C. Cir. 1994).

[53] *See* Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009–462 (1996). Prior to this amendment, EPA had announced that, as a matter of enforcement discretion, it would continue to follow the provisions of the rules it had issued. *See* CERCLA Enforcement Against Lenders and Government Entities That Acquire Property Involuntarily, 60 Fed. Reg. 63,517 (Dec. 11, 1995).

exercises decision-making control over the facility's environmental compliance, such that it has undertaken responsibility for the hazardous substance handling or disposal practices of the facility, or (ii) exercises managerial control over the facility, such that it has taken responsibility for either day-to-day decision making with respect to environmental compliance, or all or substantially all of the facility's other operational functions (as opposed to financial or administrative functions).[54] These actions by Congress and EPA sought to maintain a workable balance between the assignment of responsibility for environmental damage and the facilitation of commercial lending activity.

2. Oil Pollution Act

As noted above, CERCLA does not apply to petroleum. The primary federal environmental law that addresses petroleum products is the Oil Pollution Act ("OPA"), which makes "responsible parties" strictly liable for discharges of "oil" from specified facilities into navigable waters of the United States.[55] The OPA does not apply to liquid natural gas, coal, or other commodities.[56] Responsible parties are liable under the OPA for a variety of removal costs and damages associated with a discharge of oil or the substantial threat of a discharge.[57] As with CERCLA, a party can be liable under the OPA only if it falls into one of the specific categories of responsible parties listed in the statute. For FHC groups that trade or invest in oil, or contract with or invest in enterprises that engage in the extraction, transportation, storage, refining, or

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[54] 42 U.S.C. § 9601(20)(F)(ii). The amendment also provided that a secured creditor that forecloses on a facility or vessel is generally not liable as an "owner or operator" under CERCLA so long as it divests the facility or vessel "at the earliest practicable, commercially reasonable time[.]" 42 U.S.C. § 9601(20)(E)(ii). The few reported cases that imposed "owner" liability on lender banks that had foreclosed on property predated this amendment. *See, e.g., Guidice v. BFG Electroplating & Mfg. Co.*, 732 F. Supp. 556 (W.D. Pa. 1989); *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573 (D. Md. 1986).

[55] 33 U.S.C. § 2702(a). *See also id*. § 2701(23) (defining "oil" as "oil of any kind or in any form, including petroleum, fuel oil, sludge, oil refuse, and oil mixed with wastes other than dredged spoil").

[56] *Id*. at §§ 2701(23), 2702(a).

[57] *Id*. § 2702(b).

other processing of oil, the most relevant categories of responsible parties are those associated with vessels, pipelines, onshore facilities, and offshore facilities:

- For vessels, "responsible party" means "any person owning, operating, or demise chartering the vessel" as well as "the owner of oil being transported in a tank vessel with a single hull[.]"[58]

- For pipelines, "responsible party" means any person owning or operating the pipeline.[59]

- For onshore facilities, "responsible party" means any person owning or operating the facility.[60]

- For offshore facilities, "responsible party" means "the lessee or permittee of the area in which the facility is located or the holder of a right of use and easement granted under applicable State law or the Outer Continental Shelf Lands Act . . . for the area in which the facility is located[.]"[61]

Under these definitions, there is only one circumstance where the mere ownership of discharged oil, or the mere time or voyage chartering of the vessel from which the discharge took place (without acting as owner or operator of the vessel), can be the basis for liability: when the vessel has a single hull.[62] When determining whether a party is an "operator" under the OPA,

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[58] *Id*. § 2701(32). A demise charter is a charter agreement whereby the whole vessel is let to the charterer with a transfer to it of the entire command, possession, and control over its navigation. *See* 70 Am. Jur. 2d Shipping § 176.

[59] 33 U.S.C. § 2701(32).

[60] *Id*. An exception exists for certain governmental bodies that, as owners, transfer possession and right to use the property to another person by lease, assignment, or permit.

[61] *Id*. The same exception for governmental bodies with respect to onshore facilities applies in the context of offshore facilities as well.

[62] *See* Charles B. Anderson & Colin de la Rue, *Liability of Charterers and Cargo Owners for Pollution from Ships*, 26 Tul. Mar. L.J. 1, 15 (2001) ("Under OPA-90 there is no federal statutory oil spill liability upon the owner of oil cargo."); *see also* 33 C.F.R. § 138.20(b) (under Coast Guard rule, "[a] time or voyage charterer that does not assume responsibility for the operation of a vessel is not an operator[.]"). The Oil Pollution Act required new covered vessels to be equipped with double hulls beginning in 1995, and generally prohibited the operation of single-hulled tankers in U.S. waters after 2010. 46 U.S.C. §§ 3703a(c)(3)(C)(i)–(vi), (c)(4)(A). In 1992, the International Convention for the Prevention of Pollution from Ships, or MARPOL, was amended to impose similar double-hull standards. *See* Int'l Maritime Org. ("IMO"), Construction Requirements for Oil Tankers (2014), *available at* http://www.imo.org/OurWork/Environment/PollutionPrevention/OilPollution/Pages/constructionrequirements.aspx (stating that MARPOL was amended in 1992 to require tankers of 5,000 deadweight tons and more, ordered after July 6, 1993, to be fitted with double hulls).

courts have concluded that the *Bestfoods* analysis discussed above applies in the context of onshore facilities.[63] Accordingly, an FHC and its affiliates should not face any liability for an oil discharge under the OPA if it follows appropriate policies to ensure that it does not (i) control the day-to-day, routine, or ordinary-course operations (or the environmental-compliance program) of an affiliated or unaffiliated operator of onshore facilities; (ii) own, operate, or demise charter a vessel; or (iii) lease (or hold an authorization for) an area in which an offshore facility is located.[64]

3. Clean Water Act

The Clean Water Act ("CWA") prohibits the discharge of a pollutant into navigable waters of the United States (i) without a permit or (ii) in violation of a permit.[65] The statute defines "pollutant" broadly, and it includes most physical commodities such as oil, coal, liquid natural gas, metals, and agricultural products.[66] Like CERCLA, the CWA does not impose liability on a commodity owner merely because its product was released. Instead, the CWA imposes liability on a party who discharges a pollutant in violation of the Act or a permit issued

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[63] *See United States v. Viking Res., Inc.*, 607 F. Supp. 2d 808, 822 n.47 (S.D. Tex. 2009) (concluding that the *Bestfoods* "operator" analysis applies in OPA cases involving onshore facilities because, for onshore facilities, CERCLA's definition of an "operator" is "virtually identical" to OPA's definition of an "operator"). At least one court has held that the *Bestfoods* "operator" analysis does not apply to vessels under OPA because OPA includes a separate financial-responsibility provision for vessels. *Green Atlas Shipping SA v. United States*, 306 F. Supp. 2d 974, 980–81 (D. Or. 2003). Applying this reasoning, CERCLA's "operator" jurisprudence likewise might not govern OPA liability for "operators" of offshore facilities, because OPA includes a distinct financial-responsibility provision for offshore facilities, as well. *See* 33 U.S.C. § 2716(c).

[64] *See infra* Part I(B)(1) (discussing cargo owner liability under state statutes).

[65] 33 U.S.C. §§ 1311(a), 1362(12).

[66] *See id.* § 1362(6) (defining "pollutant" as "dredged spoil, solid waste, incinerator residue, sewage, garbage, sewage sludge, munitions, chemical wastes, biological materials, radioactive materials, heat, wrecked or discarded equipment, rock, sand, cellar dirt and industrial, municipal, and agricultural waste discharged into water"). While the CWA's definition of "pollutant" is quite broad, the effects of different commodities on the environment in the event of a release may vary greatly.

under the Act.[67] Thus, an FHC or affiliate that simply trades in physical commodities and does not itself own or operate a facility, or participate in or otherwise cause or contribute to a violation of the CWA, should not bear any direct liability under the CWA.

As under CERCLA, a party can also become liable under the CWA for "causing" or "directing" a violation. However, ordinary due diligence of an unaffiliated operator, or ordinary shareholder or board-level oversight of an affiliated operator, is insufficient to impose such liability. In *United States v. Avatar Holdings, Inc.*, for example, the court held that a parent entity was not liable under the CWA because it did not "cause" or "direct" a discharge of oil by its subsidiary, as it had not taken responsibility for decisions regarding day-to-day operations and environmental compliance.[68] Rather, the parent's role in its subsidiary's operations was limited to overall financial review and long-term strategic planning.[69] Although the parent was aware of compliance issues at the subsidiary's facility and had discussed large capital projects that could have prevented a discharge, the court concluded that the parent did not engage in the kind of operational decisions at the facility necessary to impose liability under the CWA.[70]

Accordingly, an FHC or any of its affiliates that owns or contracts with the owner of a facility that discharges a pollutant, but makes no operational decisions regarding the pollutant's extraction, transportation, storage, or processing activity that results in the discharge, should not be liable under the CWA for any discharge.

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[67] *See Comm. to Save Mokelumne River v. E. Bay Mun. Util. Dist.*, 13 F.3d 305, 309 (9th Cir. 1993) (finding defendants liable under CWA for discharging pollutant into navigable waters from point source without discharge permit); *Idaho Conservation League v. Atlanta Gold Corp.*, 844 F. Supp. 2d 1116, 1127 (D. Idaho 2012) ("Any permit noncompliance constitutes a violation of the CWA and is grounds for an enforcement action."). The CWA also imposes liability on a party who (i) performed work authorized by a permit for the discharge of dredged or fill material to navigable waters or (ii) had responsibility for or control over the performance of the work. *Stillwater of Crown Point Homeowner's Ass'n, Inc. v. Kovich*, 820 F. Supp. 2d 859, 887 (N.D. Ind. 2011).

[68] No. 93-281-CIV-FTM-21, 1996 WL 479533, at *15 (M.D. Fla. Aug. 20, 1996).

[69] *Id*.

[70] *Id*. at *15–16.

4. FHC Groups Can Adopt Policies and Procedures that Appropriately Limit the Risk of Federal Statutory Environmental Liability

As the foregoing overview demonstrates, the circumstances under which the ownership of commodities or the ownership or operation of facilities can give rise to liability under federal law are well established. Accordingly, adopting appropriate policies and procedures governing their conduct with respect to such investments can enable FHCs and their affiliates to limit the risk of direct liability under federal environmental law.[71]

On this basis, FHCs and their affiliates may conduct normal and prudent shareholder or board-of-directors oversight over portfolio companies and other investees that engage in environmentally sensitive activities without incurring a material risk of direct liability under federal environmental statutes, so long as they avoid controlling the day-to-day, routine, or ordinary-course activities of those portfolio companies and other investees relating to physical-commodities activities. In addition, FHCs and their affiliates may entrust physical commodities they own to qualified shipping and storage companies without incurring a material risk of such liability for discharges that are beyond their control to prevent, provided that they do not, beyond the necessary due diligence, exercise day-to-day operational control over such facilities. Consistent with these principles, the practices summarized in Exhibit 1 of this Appendix A, when implemented in whole or in part, depending on the relevant legal and operational risks associated with the particular activity, should afford FHCs and their affiliates significant protection from potential liability based on their physical-commodity activities.

[71] These decisions are already subject to the Board's supervision and examination and safety and soundness standards. Because courts look to similar factors under CERCLA, OPA, CWA, and other federal environmental laws in determining the direct liability of a parent entity, the same practices will help avoid liability risk under all three statutes. Courts have also applied the *Bestfoods* liability analysis to other environmental laws.

Indeed, the Board's Supervisory Letters have long recognized the value of such safeguards. Beginning in 1991, the Board identified steps that banking organizations can take to protect against the risk of environmental liability, particularly from sites contaminated with hazardous waste.[72] The Board has recognized that "[b]anks may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess, and control environmental liability."[73] Such actions must be carefully balanced such that "any policies and procedures undertaken to assess and control environmental liability cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business."[74] The Board has thus recognized the availability of effective policies and procedures to limit risk of environmental liability.[75]

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[72] *See* Federal Reserve, Supervisory Letter SR-91-20 "Environmental Liability" (Oct. 11, 1991), *available at* http://www.federalreserve.gov/boarddocs/srletters/1991/SR9120.HTM (providing a list of safeguards and controls to limit the exposure of banking organizations to potential environmental liability).

[73] Div. of Banking Supervision and Regulation, Bd. of Governors of the Fed. Reserve Sys., Commercial Bank Examination Manual § 2040.1, at p. 22 (Apr. 2012), *available at* http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf.

[74] *Id*. at 22.1.

[75] In addition, the Board has placed limits on FHCs in the complementary-authority context that: (i) limit the aggregate market value of commodities held as a result of physical-commodity trading to no more than five percent of tier 1 capital; (ii) generally limit trading to commodities approved by the Commodity Futures Trading Commission for trading on U.S. futures exchanges; and (iii) require insurance policies to address risks associated with environmentally sensitive commodities. *See The Royal Bank of Scotland Group plc*, 94 Fed. Res. Bull. C60 (2008) (approving The Royal Bank of Scotland plc's proposal to engage in physical-commodity trading where The Royal Bank of Scotland plc agreed to limit the aggregate market value of commodities held as a result of physical-commodity trading to no more than five percent of tier 1 capital, and generally limit trading to commodities approved by the Commodity Futures Trading Commission); *Citigroup Inc.*, 89 Fed. Res. Bull. 508 (2003) (approving Citigroup's proposal to engage in physical-commodity trading where Citigroup committed to the Board that the owners of the vessels that carry oil on its behalf will carry certain kinds of insurance, that such vessels will be of a certain age and quality, and that it will hire inspectors to monitor the oil storage facilities that it uses). The Board has also limited the scope of FHC involvement with energy-management services. *Fortis S.A./N.V.*, 94 Fed. Res. Bull. C20 (2008). *See generally* Div. of Banking Supervision and Regulation, Bd. of Governors of the Fed. Reserve Sys., Bank Holding Co. Supervision Manual: Limited Physical-Commodity-Trading Activities (Section 4(k) of the BHC Act) § 3920.0 (July 2008), *available at* http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc.pdf.

B. State Statutory and Common Law Liability Risk

1. State Statutes

State statutory regimes impose various liabilities and remediation obligations for releases of environmentally sensitive commodities. The vast majority of state statutes mirror the federal statutes discussed in the previous section, and do not impose liability on a commodity owner merely because its product has been released. There are a minority of state statutes that impose varying degrees of liability on commodity owners in the event of a release.[76]

Depending on the particular state, the scope of actions that can lead to liability for commodity owners under these statutes is limited in various ways. For example, most of the statutes apply only to the release of oil, and not to other commodities.[77] Some of these statutes are further narrowed to apply only to substances that enter the waters of a particular state.[78] Other states impose liability on a cargo owner only when the vessel owner or operator cannot pay for cleanup, and only if the vessel owner and operator were not in compliance with state financial-security requirements at the time of the release.[79] Under some state statutes, commodity owners can be held liable for cleanup costs, but not damages, resulting from a spill.[80] This is

[76] *See* Alaska Stat. § 46.03.822(a); Cal. Gov't Code § 8670.3; Conn. Gen. Stat. § 22a-451(a); Fla. Stat. § 376.12(10); Md. Code Ann., Envir. §§ 4-401(i)(1), 4-405(c), 4-409(a); N.C. Gen. Stat. § 143-215.94CC; N.J. Admin. Code § 7:1E-1.6; N.Y. Envtl. Conserv. Law § 71-1941; Or. Rev. Stat. § 468B.310(1); Wash. Rev. Code § 90.56.370(1). Additional state laws may govern duties and liability with respect to the transportation, storage, and handling of other types of commodities.

[77] *Cf.* Alaska Stat. § 46.03.822(a) (covering hazardous substances) *with* Cal. Gov't Code § 8670.3; Fla. Stat. § 376.12(10); Md. Code Ann., Envir. §§ 4-401(i)(1), 4-409(a); N.Y. Envtl. Conserv. Law §71-1941; Or. Rev. Stat. § 468B.310(1); Wash. Rev. Code § 90.56.370(1) (covering oil). Other states provide broader liability for those who cause contamination, but only hold substance owners responsible under a more narrow set of facts. For example, the Connecticut statute applies to owners of "hazardous wastes deemed by the commissioner to be a potential threat to human health or the environment and removed by the commissioner," while those who cause contamination can be held responsible for a wider range of actions. *See* Conn. Gen. Stat. § 22a-451(a).

[78] *See, e.g.*, Fla. Stat. § 376.12(10); Or. Rev. Stat. § 468B.310(1); N.C. Gen. Stat. § 143-215.94CC; Wash. Rev. Code § 90.56.370(1).

[79] Fla. Stat. § 376.12.

[80] *See, e.g.*, Md. Code, Envir. § 4-405(c); Fla. Stat. § 376.12.

significant because cleanup costs tend to be much more limited than the costs that can result from other damages. In addition, the state statutes provide defenses that would protect an FHC engaged in mere commodity ownership from liability, including defenses that apply when a release is caused solely by the intentional or negligent act or omission of a third party.[81]

In practice, the few state statutes that could create liability for commodity owners have not been used to target those parties. Instead, the cases focus on the facility owners or operators, the arrangers and transporters of the substances, or those who are responsible for causing releases, as discussed in the previous section.[82] For all but one of the state statutes that could, in theory, create liability for a mere commodity owner, we found no case in which a court held a party liable for damages or other costs associated with a spill based solely on its status as the owner of the commodity. And even with respect to that one statute, we have found only two instances where a court held a mere commodity owner liable under any of these state statutes. Both cases occurred more than 10 years ago, and neither involved an FHC.

The case law indicates that FHCs are unlikely to be held liable for mere commodity ownership under state statutory law. However, in view of these disparate state approaches, an FHC should, to the extent appropriate in the context of the risk profile presented in the particular

[81] *See, e.g.*, Alaska Stat. § 46.03.822(b)(1)(B)(providing a defense when "except as provided under AS 46.03.823(c) and 46.03.825(d), an intentional or negligent act or omission of a third party, other than a party or its agents in privity of contract with, or employed by, the person, and that the person (i) exercised due care with respect to the hazardous substance; and (ii) took reasonable precautions against the act or omission of the third party and against the consequences of the act or omission"); Cal. Gov't Code § 8670.56.5(b) ("A responsible person is not liable to an injured party under this section for any of the following . . . Damages caused solely by the negligence or intentional malfeasance of that injured party. [] Damages caused solely by the criminal act of a third party other than the defendant or an agent or employee of the defendant. [] Natural seepage not caused by a responsible party."); Fla. Stat. § 376.12(9) ("Liability of third parties.--In any case in which a responsible party establishes that a discharge or threat of a discharge and the resulting cleanup costs and damages were caused solely by an act or omission of one or more third parties."); N.C. Gen. Stat. § 143-215.94CC(b) ("A responsible person is not liable [for] . . . Damages caused solely by the negligence or intentional malfeasance of that injured party. [] Damages caused solely by the criminal act of a third party. . . Natural seepage not caused by a responsible person.").

[82] In some cases, the owner of the commodity is also the owner or operator of the facility or vessel from which the release occurred. In these cases, the party can be held liable based on its status as the facility or vessel owner or operator, as discussed in the previous section on federal law.

situation, conduct a jurisdiction-by-jurisdiction evaluation of the liability regimes applicable to any particular investments and activities. An FHC's review and decision making with respect to the risks of such investments and activities should be conducted in the context of the FHC's normal risk-management process, subject to board oversight.

2. Common Law

State common-law tort doctrines also present potential bases for liability for environmental harms. Persons that engage in transportation, storage, and other activities may be subject to liability on a number of theories, including strict liability in the case of abnormally dangerous activities. State common-law tort doctrines do not, however, impose liability for releases of hazardous materials or similar catastrophic events based on mere ownership of physical commodities. As discussed below, owners of commodities will be held liable for such occurrences only if they cause or contribute to an event causing a loss or are otherwise engaged in "operator" activities such as transportation, storage, generation, or processing.

a. Nuisance

Common-law liability for nuisance generally may be imposed where an entity causes an invasion of another's interest in the use and enjoyment of land and the invasion is either (i) "intentional and unreasonable" or (ii) otherwise actionable as a tort (for instance, as negligence or strict liability).[83] With regard to the first category, an invasion is "intentional" only where an actor has the purpose of causing the invasion or knows that the invasion is substantially certain to result from the actor's conduct.[84] An invasion is generally not intentional when an invasion takes place accidentally.[85] To determine whether an invasion is "unreasonable," a court

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[83] Restatement (Second) of Torts § 822; *see also Scribner v. Summers*, 84 F.3d 554, 559 (2d Cir. 1996).

[84] Restatement (Second) of Torts § 825.

[85] *Id.*

will compare the gravity of the harm caused by the invasion to the utility of the conduct, as well as the financial burdens of compensating for any harm caused to others.[86] In most instances, it would be difficult to prove that any interference with another's property arising out of mere ownership of commodities or their ordinary course transportation or storage was both "intentional" and "unreasonable."[87] As a result, FHCs and affiliates that invest in commodities will not ordinarily be liable under the first category of nuisance claims. Under the second category of nuisances, commodity owners could be liable where an invasion is otherwise actionable as a tort. As explained below, this too is unlikely unless the FHCs and their affiliates engage in activity beyond mere ownership of the released commodity.

b. Trespass

Common-law liability for trespass generally may be imposed where an entity intentionally enters, or causes a thing to enter, land in the possession of another, or where such entry is reckless or negligent and causes actual harm.[88] As is the case with nuisance, "intent" is defined as acting for the purpose of causing the invasion or with the belief that the invasion is substantially certain to result from the actor's conduct.[89] Thus, courts have been reluctant to find liability for unintentional trespass stemming from pollution activities.[90] In most instances, mere

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[86] *Id*. § 826.

[87] *See, e.g.*, *Gussack Realty Co. v. Xerox Corp.*, 224 F.3d 85, 94 (2d Cir. 2000) (finding that spills resulting from "simple and small-scale accidents or carelessness," "combined with a non-obvious theory of causation," could not give rise to a nuisance claim as there was "not the kind of intentional conduct" required for a state-law nuisance claim).

[88] Restatement (Second) of Torts §§ 158, 165.

[89] *See, e.g.*, *Brutsche v. City of Kent*, 193 P.3d 110, 116 n.7 (Wash. 2008); *see generally* Restatement (Second) of Torts § 8A.

[90] *See, e.g.*, *In re Oil Spill by the Oil Rig "Deepwater Horizon*," MDL No. 2179, 2011 U.S. Dist. LEXIS 131069, at *48 (E.D. La. Nov. 14, 2011) (finding that Louisiana's trespass claims in the context of the *Deepwater Horizon* spill were subsumed by its negligence claims, because the complaint failed to allege "that any Defendant intended to place oil [on] its property" and, as to unintentional trespass, offshore drilling was not an ultra-hazardous activity and "except in instances involving ultra-hazardous activity, a defendant is liable only when his conduct is negligent, and only for the harm caused"); *Rudd v. Electrolux Corp.*, 982 F. Supp. 355, 370 (M.D.N.C. 1997) (holding that "the

ownership of commodities or their ordinary course transportation or storage should not give rise to the type of intent necessary to support a trespass claim.

c. Negligence and Negligent Entrustment

An entity may be liable under a theory of negligence if it engages in "conduct that creates or fails to avoid unreasonable risks of foreseeable harm to others."[91] Principles of corporate separateness, as discussed in Part II, are the main protection for FHCs against the risk of negligence liability. Any risk of such negligence liability would (i) stem from operational activities beyond mere commodity ownership or arrangement for transportation or storage in the ordinary course,[92] or (ii) arise under a negligent-entrustment theory, which is a doctrine concerning the particular duty of care owed in the context of entrusting goods to another.[93]

Liability for negligent entrustment could potentially arise in the event that (i) an owner of environmentally sensitive commodities negligently entrusted the commodities to an incompetent transportation or storage facility, and (ii) the incompetent facility allowed a discharge of the commodities.[94] In some jurisdictions, an owner can be held liable for negligent entrustment if it knew or should have known that the third party to whom the material was entrusted was

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unintentional, non-negligent discharge of a hazardous substance on [defendants'] property alone does not constitute a trespass, particularly when they had no knowledge of the leak," even where it migrates onto the plaintiff's property); *United Proteins, Inc. v. Farmland*, 915 P.2d 80, 84 (Kan. 1996) (reversing trial court's finding that a discharge of hexavalent chromium gave rise to trespass, finding that there was "no basis to conclude the discharge of hexavalent chromium was either purposeful or substantially certain to occur").

[91] 1 Dobbs et al., The Law of Torts § 126 (2d ed. 2011).

[92] For example, negligence for activities beyond mere commodity ownership or arrangement for transportation or storage in the ordinary course has been alleged in the ongoing litigation concerning the train derailment and fire that occurred in Lac-Mégantic, Quebec. *See Keach v. World Fuel Servs. Corp.*, Bk. No. 1:13-bk-10670 (Bankr. D. Me. filed Jan. 30, 2014). According to the plaintiffs, World Fuel Services entities were extensively involved in all aspects of the transportation of the crude oil, including providing inappropriate rail cars to transport the oil.

[93] *See, e.g.*, *Casebolt v. Cowan*, 829 P.2d 352, 355–56 (Colo. 1992) (discussing the doctrine of negligent entrustment).

[94] Restatement (Second) of Torts § 390 (1965).

incompetent;[95] in other jurisdictions, the owner must have actual knowledge of such incompetence.[96] Additionally, the sale of a commodity, as opposed to its entrustment, does not give rise to a negligent-entrustment claim in some jurisdictions.[97]

FHCs and their affiliates can effectively minimize any risk of negligent-entrustment liability by conducting adequate due diligence on companies hired to transport or store the commodities in which they invest. The appropriate scope of due diligence will vary depending upon the underlying commodity and the nature of any trading partners.[98] One commonly used procedure is to hire a qualified third-party contractor who is responsible for vetting unaffiliated transporters and storage operators to assess their regulatory-compliance histories and to confirm the adequacy of their assets, storage facilities, and management systems.[99] In addition, contracts with transportation and storage companies may allocate the risks of unauthorized releases to those companies and provide indemnification or insurance from well-capitalized entities in the

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[95] *Id.*; *see Shaffer v. Maier*, Nos. C-900573, C-900600, 1991 WL 256493, at *8 (Ct. App. Ohio Dec. 4, 1991) (affirming a directed verdict in favor of defendant because there was no proof that the defendant knew, or knew of facts and circumstances as would allow an inference that it knew, that the third party it engaged to refuel an airplane was incompetent), *rev'd on other grounds*, 68 Ohio St. 3d 416 (1994).

[96] *See, e.g.*, *Downs v. Panhandle E. Pipeline Co.*, 694 N.E.2d 1198, 1207 (Ind. Ct. App. 1998) (requiring actual knowledge to state a negligent-entrustment claim under Indiana law).

[97] *See Thompson v. Mindis Metals, Inc.*, 692 So. 2d 805, 807 (Ala. 1997) (finding that there could be no negligent entrustment where the defendants transferred their complete ownership interests in the cargo and retained no dominion or control over them); *Nat'l Convenience Stores, Inc. v. T.T. Barge Cleaning Co.*, 883 S.W.2d 684, 687 (Tex. App.—Dallas 1994) ("The Texas cause of action does not hold a seller of a chattel liable under negligent entrustment."). *But see* Restatement (Second) of Torts § 390 (1965), cmt. (a) (providing for negligent entrustment resulting from a sale).

[98] As a practical matter, the scope of an owner's due-diligence inquiry will vary based on the trading scenario being pursued by the company and the industry prominence of the entities that an owner engages to transport and/or store its physical commodities before their sale to a subsequent owner. For example, a lesser degree of due diligence is required when a simultaneous purchase and sale of commodities takes place than when an owner contracts to sell commodities to a subsequent owner at another location, necessitating the first owner's arrangement for shipment or storage of the commodity.

[99] This option avoids any potential argument that due diligence is so extensive as to constitute the operation of the facility in question.

unlikely event that the commodity owner is subjected to liability for discharges during shipping or storage.

d. Strict Liability

Strict liability is a common-law doctrine that imposes liability on any person who conducts an abnormally dangerous activity that proximately causes harm to the person, land, or chattels of another, even if the person who conducts that activity has exercised the utmost care to prevent the harm.[100] In determining whether an activity is abnormally dangerous, courts consider factors such as (i) the degree of risk of harm; (ii) the likelihood that any resulting harm will be great; (iii) the inability to eliminate risk; (iv) whether the activity is common in the area; (v) the appropriateness of the activity to the area; and (vi) whether the danger of the activity outweighs its social value.[101]

Mere ownership of physical commodities generally is not the kind of activity that courts find to be abnormally dangerous.[102] A company could be subject to strict liability, however, if it engages in the handling, transportation or storage of certain materials, including radioactive materials and other particularly hazardous substances.[103] FHCs and their affiliates can effectively

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[100] Restatement (Second) of Torts § 519 (1977).

[101] *Id*. § 520; *see also Abbatiello v. Monsanto Co.*, 522 F. Supp. 2d 524, 531 (S.D.N.Y. 2007) (explaining that New York courts examine six factors listed in Restatement (Second) of Torts § 520 when analyzing strict-liability claims).

[102] *See Indiana Harbor Belt R.R. Co. v. Am. Cyanamid Co.*, 916 F.2d 1174, 1181 (7th Cir. 1990) (noting that "ultrahazardousness or abnormal dangerousness is, in the contemplation of the law at least, a property not of substances, but of activities: not of [a particular chemical], but of the transportation of [that chemical] by rail through populated areas"); *Valentine v. Pioneer Chlor Alkali Co. Inc.*, 109 Nev. 1107, 1110, 864 P.2d 295, 297 (1993) (holding that dangerous substances do not give rise to strict liability unless the activity involving that substance is abnormally dangerous); *Erbich Prod. Co., Inc. v. Wills*, 509 N.E.2d 850, 856 (Ind. Ct. App. 1987) (finding the fact that a substance is dangerous "not determinative" in deciding whether to impose strict liability).

[103] *See Indiana Harbor Belt*, 916 F.2d at 1182 (holding that the shipper of acrylonitrile, a hazardous chemical, by rail was not strictly liable for the consequences of a spill, but stating that the court "need not speculate on the possibility of imposing strict liability on shippers of more hazardous materials" such as bombs); *cf. Avemco Ins. Co., Inc. v. Rooto Corp.*, 967 F.2d 1105, 1107–09 (6th Cir. 1992) (affirming the district court's conclusion that storage of

manage this risk by implementing controls to ensure (a) that they do not engage in handling, transportation or storage activities with respect to such materials and (b) that any such activities conducted by any other affiliates are sufficiently separated from the FHC and its other IDI and non-IDI affiliates.

e. Negligence *Per Se*

A plaintiff seeking to impose liability under the doctrine of negligence *per se* must prove that the defendant's injurious conduct violated a statute or regulation designed to protect people in the plaintiff's position.[104] Because negligence *per se* applies only if a statute or regulation is violated, the policies and procedures described above and in Exhibit 1 of this Appendix A that limit the risk that an FHC or its affiliates will bear liability under the environmental laws also effectively limit the risk of any finding of negligence *per se*.[105]

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tanks of hydrochloric acid was not an ultrahazardous activity under Michigan law because the chemicals created little risk of harm while in storage and the risk was capable of elimination by exercise of reasonable care).

[104] *See Key v. Liquid Energy Corp.*, 906 F.2d 500, 506 (10th Cir. 1990) (holding that the duties imposed by transportation-safety regulations are owed to the general public as well as parties who transport or sell hazardous materials in their dealings with one another); *Poliskie Line Oceaniczne v. Hooker Chem. Corp*., 499 F. Supp. 94, 97 (S.D.N.Y. 1980) (holding that a company's violation of regulations regarding stowage of drums of a hazardous chemical would constitute negligence *per se* with respect to harm caused by an accident involving the chemical).

[105] In addition, these risks are limited by careful and prudent compliance by operating entities with permitting and operational requirements set forth in any applicable statutes. For example, the Hazardous Materials Transportation Act requires compliance with regulations for transporting hazardous materials promulgated by the Secretary of Transportation. 49 U.S.C. § 5106; 49 C.F.R. § 171.2. These regulations first classify different types of hazardous materials and then specify the types of packaging that must be used when transporting each class of materials. *See generally* 49 C.F.R. §§ 172.101, 173.240–.249 (listing hazardous materials and bulk packaging requirements). The regulations also require that persons offering or accepting hazardous materials for transportation register with the Department of Transportation, subject to certain exceptions for smaller-quantity shipments. 49 C.F.R. §§ 171.2(d), 107.601. Another example is the Pipeline Safety Act, which requires compliance with regulations promulgated by the Secretary of Transportation, setting "minimum safety standards for pipeline transportation and for pipeline facilities." 49 U.S.C. § 60102(a)(2). These regulations establish a variety of requirements, including as to pipeline construction, pipeline design, pipeline testing, pipeline operations, and qualifications of personnel. 49 C.F.R. pt. 192. A separate set of regulations applies to liquefied-natural-gas facilities. 49 C.F.R. pt. 193. The Pipeline Safety Act also requires regular pipeline inspection and maintenance. 49 U.S.C. § 60108.

f. Additional Protections from Common-Law Liability

In some situations, federal law will prevent courts from applying state common-law regimes to impose liability for contamination caused by environmental incidents. For instance, the U.S. Court of Appeals for the Fifth Circuit recently held, in the context of the *Deepwater Horizon* incident, that the regulatory structure provided by Congress in the CWA and OPA preempts the application of state law to claims arising from an oil spill that occurs outside state waters, such as in the waters of another state or in the Outer Continental Shelf.[106] Similarly, and despite potential concerns about the unpredictability of climate change liability and consequent insurance coverage,[107] the Supreme Court has held that any cause of action to address climate-change-causing power plant emissions under a theory of federal common-law nuisance is displaced by the Clean Air Act's grant of regulatory authority to EPA to address those emissions.[108] As a result, there are significant limitations to common-law theories of liability that a commodity owner could incur for a product release.[109] And, in the event that tort liability is

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[106] *In re Deepwater Horizon*, 745 F.3d 157, 174 (5th Cir. 2014) (citing *Int'l Paper Co. v. Ouellette*, 479 U.S. 481 (1987)).

[107] *See Am. Elec. Power Co. v. Connecticut*, 564 U.S. 410 (2011).

[108] *Id.* at 424. ("We hold that the Clean Air Act and the EPA actions it authorizes displace any federal common law right to seek abatement of carbon-dioxide emissions from fossil-fuel fired power plants.").

[109] Not all state common-law claims are categorically preempted by federal environmental statutes. Even where not categorically preempted, they may be barred as a matter of conflict preemption in some instances. For instance, personal injury and property damage tort claims typically are not categorically preempted under CERCLA. *See, e.g.*, *Village of DePue, Ill. v. Exxon Mobil Corp.*, 537 F.3d 775, 786 (7th Cir. 2008) ("CERCLA contemplates 'action[s] brought under State law for personal injury, or property damages, which are caused or contributed to by exposure to any hazardous substance, or pollutant or contaminant, released into the environment from a facility.'" (alteration in original) (quoting 42 U.S.C. § 9658(a)(1))). Further, the Supreme Court has held that "nothing in the [Clean Water] Act bars aggrieved individuals from bringing a nuisance claim pursuant to the law of the source State." *Ouellette*, 479 U.S. at 497; *see also In re Deepwater Horizon*, 745 F.3d at 174 (noting that state-law claims would not be preempted by CWA or OPA for sources of pollution "on the land or navigable waters within a state," and that preemption is "limited to situations in which the affected state is not the point source jurisdiction"). In addition, state-law nuisance, negligence, and trespass claims have been found by one court not to be categorically preempted by the Clean Air Act, although the scope of the Supreme Court's decision in *American Electric Power Co. v. Connecticut*, 131 S. Ct. 2527 (2011), has yet to be settled. *See Bell v. Cheswick Generating Station*, 734 F.3d 188, 197 (3d Cir. 2013), *cert. denied*, 134 S. Ct. 2696 (2014). *But see N.C. ex rel. Cooper v. TVA*, 615 F.3d 291, 302–03 (4th Cir. 2010) (holding that state common-law nuisance claims are generally preempted by the Clean Air Act).

imposed upon an affiliated operating entity, an FHC can find additional protection by in taking appropriate steps to prevent veil-piercing liability, as described in Part II.

C. Effectiveness of Existing Environmental Laws

Having discussed the established legal principles and regulatory practices that protect FHCs and their affiliates against environmental liability, it is also worth noting that the environmental regulatory system is generally effective in minimizing the frequency and scale of environmental incidents that may give rise to liability in the first instance. Environmental regulatory agencies have responded in a robust fashion to emerging environmental threats and to the lessons learned from significant environmental events, such as large oil spills. In addition, companies are adopting sophisticated environmental management systems to assure the integrity of their environmental compliance and performance. The combination of comprehensive regulation and active responses to environmental incidents has resulted in a significant decrease in pollution events.[110]

Environmental regulation has grown ever more comprehensive and sophisticated. EPA administers some two dozen pollution-control laws, as well as numerous Executive Orders, and has issued thousands of pages of detailed interpretive regulations and other guidance documents pursuant to these laws.[111] Other agencies administer a wide range of pertinent rules, and states

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[110] *See infra* notes 120–25.

[111] *See* Atomic Energy Act, 42 U.S.C. §§ 2011–2297h-13; Chemical Safety Information, Site Security and Fuels Regulatory Relief Act, Pub. L. No. 106-40, 113 Stat. 211; Clean Air Act, 42 U.S.C. §§ 7401–7671q; Clean Water Act (Federal Water Pollution Control Amendments of 1972), 33 U.S.C. §§ 1251–1387; Comprehensive Environmental Response, Compensation, and Liability Act (Superfund), 42 U.S.C. §§ 9601–9675; Emergency Planning and Community Right-to-Know Act, 42 U.S.C. §§ 11004–50; Endangered Species Act, 16 U.S.C. §§ 1531–1544; Energy Independence and Security Act, 42 U.S.C. §§ 17001–17386; Energy Policy Act, 42 U.S.C. §§ 15801–16538; Federal Food, Drug, and Cosmetic Act, 21 U.S.C. §§ 301–399f; Federal Insecticide, Fungicide, and Rodenticide Act, 7 U.S.C. §§ 136–136y; Food Quality Protection Act, Pub. L. No. 104-170, 110 Stat. 1491; Marine Protection, Research, and Sanctuaries Act (Ocean Dumping Act), 16 U.S.C. § 1431–1445c-1 and 33 U.S.C. §§ 1441–1445; National Environmental Policy Act, 42 U.S.C. §§ 4321–4370h; National Technology Transfer and Advancement Act, 15 U.S.C. §§ 3701–3722; Noise Control Act, 42 U.S.C. §§ 4901–4918; Nuclear Waste Policy Act, 42 U.S.C. §§ 10101–10270; Occupational Safety and Health Act, 29 U.S.C. §§ 651–678; Oil Pollution Act, 33

have their own complementary system of regulation.[112] These state and federal agencies frequently update, expand, and refine environmental regulations to improve their effectiveness.[113] By creating incentives for careful environmental performance, environmental enforcement serves an important deterrent function.[114]

U.S.C. §§ 2701–2762; Pollution Prevention Act, 42 U.S.C. §§ 13101–13109; Resource Conservation and Recovery Act, 42 U.S.C. §§ 6901–6992k; Safe Drinking Water Act, 42 U.S.C. §§ 300f–300j-26; Shore Protection Act, 33 U.S.C. §§ 2601–2623; Toxic Substances Control Act, 15 U.S.C. §§ 2601–2697; Exec. Order No. 12,898, 59 Fed. Reg. 7629 (Feb. 16, 1994): Federal Actions to Address Environmental Justice in Minority Populations and Low-Income Populations; Exec. Order No. 13,045, 62 Fed. Reg. 19,885 (Apr. 23, 1997): Protection of Children from Environmental Health Risks and Safety Risks; Exec. Order No. 13,211, 66 Fed. Reg. 28,355 (May 22, 2001): Actions Concerning Regulations That Significantly Affect Energy Supply, Distribution, or Use; *see also* 40 C.F.R. pts. 1–1700.

[112] *See* Council on Environmental Quality, Regulations for Implementing the Procedural Provisions of the National Environmental Policy Act, Appendix II: Federal and Federal-State Agencies with Jurisdiction by Law or Special Expertise on Environmental Quality Issues, 49 Fed. Reg. 49,754–78 (1984) (listing federal agency environmental authorizations); Jonathan H. Adler, *When is Two a Crowd? The Impact of Federal Action on State Environmental Regulation*, 31 Harv. Envtl. L. Rev. 67 (2007) (providing an overview of state environmental regulations).

[113] Multiple federal agencies have recently issued proposed or final rules, or implemented new policies, that may be pertinent to FHC commodity activities. *See, e.g.* Bureau of Ocean Energy Management, NTL No. 2016-N01, Notice to Lessees and Operators of Federal Oil and Gas, and Sulfur Leases, and Holders of Pipeline Right-of-way and Right-of-use Easement Grants in the Outer Continental Shelf (July 14, 2016) (increasing the financial assurance requirements for lessees and operators to cover future potential decommissioning obligations); Bureau of Safety and Environmental Enforcement, Oil and Gas and Sulfur Operations in the Outer Continental Shelf—Blowout Preventer Systems and Well Control, 81 Fed. Reg. 25,887 (Apr. 29, 2016) (adopting industry standards in the areas of well design, well control, casing, etc., and implementing recommendations from various investigations of the Deepwater Horizon incident); Pipeline and Hazardous Materials Safety Administration, Hazardous Materials: Reverse Logistics (RRR), 81 Fed. Reg. 18,527 (Mar. 31, 2016) (establishing a regulatory definition of 'reverse logistics' and outlining the responsibilities of those that offer hazardous materials returned by retail customers); Environmental Protection Agency, Final Rule: Accidental Release Prevention Requirements: Risk Management Programs Under the Clean Air Act, 82 Fed. Reg. 4594 (January 13, 2017) (amending existing Risk Management Program regulations proposed to improve chemical process safety, assist local emergency authorities, and improve public awareness of chemical hazards at regulated sources; currently under a temporary implementation freeze by the new administration); Pipeline and Hazardous Materials Safety Administration, Proposed Rule: Pipeline Safety: Safety of Hazardous Liquid Pipelines, 80 Fed. Reg. 61,609 (Oct. 13, 2015) (proposing changes to the hazardous liquid pipeline safety regulations); Pipeline and Hazardous Materials Safety Administration, Proposed Rule: Pipeline Safety: Plastic Pipe Rule, 80 Fed. Reg. 29,263 (May 21, 2015) (proposing to amend existing regulations to address regulatory requirements involving plastic piping systems used in gas services); Pipeline and Hazardous Materials Safety Administration, Hazardous Materials: Enhanced Tank Car Standards and Operational Controls for High-Hazard Flammable Trains, 80 Fed. Reg. 26,644 (May 8, 2015) (adopting requirements designed to reduce the consequences and, in some instances, reduce the probability of accidents involving trains transporting large quantities of flammable liquids); Bureau of Ocean Energy Management, Consumer Price Index Adjustments of the Oil Pollution Act of 1990 Limit of Liability for Offshore Facilities, 79 Fed. Reg. 73,832 (Dec. 12, 2014) (increasing the limit of liability for damages under the OPA from $75 million to $133.65 million); Pipeline and Hazardous Materials Safety Administration, Proposed Rule: Pipeline Safety: Safety of Gas Transmission and Gathering Pipelines, 81 Fed. Reg. 20,721 (Apr. 8, 2016) (proposing the adoption and expansion of risk-based safety practices to pipelines not currently covered under existing regulations); EPA, Financial Responsibility Requirements Under CERCLA § 108(b) for Classes of Facilities in the Hardrock

In part as a consequence, operating companies are increasingly adopting standardized environmental management systems to assure the integrity of their compliance with environmental rules.[115] Through 2015, the last year for which statistics are available, at least 319,324 ISO 14001:2004 certificates—evidencing compliance with this leading global environmental management standard[116]—had been issued worldwide.[117] This combination of public and private standards and restrictions serve to reduce the risks involved in commodity-related activities in the first instance. Further, when environmental incidents have occurred,

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Mining Industry, 82 Fed. Reg. 3388 (Jan. 11, 2017). None of these actions is likely to have the effect of imposing liability on mere owners of physical commodities.

[114] *See* Jay Shimshack, *Monitoring, Enforcement, & Environmental Compliance: Understanding Specific & General Deterrence: State-of-Science White Paper* (Oct. 2007), *available at* http://www.epa.gov/compliance/resources/reports/compliance/research/meec-whitepaper.pdf (prepared for Tufts University under contract in response to EPA RFQ TC0078); Mark A. Cohen, *Empirical Research on the Deterrent Effect of Environmental Monitoring and Enforcement*, 30 Envtl. Law 10, 245 (Apr. 2000).

[115] *See generally* Position Statement on Environmental Management Systems (EMSs), 71 Fed. Reg. 5664 (Feb. 2, 2006) ("EMSs provide organizations of all types with a structured system and approach for managing environmental and regulatory responsibilities to improve overall environmental performance and stewardship.").

[116] ISO 14001:2004 "specifies requirements for an environmental management system to enable an organization to develop and implement a policy and objectives which take into account legal requirements and information about significant environmental aspects." ISO 14001:2004 Introduction, *available at* https://www.iso.org/obp/ui/#iso:std:iso:14001:ed-2:v1:en. The purpose of the standard is to ensure that the EMS will enable the organization "to comply with applicable legal requirements and with other requirements to which the organization subscribes." *Id*. The EMS must identify the organization's activities that may have a significant environmental impact, establish performance objectives, be implemented to achieve those objectives (*e.g.*, through employee training), establish a system for taking corrective action, and provide for periodic reviews of the EMS by top management to make any necessary adjustments. EPA, *Environmental Management Systems/ISO 14001, available at* http://water.epa.gov/polwaste/wastewater/Environmental-Management-System-ISO-14001-Frequently-Asked-Questions.cfm. "The program also includes a private third-party auditing and certification scheme to verify compliance and implementation." David A. Wirth, *The International Organization for Standards*, 36 B.C. Envtl. Aff. L. Rev. 79, 83 (2009). EPA has stated that properly implemented EMS programs under this standard "could serve as a valuable tool to help organizations improve their environmental performance, increase the use of pollution prevention, and improve compliance." EPA, *Environmental Management Systems/ISO 14001, available at* http://water.epa.gov/polwaste/wastewater/Environmental-Management-System-ISO-14001-Frequently-Asked-Questions.cfm.

[117] *See ISO Survey 2015*, *available at* http://www.iso.org/iso/the_iso_survey_of_management_system_standard_certifications_2015.pdf.

industry and government have rapidly responded by studying the events, innovating, and strengthening the regulatory framework to reduce the risk of recurrence.[118]

[118] There are a number of prominent examples of such rapid responses by industry and government. In the wake of the 2013 West Texas fertilizer plant explosion, for example, the President issued an Executive Order calling for, among other things, enhanced coordination among agencies and levels of government, better information sharing, and the promotion of industry best practices—all designed to improve chemical facility safety and security and reduce the risks of future incidents. Exec. Order No. 13650, 78 Fed. Reg. 48,033 (Aug. 1, 2013). *See also* Envtl. Prot. Agency, Proposed Rule, Modernization of the Accidental Release Prevention Regulations Under Clean Air Act, 81 Fed. Reg. 13,638 (March 14, 2016); Occupational Safety and Health Admin., Request for Information, Process Safety Management and Prevention of Major Chemical Accidents, 78 Fed. Reg. 73,756 (Dec. 9, 2013).

Since the *Deepwater Horizon* incident, a Joint Industry Oil Spill Preparedness and Response Task Force was formed, and the industry has responded further by significantly increasing the level of preparedness and devising self-regulatory structures to improve its safety culture. *See* Joint Indus. Oil Spill Preparedness and Response Task Force, Second Progress Report on Industry Recommendations to Improve Oil Spill Preparedness and Response (Nov. 16, 2012), *available at* http://www.api.org/~/media/Files/Oil-and-Natural-Gas/Exploration/Offshore/OSPR-JITF-Project-Progress-Report.pdf. Two industry consortia have developed significant response capabilities, including new high capacity deepwater well blowout containment systems. *See* Marine Well Containment Co. website, *available at* [https://marinewellcontainment.com/containment.php]; Jennifer A. Dlouhy, *Feds, industry workers finish test of emergency offshore equipment*, FuelFix.com (May 7, 2013), *available at* http://fuelfix.com/blog/2013/05/07/feds-industry-workers-finish-test-of-emergency-offshore-equipment/.

Likewise, the federal government engaged in an extensive study of the *Deepwater Horizon* incident and completely reformulated the structure of government oversight and regulatory activities in response to the accident—even creating new regulatory agencies. These steps greatly strengthened the system for evaluating, permitting, and overseeing such actions. BP Oil Spill Comm'n Report, *Deep Water: The Gulf Oil Disaster and the Future of Offshore Drilling* (Jan. 2011) (final report to the President), *available at* http://www.gpo.gov/fdsys/pkg/GPO-OILCOMMISSION/pdf/GPO-OILCOMMISSION.pdf; U.S. Dep't of Interior (DOI), Press Release: Interior Department Completes Reorganization of the Former MMS (Sept. 30, 2011), *available at* http://www.doi.gov/news/pressreleases/Interior-Department-Completes-Reorganization-of-the-Former-MMS.cfm; Oil Spill Comm'n Action, *Assessing Progress: Three Years Later* (Apr. 17, 2013), *available at* http://oscaction.org/wp-content/uploads/FINAL_OSCA-No2-booklet-Apr-2013_web.pdf; DOI/Bureau of Ocean Energy Mgmt. (BOEM), Information Collection: Oil Spill Financial Responsibility for Offshore Facilities; Proposed Collection for OMB Review; Comment Request MMAA104000, 81 Fed. Reg. 54,123 (Aug. 15, 2016); DOI/Bureau of Safety & Environmental Enforcement (BSEE), Final Rule, Blowout Prevention Systems, 81 Fed. Reg. 25,888 (April 29, 2016); U.S. Coast Guard, *Final Action Memorandum - Incident Specific Preparedness Review (ISPR) Deepwater Horizon Oil Spill* (Jan. 2011), *available at* http://www.uscg.mil/foia/docs/DWH/BPDWH.pdf.

In addition, the 2010 natural gas transmission pipeline rupture in San Bruno, California resulted in an extensive regulatory response, including improved oversight, steps to enhance pipeline integrity, and better emergency response practices. *See* U.S. Dep't of Transp., Pipeline and Hazardous Materials Safety Admin., *PHMSA Actions Taken Related to San Bruno Incident*, *available at* http://www.phmsa.dot.gov/staticfiles/PHMSA/DownloadableFiles/Files/Pipeline/archives/docs/sanbruno-ca/PHMSA%20San%20Bruno%20Related%20Actions%20Updated%209-9-2014.pdf; Nat'l Transp. Safety Bd., *Pipeline Accident Report, Pacific Gas And Electric Company Natural Gas Transmission Pipeline Rupture and Fire* PAR-11-01 (Aug. 30, 2011), *available at*http://www.ntsb.gov/investigations/AccidentReports/Reports/PAR1101.pdf.

Such responses have resulted in significant improvements in basic equipment as well. After the 1989 *Exxon Valdez* spill, Congress passed the Oil Pollution Act of 1990. One of the provisions of OPA required tank vessels carrying oil in bulk to be "equipped with a double hull" and established a schedule for compliance. 46 U.S.C. § 3703a. OPA required new covered vessels to be equipped with double hulls beginning in 1995 and generally prohibited the operation of single-hulled tankers in U.S. waters after 2010. *Id*. § 3703a(c)(3)(C)(1), (c)(4)(A). Underscoring

The existence and enforcement of this body of rigorous pollution-control laws, the continual refinement of those laws, careful internal management practices, and well-considered operational changes in response to significant incidents have resulted in improved environmental outcomes and lower risk.[119] For example, notwithstanding dramatic events, such as the *Deepwater Horizon* incident, both the number and severity of oil spills have dramatically decreased over the last several decades.[120] The mandatory move to double-hulled oil tankers in the wake of the *Exxon Valdez* and *Erika* events has produced a dramatic drop in spills from shipments of oil by sea. Despite an increase in seaborne oil trade since 1990, the number of tanker spills releasing greater than seven tons of oil has consistently declined.[121] Similarly, the

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Congress's concern, this schedule of compliance was "drafted to ensure that the requirement for double hulls or double containment systems be implemented as quickly as possible," taking into account the need of operators to replace their existing fleets. H.R. Rep. 101-653, at 141 (1990) (Conf. Rep.). The Coast Guard is responsible for implementing these statutory requirements, and has promulgated a set of implementing regulations. 33 C.F.R. § 157.10d. The adoption by the United States of these double-hull requirements helped lead to the amendment in 1992 of MARPOL, the main international treaty regulating pollution by ships, to impose similar double hull standards. *See* IMO, *Construction Requirements for Oil Tankers* (2014), *available at* http://www.imo.org/OurWork/Environment/PollutionPrevention/OilPollution/Pages/constructionrequirements.aspx; Elizabeth Galiano, *In the Wake of the PRESTIGE Disaster*, 28 Tul. Mar. L.J. 113, 120 (2004) (noting that "U.S. pressure in the wake of the Exxon Valdez spill" led to the 1992 MARPOL amendment).

[119] *See* Jonathan Ramseur, *Oil Spills in U.S. Coastal Waters: Background, Governance, and Issues for Congress*, at 2 (Feb. 5, 2008), *available at* http://edocs.dlis.state.fl.us/fldocs/oilspill/federal/79721884.pdf ("During the past two decades, while U.S. oil imports and consumption have steadily risen, oil spill incidents and the volume of oil spilled have not followed a similar course. In general, the annual number and volume of oil spills have shown declines—in some cases, dramatic declines.").

[120] *Id.*

[121] Int'l Tanker Owners Pollution Fed'n Ltd., *Oil Tanker Spill Statistics 2015*, *available at* http://www.itopf.com/information-services/data-and-statistics/statistics/. Part of this decrease is attributable to the use of double-hulled tankers. A 2001 simulation analysis found that the use of double hulls reduced the number of spills in simulated instances of collision or grounding between fifty-four percent and sixty-seven percent for the tanker types studied. Trans. Res. Bd., Spec. Rep. No. 259, Environmental Performance of Tanker Designs in Collision and Grounding 80 (2001), *available at* http://onlinepubs.trb.org/onlinepubs/sr/sr259.pdf. When spills do occur, double-hulled tankers release less oil: a recent study examining Coast Guard oil spill data found that the use of double hulls "reduces the size of oil spills by tanker ship accidents by 62% and that for tank-barge accident oil spills by 20%." Tsz Leung Yip, *The effectiveness of double hulls in reducing accident spillage*, Mar. Pol. Bull. 2427, 2432 (Nov. 2011), *available at* http://bpa.odu.edu/port/research/The%20effectiveness%20of%20double%20hulls%20in%20reducing%20vessel-accident%20oil%20spillage.pdf.

frequency of serious pipeline accidents involving hazardous materials is decreasing.[122] The same is true of railroad accidents.[123] In addition, there has been a significant decrease in toxic chemical releases in recent years.[124]

As the statistics demonstrate, these regulations and practices, combined with the safeguards developed to avoid liability under environmental statutes and doctrines, as described above, effectively limit the environmental liability risk of an FHC group.

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[122] *See* Pipeline & Hazardous Materials Safety Admin., U.S. Dep't of Trans., *Serious Pipeline Incidents* (Oct. 28, 2016), *available at* https://hip.phmsa.dot.gov/analyticsSOAP/saw.dll?Portalpages (showing that the number of serious incidents for all pipelines and serious gas transmission pipeline incidents have decreased from 1996 to 2015); Research and Special Programs Admin., U.S. Dep't of Trans., *Hazardous Liquid Pipeline Accidents Caused by Excavation Damage in 1991–2002* (Oct. 9, 2003), *available at* http://www.viadata.com/pipeliner/library_docs/mccainhearing.pdf (showing that the number of hazardous-liquid pipeline accidents by excavation decreased from the early 1990s to early 2000s and the number of pipeline-safety programs increased during that time period).

[123] *See* U.S. Dep't of Trans., Fed. R.R. Admin., *Hazardous Materials Transportation* (last visited Oct. 28, 2016), https://www.fra.dot.gov/Page/P0151 ("Rail transportation of hazardous materials in the United States is recognized to be the safest method of moving large quantities of chemicals over long distances. Recent statistics show that the rail industry's safety performance, as a whole, is improving."); Ass'n of Am. R.R.s, *Railroads: Moving America Safely* (Aug. 2016), https://www.aar.org/BackgroundPapers/Railroads%20Moving%20America%20Safely.pdf ("The train accident rate in 2015 was down 77 percent from 1980 and down 37 percent from 2000; the employee injury rate in 2015 was down 84 percent from 1980 and down 47 percent from 2000; and the grade crossing collision rate in 2015 was down 81 percent from 1980 and down 42 percent from 2000. By all of these measures, recent years have been the safest in rail history." Ass'n of Am. R.R.s, Press Release: AAR Celebrates Rail Industry's Safest Year on Record (Mar. 11, 2013), https://www.aar.org/newsandevents/Press-Releases/Pages/AAR-Celebrates-Rail-Industrys-Safest-Year-On-Record.aspx ("Overall, 2012 set a new record for railroad safety, breaking the previous record set in 2011, which in turn broke the record set in 2010. In 2012, compared to 2011, the train accident rate per million train miles was down 19 percent, the employee casualty rate was down 9 percent and the grade crossing collision rate was down 8 percent. . . . According to [Federal Railroad Administration] data, from 1980 to 2012 the U.S. train accident rate fell 80 percent and the U.S. rail employee injury rate fell 85 percent. Since 2000, the declines have been 45 percent and 52 percent, respectively. Train collisions per million train-miles have dropped 87 percent since 1980 and 36 percent since 2000.").

[124] *See* EPA, *2014 TRI National Analysis: Executive Summary* (2014), https://www.epa.gov/sites/production/files/2016-01/documents/2014-tri-na-exec-summary.pdf ("From 2013 to 2014 there was a 6% decrease in disposal or other releases. . . . Air releases also decreased from 2013 to 2014 by 4% (34 million pounds), primarily caused by decreases from the chemical manufacturing and electric utilities sectors."); Steven F. Hayward, 2011 Almanac of Environmental Trends 187, 192 (2011), *available at* https://www.aei.org/wp-content/uploads/2011/10/Hayward-almanac2011.pdf (showing a 65 percent reduction in releases of the 225 core chemicals tracked by EPA between 1988 and 2008).

II. Well-Established Doctrines of Corporate Separateness Protect FHC Groups from Liability for Investments in Enterprises that Engage in Environmentally Sensitive Activities.

In the Proposed Rule, the Board points to the risk of an FHC being held responsible for the acts or liabilities of a subsidiary, portfolio company, or other investee in circumstances where the legal separation between the subsidiary and the FHC is disregarded. FHCs that adopt and adhere to appropriate policies and procedures designed to ensure corporate separateness should face minimal risks from investments in subsidiary enterprises that engage in any environmentally sensitive activities under "veil-piercing" or similar legal theories.

It is a bedrock principle of corporate law that stockholders are not liable for the obligations of a corporation.[125] Indeed, the law permits the use of a corporation for the very purpose of enabling its owners to avoid personal liability.[126] This fundamental tenet applies in all corporate ownership structures, including circumstances where the corporation is wholly owned.[127] It applies regardless of whether the underlying liability arises from a contract claim or a tort claim,[128] and regardless of whether the claimant is an individual, an enterprise, or a governmental body.[129] The analysis is also the same when the obligation arises from an environmental statute.

The only exception to this doctrine of limited liability for stockholders arises when a court decides to "pierce the corporate veil." The veil-piercing jurisprudence is almost entirely based on common law, and, as a result, the standards for applying the doctrine may vary from

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[125] *Lowendahl v. Baltimore & Ohio R.R. Co.*, 287 N.Y.S. 62, 72 (1st Dep't 1936), *aff'd*, 272 N.Y. 360 (1936).

[126] *Itel Containers Int'l Corp. v. Atlanttrafik Exp. Serv. Ltd.*, 909 F.2d 698, 704 (2d Cir. 1990); *Walkovszky v. Carlton*, 18 N.Y.2d 414, 417 (1966).

[127] *Horowitz v. Aetna Life Ins.*, 539 N.Y.S.2d 50, 53 (2d Dep't 1989).

[128] *See, e.g., Itel Containers*, 909 F.2d at 698 (contract claim); *Walkovszky*, 18 N.Y.2d at 414 (tort claim).

[129] *Lowendahl*, 287 N.Y.S. at 64 (individual claimant); *Itel Containers*, 909 F.2d at 700 (enterprise claimant); *Matter of Morris v. N.Y. State Dep't of Taxation & Fin.*, 82 N.Y.2d 135, 138 (1993) (governmental body claimant).

jurisdiction to jurisdiction. Nonetheless, there are well-established practices that stockholders and other investors can follow to strengthen the corporate separateness of the stockholder and the corporation and minimize any risk that the corporate veil will be pierced.

This Part analyzes the doctrine of corporate separateness under the two state law regimes most likely to apply in a case involving potential liability for an FHC: New York, which is the leading state for the adjudication of commercial disputes, and Delaware, which is the state of incorporation for most large U.S. corporations and is commonly used by FHCs to form their subsidiaries.[130] Although the discussion below focuses on veil-piercing jurisprudence in the context of corporations, the same principles apply to limited liability companies in those jurisdictions.[131]

A. New York Veil-Piercing Jurisprudence

In New York, piercing the corporate veil requires a showing that (i) the stockholder exercised complete domination of the corporation with respect to the action involved, and (ii) that such domination was used to commit a fraud or wrong against the plaintiff that resulted in the plaintiff's injury.[132] Importantly, even where domination and control are found, veil-

[130] Most U.S. states follow the "internal affairs doctrine" and look to the law of the state of incorporation of the subject corporation for the applicable principles that would apply in a veil-piercing analysis. *See* John H. Matheson, *The Modern Law of Corporate Groups: An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context*, 87 N.C. L. REV. 1091, 1096 (2009) (discussing the internal affairs doctrine in the context of veil-piercing claims brought against U.S. entities with foreign parents). This is not the universal conflict of laws principle in this context. However, it is likely that a relationship that is structured to withstand veil piercing in New York and Delaware would also be respected in most, if not all, states. *See id*. at 1112 (surveying veil-piercing cases in various states and identifying certain factors regularly cited by the courts in those cases).

[131] *See, e.g., Colonial Sur. Co. v. Lakeview Advisors, LLC*, 941 N.Y.S.2d 371, 373 (4th Dep't 2012) (stating that "[i]t is well settled that 'the doctrine of piercing the corporate veil . . . applies to limited liability companies'" (internal citations omitted)); *Trs. of Vill. of Arden v. Unity Constr. Co.*, No. C.A. 15025, 2000 WL 130627, at *3 (Del. Ch. 2000) (applying corporate veil-piercing analysis in order to dismiss plaintiff's claim that two Delaware LLCs were alter egos of each other).

[132] *Cobalt Partners, L.P. v. GSC Capital Corp.*, 944 N.Y.S.2d 30, 33 (1st Dep't 2012) (quoting *Morris*, 82 N.Y.2d at 141); *East Hampton Union Free Sch. Dist. v. Sandpebble Builders, Inc.*, 994 N.Y.S.2d 94, 98 (2d Dep't 2009).

piercing generally will not occur unless the plaintiff shows that the domination led to inequity, fraud, or malfeasance.[133]

Domination in the context of a veil-piercing claim does not mean mere control. Rather, it means an extraordinary level of control "so complete that the corporation may be said to have no will, mind or existence of its own and to be operated as a mere department of the business of the stockholder."[134] This domination is sometimes characterized as the stockholder treating the corporation as its own "instrumentality"[135] or its "alter ego."[136] Where courts have found that this level of domination and control was not present, they have almost universally refused to pierce the corporate veil.[137]

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[133] *TNS Holdings v. MKI Sec. Corp.*, 92 N.Y.2d 335, 339 (1998); *see also Matheson*, *supra* note 131, at 1127, 1129 (stating that "courts have refused to adopt unlimited parental liability based solely on extraordinary control or domination" and "where fraud or misrepresentation is not found, courts refused to pierce in more than nine out of ten cases, irrespective of the presence of other factors"); *Freeman v. Complex Computing Co., Inc.*, 119 F.3d 1044, 1053 (2d Cir. 1997) (stating that, in New York, "the element of domination and control never was considered to be sufficient of itself to justify the piercing of a corporate veil").

[134] *Lowendahl*, 287 N.Y.S. at 73.

[135] The "instrumentality" doctrine cited by some New York courts generally involves a three-factor test. As set forth in *Lowendahl*, the three factors include: (i) control, not merely majority or complete stock control, but to such an extent (in disregard of the subsidiary's corporate paraphernalia, directors, and officers) that the subsidiary has become a mere instrumentality or department of the parent's own business and the parent is the true actor in the transaction attacked, or where the business and officers of the two corporations are so intertwined that it is impossible or impracticable to identify the corporation that participated in that transaction; (ii) such control has been used by the parent to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of the plaintiff's legal rights; and (iii) the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of. *Id*. at 76.

[136] The "alter ego" doctrine cited by some New York courts is slightly different in formulation from the instrumentality doctrine, but its effect is substantially the same. In determining whether a subsidiary is the alter ego of its parent, courts generally look to whether the subsidiary has been so dominated by its parent, and its separate identity so disregarded, that it primarily transacted the dominator's business rather than its own and can be called the parent's "alter ego." *William Passalacqua Builders, Inc. v. Resnick Developers South, Inc.*, 933 F.2d 131, 138 (2d Cir. 1991) (applying New York law) (quoting *Gartner v. Snyder*, 607 F.2d 582, 586 (2d Cir. 1979)). As noted above, "the control must be used to commit a fraud or other wrong that causes plaintiff's loss." *Id*.

[137] *Matheson*, *supra* note 131, at 1124–25 ("[I]f no control or dominance was found, the courts almost literally refused to pierce the corporate veil, absolving the parent from liability in 97.9% of the cases."); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1065 (1991) (finding that, when courts noted an absence of domination and control, they refused to pierce the corporate veil in 99.4 percent of the cases). Empirical studies such as these include some useful information, but most of the information that they contain is not instructive because they reflect the outcomes of lawsuits, such as those involving individual owners of small enterprises, that bear no similarity to the scenarios faced by sophisticated institutions, such as

The court in *William Passalacqua Builders, Inc. v. Resnick Developers South, Inc.* set forth a number of factors for determining whether the requisite level of domination exists to support a veil-piercing claim.[138] These factors, which are often cited by New York courts, include:

> (1) the absence of the formalities and paraphernalia that are part and parcel of the corporate existence, *i.e.*, issuance of stock, election of directors, keeping of corporate records and the like, (2) inadequate capitalization, (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes, (4) overlap in ownership, officers, directors, and personnel, (5) common office space, address and telephone numbers of corporate entities, (6) the amount of business discretion displayed by the allegedly dominated corporation, (7) whether the related corporations deal with the dominated corporation at arms length, (8) whether the corporations are treated as independent profit centers, (9) the payment or guarantee of debts of the dominated corporation by other corporations in the group, and (10) whether the corporation in question had property that was used by other of the corporations as if it were its own.[139]

No single factor is determinative, and courts weigh all of the available facts to determine whether liability should be imposed.

These factors were applied in the environmental context in the litigation stemming from an environmental disaster in Bhopal, India. In *Sahu* v. *Union Carbide Corp.*,[140] the plaintiffs sought monetary damages and medical monitoring from defendant Union Carbide Corporation ("UCC") for injuries caused by UCC's subsidiary, Union Carbide India Limited ("UCIL"), in

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FHCs. *See Matheson*, *supra* note 131, at 1091 ("Courts seldom pierce the subsidiary's corporate veil and do so much less often than in the overall universe of piercing cases, including the classic case of a small business with one or a few individual owners.").

138 933 F.2d at 139.

139 *Id*.

140 No. 04 Civ. 8825 JFK, 2012 WL 2422757, at *1 (S.D.N.Y. 2012), *aff'd*, 528 Fed. App'x. 96 (2d Cir. 2013).

Bhopal.[141] Applying New York law, the court determined that there was a "marked lack of evidence of domination" under the factors set out in *Passalacqua*.[142]

First, in considering the capitalization factor, the court found that the subsidiary was an independent going concern with adequate capitalization and assets, notwithstanding the plaintiffs' claim that the subsidiary had lost approximately one-third of its value and would be unable to pay class damages.[143] The court emphasized that the subsidiary's inability to pay a specific dollar amount of future damages was not relevant to the veil-piercing analysis; rather, the subsidiary's financial status was material only to the extent that it shed light on the subsidiary's legitimacy as a corporation.[144]

Second, the court found that, even assuming that UCC approved the strategic plan for the Bhopal plant, "nothing . . . [in the record] indicates that UCC controlled every step UCIL took at Bhopal to implement that strategy."[145] The court indicated, "it is entirely appropriate for a parent corporation to approve major expenditures and policies involving the subsidiary, and for employees of the parent and subsidiary corporations to meet periodically to discuss business matters."[146]

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[141] Specifically, the plaintiffs alleged that UCIL's pesticide manufacturing plant leaked hazardous waste, which polluted the soil and drinking water in the residential communities surrounding the plant's site. *Id.* at *3.

[142] *Id*.

[143] *Id*. at *19.

[144] *Id*. *See also Matter of Multiponics, Inc.*, 622 F 2d. 709, 717 (5th Cir. 1980) ("Generally [the court] look[s] to initial capitalization, asking whether a company was adequately capitalized at the time of its organization."); WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS, § 41.33 (rev. vol. 2013) ("A corporation that was adequately capitalized when formed but subsequently suffers financial reverses is not undercapitalized.").

[145] 2012 WL 2422757, at *20.

[146] *Id*. (quoting *Fletcher v. Atex, Inc.*, 861 F. Supp. 242, 245 (S.D.N.Y. 1994), *aff'd*, 68 F.3d 1451 (2d Cir. 1995)). Notably, the standard articulated by the court for appropriate parent involvement closely tracks the standards articulated by the Board for FHC involvement in investee company affairs under the merchant banking regulations. *See* 12 C.F.R. § 225.171(d)(2) (permitting an FHC to retain approval or consultation rights over, *inter alia*, the acquisition by an investee of significant assets or control of another company, as well as significant changes to the

Third, the court found that the similarity in workplace safety standards, equipment, and design between UCIL and a U.S. plant of UCC in no way implied that UCC micromanaged or controlled design and operations in Bhopal. Rather, according to the court, these similarities were the natural result of an arm's-length design purchase agreement between the two entities; this and other arm's-length contractual arrangements between the two entities were not indicative of domination by UCC.[147] Looking to the second prong of the veil-piercing test, the *Sahu* court further found that there was no allegation or evidence that any domination by UCC over UCIL was effected for the purpose of committing a fraud or wrong against the plaintiff. The court thus held that, even if such domination existed, piercing the corporate veil was inappropriate.[148]

The corporate separateness principle that protected UCC in *Sahu* also protects financial investors. In *Capmark Financial Group Inc. v. Goldman Sachs Credit Partners L.P.*, for example, the court declined to pierce the corporate veil between Goldman Sachs entities that had invested in Capmark, a debtor that had entered bankruptcy, and other Goldman Sachs entities that were lenders to Capmark.[149] Applying an identical analysis under applicable New York, Delaware, and Nova Scotia law, the court held that there was no evidence of "complete domination and control" or that the Goldman Sachs entities (including their shared corporate parent) had neglected the formalities of corporate separateness, such as by commingling funds or inadequately capitalizing a subsidiary.[150] Rather, the Goldman entities had acted in ways typical of a shareholder or parent corporation that do not trigger veil-piercing liability even when the

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investee's business plan). The practices and restrictions mandated by the Board's merchant banking regulations, as discussed below, significantly limit the risk of veil-piercing, including in the commodities context.

147 *Sahu*, 2012 WL 2422757, at *21.

148 *Id*. at *21

149 491 B.R. 335 (S.D.N.Y. 2013).

150 *Id*. at 349.

parent and subsidiary share officers, directors, and employees.[151] The court also indicated that even if there had been control or domination, the Goldman entities were not "sham" entities incorporated to perpetrate a fraud or injustice, and that veil-piercing would therefore not be appropriate.[152]

As these cases indicate, the high threshold for demonstrating domination and control, combined with the additional requirement that such domination and control be effected for the purpose of committing a fraud or wrong, make it highly unlikely that an FHC adhering to appropriate corporate separateness guidelines would be found liable for the actions or liabilities of a subsidiary under New York law.

B. Delaware Veil-Piercing Jurisprudence

As in New York, Delaware courts do not easily disregard corporate separateness to hold a parent liable for the actions of its subsidiary.[153] In general, Delaware courts will not pierce the

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[151] *Id*. at 349–50.

[152] *Id*. at 350. As a result of this high threshold, courts find that a shareholder has the domination sufficient to trigger veil-piercing only in extreme circumstances. For example, the court in *Director's Guild of America* v. *Garrison Productions, Inc.* found the requisite domination and control where the defendant, *inter alia*, "controlled every asset, made all major decisions with respect to the funding of the corporation, and treated the corporation as his own instrumentality[.]"733 F. Supp. 755, 762 (S.D.N.Y. 1990) (applying New York law). *In Director's Guild of America*, the defendant individual contributed ninety-nine percent of the production corporation's cash capital; eventually became the sole shareholder; had board veto power; advanced and authorized all funds (ultimately on a daily basis) for the corporation to meet its obligations, thereby deliberately undercapitalizing the corporation; and ultimately made the decision not to pay the award amount or wages at issue. In addition, the court found that the defendant operated the production corporation with little regard for corporate formalities. He often bypassed the corporation to pay creditors directly, and the corporation had no minutes or records of corporate meetings or records of directors authorizing significant events. *Id*. at 760–61. Likewise, in *888 7th Avenue Associates Limited Partnership v. Arlen Corp*., the court determined that there was sufficient domination and control when the plaintiff pled allegations that the parent incorporator and sole owner of an undercapitalized subsidiary shared common officers and directors with the subsidiary, and exercised free access to the subsidiary's bank accounts for payment of its own salaries and operating expenses, as well as those of other affiliates. 569 N.Y.S.2d 16, 17 (1st Dep't 1991) (affirming lower court's order denying defendant's motion to dismiss a veil-piercing claim).

[153] *See, e.g., Harco Nat'l Ins. Co. v. Green Farms Inc.*, CIV. A. No. 1131, 1989 WL 110537, at *5 (Del. Ch. 1989) ("It should be noted at the outset that persuading a Delaware Court to disregard the corporate entity is a difficult task.").

corporate veil unless (i) fraud in the use of the corporate form is present,[154] or (ii) the parent exerts exclusive domination and control such that the subsidiary becomes a "mere instrumentality" or "alter ego" of the parent.[155] Delaware courts have not made a clear distinction between the terms "mere instrumentality" and "alter ego,"[156] but to succeed on either type of claim, the plaintiff must show that (i) the parent and subsidiary operated as a single economic entity, and (ii) an element of injustice or unfairness is present.[157] Factors cited by Delaware courts in assessing such claims are similar to those cited by New York courts, and include:

> whether the corporation was adequately capitalized for the corporate undertaking; whether the corporation was solvent; whether dividends were paid, corporate records kept, officers and directors functioned properly, and other corporate formalities were observed; whether the dominant shareholder siphoned corporate funds; and whether, in general, the corporation simply functioned as a facade for the dominant shareholder.[158]

Accordingly, the same actions that limit the risk of veil-piercing in New York will also limit the risk of veil-piercing in Delaware.[159]

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[154] *See Irwin & Leighton, Inc. v. W.M. Anderson Co.*, 532 A.2d 983, 987 (Del. Ch. 1992) ("The protection offered by the corporate form, however, is not absolute; equity has long acted to extend a corporate liability to those in control of the corporation in appropriate circumstances. The paradigm instance involves the use of a corporate form to perpetrate a fraud.").

[155] *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 793 (Del. Ch. 1992); *Commerce Indus., Inc. v. MWA Intelligence, Inc.*, C.A. No. 7471-VCP, 2013 WL 5621678, at *27 (Del. Ch. 2013).

[156] *See, e.g., Mabon, Nugent & Co. v. Tex. Am. Energy Corp.*, CIV. A. No. 8578, 1990 WL 44267, at *5 (Del. Ch. 1990) ("In the present case, the question of whether TAO was TAE's alter ego or mere instrumentality may be restated to be whether TAO and TAE operated as a single economic entity such that it would be inequitable for this Court to uphold a legal distinction between them.").

[157] *Harper v. Del. Valley Broadcasters, Inc.*, 743 F. Supp. 1076, 1085 (D. Del. 1990) (citing *Mabon*, 1990 WL 44267, at *5), *aff'd*, 932 F.2d 959 (3d Cir. 1991).

[158] *Harco*, 1989 WL 110537, at *4 (quoting *Golden Acres, Inc.*, 702 F. Supp. at 1104).

[159] *See, e.g., LaCourte v. JP Morgan Chase & Co.*, 12 Civ. 9453 (JSR), 2013 WL 4830935, at *6¬7 (S.D.N.Y. Sept. 4, 2013) (dismissing veil-piercing claims against a nonbank subsidiary of an FHC under Delaware law where the plaintiff did not allege facts sufficient to show "complete domination" by the nonbank subsidiary of its own subsidiary, but only that the parent "controlled its subsidiaries in routine ways," and the plaintiff failed to allege that it was defrauded by an abuse of the corporate form; and dismissing veil-piercing claims against the FHC itself for the same reasons); *see also id*. at *6 n.2 (noting that "New York and Delaware veil-piercing law do not materially differ"). In addition, entities that observe the appropriate formalities and avoid committing fraud do not face a material risk of veil-piercing in other jurisdictions, such as Rhode Island. *See Miller v. Dixon Indus. Corp.*, 513 A.2d

C. Veil-Piercing in the Context of Environmental Statutes

In the context of environmental laws such as CERCLA, courts apply the same veil-piercing analysis that they use in other context. The Supreme Court explained in *Bestfoods* that, under the "deeply ingrained" principle that a parent corporation is not liable for the acts of its subsidiaries, veil-piercing is the exception rather than the rule:

> It is a general principle of corporate law deeply ingrained in our economic and legal systems that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries. . . . Thus, it is hornbook law that the exercise of the control which stock ownership gives to the stockholders . . . will not create liability beyond the assets of the subsidiary. That control includes the election of directors, the making of by-laws . . . and the doing of all other acts incident to the legal status of stockholders. Nor will a duplication of some or all of the directors or executive officers be fatal. . . . Although this respect for corporate distinctions when the subsidiary is a polluter has been severely criticized in the literature, nothing in CERCLA purports to reject this bedrock principle, and against this venerable common-law backdrop, the congressional silence is audible.[160]

Based on these principles, the Supreme Court held that a parent corporation may be charged with derivative CERCLA liability for its subsidiaries' actions only when veil-piercing is warranted.[161]

Since *Bestfoods*, courts have consistently applied standard veil-piercing analysis to determine whether a parent entity is indirectly liable under CERCLA and other environmental statutes. For example, in *United States v. Friedland*, a group of potentially responsible parties to a cost recovery action filed cross-claims against a parent entity, alleging that it was liable for

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597, 604–05 (R.I. 1986) (holding that separate corporate identities had to be respected in the absence of "inequity, fraud, undercapitalization, or domination" by the parent corporation); *R & B Elec. Co., Inc. v. Amco Constr. Co., Inc.*, 471 A.2d 1351, 1354 (R.I. 1984) (holding that the corporate veil should not be pierced when there was no "deception, fraud, or other wrongdoing" by the companies, and no evidence suggesting that legal formalities were not observed or that the corporation was "merely a sham behind which its shareholders conducted their personal affairs").

[160] 524 U.S. at 61–62 (citations omitted).

[161] *Id*. at 63. *Bestfoods* also noted that courts are divided as to whether state law or a federal common law of veil-piercing should apply with respect to indirect liability under CERCLA. *Id*. at 63 n.9. The Court did not decide the question, *id.*, and courts remain divided in their approaches. *See New York v. Nat'l Servs. Indus., Inc.*, 460 F.3d 201, 207–08 (2d Cir. 2006) (describing rulings in different circuits).

CERCLA violations stemming from the disposal of waste by its subsidiary.[162] The court applied Colorado veil-piercing law and held that the plaintiff had not met its burden of demonstrating that the corporate veil should be pierced, even though (i) the parent had majority stock ownership of the subsidiary; (ii) the parent and subsidiary shared an officer and two directors; and (iii) there was a dispute as to whether certain officers of the subsidiary, who were employees of the parent, acted independently in the interest of the subsidiary or took directives from the parent.[163] Because the other relevant factors supported corporate separateness, the court did not allow the veil-piercing claims to proceed to impose derivative liability on the parent entity.[164]

Courts also apply the *Bestfoods* veil-piercing analysis in the context of other environmental statutes, such as the CWA and the OPA. In *United States v. Viking Resources, Inc.*, for instance, the court held that the *Bestfoods* analysis concerning corporate separateness applies in the context of the OPA.[165] Likewise, the court in *In re Appalachian Fuels, LLC* applied *Bestfoods* to indirect liability claims under the Clean Water Act and Surface Mining Control and Reclamation Act, as well as to statutory claims under state law.[166] Because courts

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[162] 173 F. Supp. 2d 1077 (D. Colo. 2001).

[163] *Id*. at 1092–93.

[164] *Id*. at 1093. In particular, in granting summary judgment to A.O. Smith, the parent company, on the derivative liability claims, the court found no evidence that (i) A.O. Smith financed SCMI, the subsidiary, other than certain loans made (which did not appear improper); (ii) A.O. Smith caused SCMI's incorporation; (iii) SCMI was grossly undercapitalized; (iv) A.O. Smith generally paid the salaries, expenses, or losses of SCMI; (v) SCMI had substantially no business that except with A.O. Smith or no assets except those conveyed to SCMI by A.O. Smith; (vi) SCMI was referred to as a department or division of A.O. Smith; or (vii) A.O. Smith did not observe the formalities of legal separateness with respect to SCMI. *Id*.

[165] 607 F. Supp. 2d 808, 823 (S.D. Tex. 2009). The court in *Viking Resources* held that there was a genuine issue of material fact as to whether to pierce the corporate veil and hold the individual shareholder responsible for the company's OPA liability. *Id*. at 824. Notably, the shareholder admitted that he often did not carry out corporate formalities for the company, did not maintain records to document the formalities that he did carry out, and used the company's checking account to pay personal expenses. *Id.* at 823–24. This case demonstrates one potential veil-piercing scenario, but the defendant's failure to take even rudimentary steps to avoid veil-piercing renders it inapposite to the situations that arise when FHCs make investments.

[166] 493 B.R. 1, 17 (6th Cir. BAP 2013).

apply the same veil-piercing analysis with respect to environmental liability as they do with respect to other types of liability, the policies and procedures that FHCs use to maintain corporate separateness in general are equally effective at shielding FHCs from derivative environmental liability.

D. Application to Merchant Banking Investments

In the case of investments made by FHCs and their non-IDI affiliates under the merchant banking authority, the Board's regulations already prescribe certain corporate formalities, limiting any risk of piercing the corporate veil between an FHC or any of its non-IDI affiliates and any of its portfolio companies. Indeed, the regulations require that FHCs "[e]nsure the maintenance of corporate separateness between the [FHC] and each company in which the [FHC] holds an interest under this subpart and protect the [FHC] and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of each such company[.]"[167] Accordingly, the Board conducts examinations of FHCs to ensure that they maintain corporate separateness through policies, procedures, records, and systems.[168]

In addition, merchant banking investments may be held by an FHC or its non-IDI affiliates only for a period of time that enables the sale or disposition of the investment on a reasonable basis consistent with the financial viability of merchant banking investment activities.[169] As such, they represent investments that should be held separate and apart from an FHC's core business, thus limiting the risk that the corporate veil will be pierced.

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[167] 12 C.F.R. § 225.175(a)(iv).

[168] *See* Bank Holding Company Supervision Manual § 3907.0.7.1; *see also* Supervision and Regulation Letter 00-9, "Supervisory Guidance on Equity Investment and Merchant Banking Activities" (June 22, 2000).

[169] 12 C.F.R. § 225.172(a).

Section 4(k)(4)(H) of the Bank Holding Company Act and its implementing regulations set forth in Subpart J of Regulation Y impose limitations on participation by the FHC or its other subsidiaries in routinely managing or operating portfolio companies. These regulations clarify that director interlocks with the portfolio company and certain types of agreements and covenants that affect only extraordinary corporate events would not, as a general matter, be considered routine management or operation and so would be permitted in most circumstances.[170] They provide that an FHC or any of its affiliates would be considered to be engaged in routinely managing or operating a portfolio company if (i) the FHC or such affiliate establishes certain interlocks at the officer or employee level of the portfolio company or (ii) has certain other arrangements involving day-to-day management or participation in ordinary course business decisions.[171] An FHC or its affiliate will be permitted to manage the routine affairs of, or operate, a portfolio company, only when this is necessary to address a material risk to the value or operation of the portfolio company (for example, in the event of a significant operating loss or departure of senior management).[172] This involvement must be temporary, and last only for the time necessary for the FHC or its affiliate to address the cause of involvement, obtain suitable alternative management arrangements, dispose of the investment, or otherwise obtain a reasonable return on the investment.[173] Generally, an FHC would be required to provide the

[170] *Id*. § 225.171(d).

[171] *Id*. § 225.171(b).

[172] *Id*. § 225.171(e).

[173] *Id*. § 225.171(e)(2). To the extent an FHC takes advantage of this limited authority to manage the routine affairs of a portfolio company, the FHC will need to tailor its day-to-day involvement to limit the environmental risk presented by the portfolio company, depending on the magnitude of the risk involved.

Board written notice before engaging, or allowing an affiliate to engage, in routine management or operation of the portfolio company for a period greater than nine months.[174]

These limitations on merchant banking activities should limit the possibility of an FHC being held responsible for the liabilities of an investee under a veil-piercing theory to a level consistent with each FHC's risk tolerance, as established by its board of directors, and its risk management framework, each of which is subject to the Board's supervision and examination and safety and soundness standards. Further, these limitations may be combined with policies that are traditionally used to promote corporate separateness, as described below and in Exhibit 1 of this Appendix A.

E. Effective Policies and Procedures

Pursuant to the applicable legal framework, and in accordance with the requirements and limitations of the merchant banking authority, there are numerous safeguards that FHCs can implement to manage veil-piercing risks effectively. Like many risks faced by FHCs, the risk of liability in these circumstances must be understood and addressed through appropriate policies and procedures.

Exhibit 1 of this Appendix A contains a description of a range of policies and procedures, which are consistent with the restrictions on exercising control over routine management of a merchant banking investee, and which may be appropriate to apply depending on the FHC's assessment of the risks arising from the circumstances of an investment. Investment guidelines that promote the safeguards listed in Exhibit 1 of this Appendix A, if followed, maximize the likelihood that courts will not deviate from longstanding corporate law tradition and will continue to respect the corporate veil between FHCs and their portfolio companies and other

[174] *Id*. § 225.171(e)(3).

investees. FHCs have every incentive to adopt appropriate policies, and indeed, we are not aware of any case in New York or Delaware where an FHC has been held liable for the debts or other liabilities of a subsidiary as a result of a court piercing the corporate veil.

EXHIBIT 1 TO APPENDIX A

PRACTICES FOR LIMITING ENVIRONMENTAL LIABILITY AND ENSURING THAT LEGAL ENTITY SEPARATENESS WILL BE RESPECTED

COVINGTON & BURLING LLP
DAVIS POLK & WARDWELL LLP
SULLIVAN & CROMWELL LLP
VINSON & ELKINS LLP

Attached.

Practices for Limiting Environmental Liability and Ensuring that Legal Entity Separateness Will Be Respected

As explained in the Joint Memorandum of Law prepared by [Covington & Burling LLP, Davis Polk & Wardwell LLP, Sullivan & Cromwell LLP and] Vinson & Elkins LLP,[1] an FHC that engages in commodities-related trading and investment activities may promote responsible environmental conduct and manage associated environmental liability risk through a range of safeguards. Whether one or more of these safeguards is appropriate to a particular activity or investment will depend on the legal and operational risks associated with that activity or investment. For example, the transport of a commodity such as iron may involve less risk of environmental harm than the transport of oil. Accordingly, some of the measures described below may be advisable generally with respect to particular activities, whereas others may be warranted only in particular circumstances, in response to particular risks. We understand that many of these measures are currently in place, in varying degrees, among FHCs that engage in commodities-related trading and investment.

Commodities Trading and Investment

An FHC or subsidiary that engages in market making and other client-intermediation services in physical commodities, including making or taking physical delivery of or maintaining inventories in physical commodities, can limit the risk of environmental incidents associated with the transportation, storage and processing of such commodities for the FHC or such subsidiary, and the magnitude of any resulting liability, through some or all of the following measures, depending on the nature of the associated risks:

1. Conduct an appropriate analysis of potential environmental liabilities associated with the type of commodities and transactions in which they engage to ensure that potentially material risks are identified in advance so that reasonable safeguards against liability can be identified and deployed. The analysis should be calibrated based on the nature of the involvement and the potential magnitude of the liability.

2. Avoid operating vessels, railcars, pipelines or other transportation or storage facilities used to transport physical commodities, and avoid being an operational owner (as opposed to being a non-operating owner in connection with a traditional lease-financing transaction) of vessels, railcars, pipelines or other transportation or storage facilities used to transport environmentally sensitive commodities.

[1] This appendix is being provided to SIFMA in connection with its comment letter to the Board regarding the Proposed Rule, and solely for use by SIFMA in that context. It may not be relied upon by SIFMA for any other purpose, and may not be relied upon by any party other than SIFMA for any purpose. This appendix is provided to SIFMA jointly by the four law firms. The substantive legal analysis with respect to environmental liability has been primarily contributed by Covington & Burling LLP and Vinson & Elkins LLP. The legal analysis with regard to the other subjects addressed by the appendix reflects the contributions of each of the four firms.

3. Contract for transportation and storage of physical commodities with owners and operators of transportation, storage or processing facilities that:

   a. are appropriately licensed and qualified to perform the required services, have documented histories of performing such services safely, and are managed independently of the FHC or subsidiary;

   b. maintain and operate their facilities in compliance with government-mandated and/or industry-approved safety standards (e.g., double-hulled oil tankers); and

   c. are adequately capitalized and have financial resources (including insurance) appropriate for the conduct of their business activities (including any anticipated risks).

4. Adopt and implement procedures to ensure that, when contracting with or selecting appropriate providers of transportation, storage, or processing services, the FHC will not control or become excessively involved in the establishment of, or compliance with, the environmental safeguards of such service providers. As necessary (e.g., when evaluating the fitness of prospective service providers unknown to the FHC), conduct appropriate vetting or engage third-party vendors with industry expertise to assist in vetting prospective service providers and their operations.

5. To the extent practicable, structure operations and transactions involving purchase, sale and transportation of physical commodities so that the FHC or subsidiary is merely the "shipper" of the physical commodities to be transported and obtains contractual indemnification for any losses sustained or liabilities incurred as a result of the service provider's conduct.

6. Provide appropriate training for FHC and subsidiary personnel who are engaged in commodity-related activities so that they are aware of the potential risks associated with the commodities involved in the transactions in which they engage and understand the policies and procedures in place to protect the FHC or subsidiary.

7. Maintain appropriate liability coverage commensurate with the anticipated risks of their physical-commodity activities.

Portfolio Company Investments

FHCs may invest in portfolio companies or other investees that engage in commodities handling activities, such as the extraction, processing, storage or transportation of commodities, or that engage in commodities trading and investment. FHCs can limit their potential exposure on theories of veil-piercing to environmental liabilities of such portfolio companies or investees through a variety of practices designed to ensure that their corporate separateness is respected. Depending on the operational and legal risks associated with their activities, different portfolio

companies and investees will pose differing levels of environmental liability risk. Accordingly, the degree to which the measures described below may be appropriate with regard to a particular portfolio company or investee will vary depending on the degree of risk.

1. An FHC may exercise its right to elect some or all members to the board of directors (or other similar governing body) without compromising the legal entity separateness of the FHC and an investee, so long as such persons discharge any applicable fiduciary duties and exercise their responsibilities to oversee management, and the officers of the investee actually manage the day-to-day operations of the business. In appropriate cases, one or more of the investee's directors should be independent of the FHC.

2. Control over the board of directors (or another similar governing body) will not compromise legal entity separateness so long as the members of such governing body make decisions based upon the best interests of the investee and of its owners qua owners in accordance with any applicable fiduciary duties.

3. In appropriate circumstances (and, with respect to merchant banking investments, to the extent not inconsistent with applicable Board regulations), an FHC may appoint one or more of its own employees as officers of a portfolio company or other investee without compromising its limited liability veil, provided that the number of common officers is limited and the officers discharge any applicable fiduciary duties to the portfolio company and do not take action for the benefit of the FHC that is contrary to the best interests of the portfolio company, or operate the portfolio company as an instrumentality or alter-ego of the FHC.

4. An FHC can minimize the risk of piercing of the limited liability veil of a portfolio company or other investee by following standard legal entity formalities:

    a. issuance of ownership interests (in physical or book entry form) in the investees against documented receipt of consideration;

    b. meetings of the owners of the investee held not less than annually for the election of the board of directors (or other similar governing body) of the investee, with minutes of the meetings documented and maintained in the records of the investee;

    c. meetings of the board of directors (or similar governing body) of the investee held not less than quarterly, with minutes of the meetings documented, approved and maintained in the records of the investee;

    d. annual election of officers of the investee by the board of directors (or similar governing body), with the number, qualifications and functions of the officers appropriate for the size and activities of the investee; and

    e. exercise of appropriate and customary discretion by the officers of the investee in running the business.

5. The following are important safeguards for an FHC to apply in its risk management program, as appropriate, in order to minimize any risk that legal entity separateness between an FHC and each of its portfolio companies and other investees will be disregarded:

   a. assurances at the time of investment that each investee is adequately capitalized for its intended business activities;

   b. separate cash-management functions, and no commingling of funds between the FHC and its investee; independent and arm's-length financing arrangements will further help ensure that legal entity separateness will be respected;

   c. maintenance by the investee of its own business operations, office space, address, telephone number, e-mail address and similar aspects of independent existence; separateness will more likely be respected if assets are not shared or commingled, promotional and other literature makes clear that the investee is a separate business enterprise and not a division of the FHC, and the name of the investee does not include any of the distinguishing features of the FHC's name;

   d. treatment of the investee as an independent profit center; independence will be enhanced if any incentive compensation of officers and employees of the investee for their work at the investee is based primarily upon the performance of the investee, not the performance of the FHC;

   e. all dealings between the FHC and the investee are on an arm's-length basis, and any related-party transactions above an appropriate threshold are approved by the investee's board of directors (or similar governing body), or an appropriate committee of that body; if the investee has one or more independent members, they should provide this approval; and

   f. the relationship of the investee with the FHC is not mischaracterized to any third party in a manner that could fraudulently induce the third party to take, or refrain from taking, an action.

6. An FHC can limit its potential liability arising out of the commodities activities of a portfolio company or other investee by avoiding employee involvement in day-to-day decision-making regarding facility operations or environmental compliance of such an entity, including avoiding:

   a. making waste disposal decisions;

   b. making decisions regarding investigations of environmental contamination;

   c. making maintenance decisions;

d. directly contracting with transportation and waste disposal companies to remove contaminants from an investee's property;

e. operating the investee's physical facilities;

f. creating a misimpression that it controls or operates the investee's facilities; and

g. interfacing directly with environmental regulators concerning operations at an investee's facility.

7. An FHC can also limit its potential liability arising out of the commodities activities of a portfolio company or other investee by avoiding crossing the line between appropriate oversight by an owner or board of directors (or other similar governing bodies) over such an investee and controlling the day-to-day operations of the investee's commodity-related activities, by:

a. ensuring that the investee creates and enforces its own policies and operational plans regarding environmental compliance;

b. giving broad rather than detailed policy directives to the investees, such that the FHC is not viewed as managing, directing or conducting operational functions or environmental compliance of a facility; and

c. providing any consulting services to the investees on an arm's length basis.

8. As part of the FHC's consideration of whether to make or retain an investment in a portfolio company or other investee engaged in commodities activities, in appropriate circumstances the FHC should assess and evaluate the environmental and veil-piercing laws of the jurisdictions in which the investee operates, whether inside or outside the United States.

9. Ensure that risks presented by operations of portfolio companies or other investees engaged in the extraction, processing, storage or transportation of physical commodities are appropriately limited by ensuring that the management of each such company is trained and motivated to take appropriate steps to ensure that the company:

a. Conducts an appropriate analysis of potential environmental liabilities associated with the commodity activities in question to ensure that potentially material risks are identified and reasonable safeguards against liability are identified and deployed. The analysis should be more rigorous as the potential magnitude of the liability increases;

b. Establishes risk-management and safety programs adequate to limit the risks of its operations to levels consistent with parameters established by its board;

c. Trains personnel engaged in commodity activities so that they are aware of the potential risks associated with those activities and understand the risk-mitigation options available to protect the company; and

d. Maintains appropriate liability coverage commensurate with the anticipated risks of its physical-commodity activities.

APPENDIX B

EXTREMELY HAZARDOUS SUBSTANCES AND THEIR THRESHOLD PLANNING QUANTITIES[1]

(DOCKET NO. R-11547; RIN 7100AE-58)

Chemical Name	Threshold Planning Quantity (pounds)
Acetone Cyanohydrin	1,000
Acetone Thiosemicarbazide	1,000/10,000
Acrolein	500
Acrylamide	1,000/10,000
Acrylonitrile	10,000
Acrylyl Chloride	100
Adiponitrile	1,000
Aldicarb	100/10,000
Aldrin	500/10,000
Allyl Alcohol	1,000
Allylamine	500
Aluminum Phosphide	500
Aminopterin	500/10,000
Amiton	500
Amiton Oxalate	100/10,000
Ammonia	500
Amphetamine	1,000
Aniline	1,000
Aniline, 2,4,6-trimethyl-	500
Antimony pentafluoride	500
Antimycin A	1,000/10,000
ANTU	500/10,000
Arsenic pentoxide	100/10,000
Arsenous oxide	100/10,000
Arsenous trichloride	500
Arsine	100
Azinphos-Ethyl	100/10,000
Azinphos-Methyl	10/10,000
Benzal Chloride	500
Benzenamine, 3-(trifluoromethyl)-	500

[1] *See* 40 C.F.R. pt 355, app. A –The List of Extremely Hazardous Substances and Their Threshold Planning Quantities.; *see also* 42 U.S.C. § 11002.

Chemical Name	Threshold Planning Quantity (pounds)
Benzene, 1-(chloromethyl)-4-nitro-	500/10,000
Benzenearsonic Acid	10/10,000
Benzimidazole,4,5-Dichloro-2- (Trifluoromethyl)	500/10,000
Benzotrichloride [Benzoic trichloride]	100
Benzyl Chloride	500
Benzyl Cyanide	500
Bicyclo[2.2.1]Heptane-2-Carbonitrile, 5- chloro-6	500/10,000
Bis (Chloromethyl) Ketone 10/500	
Bitoscanate	500/10,000
Boron Trichloride	500
Boron Trifluoride	500
Boron Trifluoride compound with Methyl Ether (1:1)	1,000
Bromadiolone	100/10,000
Bromine	500
Cadmium Oxide	100/10,000
Cadmium Stearate	1,000/10,000
Calcium arsenate	500/10,000
Camphechlor	500/10,000
Cantharidin	100/10,000
Carbachol Chloride	500/10,000
Carbamic acid, methyl-, 0-(((2,4-dimethyl-1, 3- dithiolan-2-yl) Methylene) Amino)	100/10,000
Carbofuran	10/10,000
Carbon Disulfide	10,000
Carbophenothion	500
Chlordane	1,000
Chlorfenvinfos	500
Chlorine	100
Chlormephos	500
Chlormequat Chloride	100/10,000
Chloroacetic Acid	100/10,000
Chloroethanol	500
Chloroethyl Chloroformate	1,000
Chloroform	10,000
Chloromethyl ether	100
Chloromethyl methyl ether	100
Chlorophacinone	100/10,000
Chloroxuron	500/10,000
Chlorthiophos	500
Chromic Chloride	1/10,000
Cobalt Carbonyl	10/10,000
Cobalt, ((2,2'-(1,2-Ethanediyl-bis- (nitrilomethylidyne)	100/10,000
Colchicine	10/10,000

Chemical Name	Threshold Planning Quantity (pounds)
Coumaphos	100/10,000
Coumatetralyl	500/10,000
Cresol,o-	1,000/10,000
Crimidine	100/10,000
Crotonaldehyde, (E)-	1,000
Crotonaldehyde	1,000
Cyanogen Bromide	500/10,000
Cyanogen Iodide	1,000/10,000
Cyanophos	1,000
Cyanuric Fluoride	100
Cycloheximide	100/10,000
Cyclohexylamine	10,000
Decaborane (14)	500/10,000
Demeton	500
Demeton-S-Methyl	500
Dialifor	100/10,000
Diborane	100
Dichloroethyl ether	10,000
Dichloromethylphenylsilane	1,000
Dichlorvos	1,000
Dicrotophos	100
Diepoxybutane	500
Diethyl Chlorophosphate	500
Digitoxin	100/10,000
Diglycidyl Ether	1,000
Digoxin	10/10,000
Dimefox	500
Dimethoate	500/10,000
Dimethyl Phosphoro-chloridothioate	500
Dimethyl sulfate	500
Dimethyl-p-Phenylenediamine	10/10,000
Dimethyldichlorosilane	500
Dimethylhydrazine	1,000
Dimetilan	500/10,000
Dinitrocresol	10/10,000
Dinoseb	100/10,000
Dinoterb	500/10,000
Dioxathion	500
Diphacinone	10/10,000
Diphosphoramide, octamethyl-	100
Disulfoton	500
Dithiazanine Iodide	500/10,000
Dithiobiuret	100/10,000

Chemical Name	Threshold Planning Quantity (pounds)
Emetine, Dihydrochloride	1/10,000
Endosulfan	10/10,000
Endothion	500/10,000
Endrin	500/10,000
Epichlorohydrin	1,000
EPN	100/10,000
Ergocalciferol	1,000/10,000
Ergotamine Tartrate	500/10,000
Ethanesulfonyl Chloride, 2-Chloro-	500
Ethanol, 1,2-Dichloro-, Acetate	1,000
Ethion	1,000
Ethoprophos	1,000
Ethyl bis (2-Chloroethyl) Amine	500
Ethylene Fluorohydrin	10
Ethylene oxide	1,000
Ethylenediamine	10,000
Ethyleneimine	500
Ethylthiocyanate	10,000
Fenamiphos	10/10,000
Fensulfothion	500
Fluenetil	100/10,000
Fluorine	500
Fluoroacetamide	100/10,000
Fluoroacetic Acid	10/10,000
Fluoroacetyl Chloride	10
Fluorouracil	500/10,000
Fonofos	500
Formaldehyde	500
Formaldehyde Cyanohydrin	1,000
Formethanate Hydrochloride	500/10,000
Formothion	100
Formparanate	100/10,000
Fosthietan	500
Fuberidazole	100/10,000
Furan	500
Gallium Trichloride	500/10,000
Hexachlorocyclopentadiene	100
Hexamethylenediamine, N,N’-Dibutyl-	500
Hydrazine	1,000
Hydrocyanic Acid (Hydrogen cyanide)	100
Hydrogen Chloride (gas only)	500
Hydrogen Fluoride	100
Hydrogen Peroxide (Conc > 52%)	1,000

Chemical Name	Threshold Planning Quantity (pounds)
Hydrogen Selenide	10
Hydrogen Sulfide	500
Hydroquinone	500/10,000
Iron, pentacarbonyl	100
Isobenzan	100/10,000
Isobutyronitrile	1,000
Isocyanic Acid, 3,4-Dichlorophenyl Ester	500/10,000
Isodrin	100/10,000
Isofluorphate	100
Isophorone Diisocyanate	500
Isopropyl Chloroformate	1,000
Isopropylmethylpyrazolyl Dimethylcarbamate	500
Lactonitrile	1,000
Leptophos	500/10,000
Lewisite	10
Lindane (“gamma-BHC”)	1,000/10,000
Lithium Hydride	100
Malononitrile	500/10,000
Maganese, Tricarbonyl Methylcyclopentadienyl	100
Mechlorethamine	10
Mephosfolan	500
Mercuric Acetate	500/10,000
Mercuric Chloride	500/10,000
Mercuric Oxide	500/10,000
Methacrolein Diacetate	1,000
Methacrylic Anhydride	500
Methacrylonitrile	500
Methacryloyl Chloride	100
Methacryloyloxyethyl isocyanate	100
Methamidophos	100/10,000
Methanesulfonyl Fluoride	1,000
Methidathion	500/10,000
Methiocarb	500/10,000
Methomyl	500/10,000
Methoxyethylmercuric Acetate	500/10,000
Methyl 2-Chloroacrylate	500
Methyl bromide	1,000
Methyl Chloroformate	500
Methyl Hydrazine	500
Methyl Isocyanate	500
Methyl Isothiocyanate	500
Methyl Mercaptan	500
Methyl Phenkapton	500

Chemical Name	Threshold Planning Quantity (pounds)
Methyl Phosphonic Dichloride	100
Methyl Thiocyanate	10,000
Methyl Vinyl Ketone	10
Methylmercuric Dicyanamide	500/10,000
Methyltrichlorosilane	500
Metolcarb	100/10,000
Mevinphos	500
Mexacarbate	500/10,000
Mitomycin C	500/10,000
Monocrotophos	10/10,000
Muscimol	500/10,000
Mustard gas	500
Nickel carbonyl	1
Nicotine	100
Nicotine sulfate	100/10,000
Nitric Acid	1,000
Nitric Oxide	100
Nitrobenzene	10,000
Nitrocyclohexane	500
Nitrosodimethylamine	1,000
Nitrogen Dioxide	100
Norbormide	100/10,000
OrganoRhodium Complex (PMN-82-147)	10/10,000
Ouabain	100/10,000
Oxamyl	100/10,000
Oxetane, 3,3-bis (Chloromethyl)-	500
Oxydisulfoton	500
Ozone	100
Paraquat Dichloride	10/10,000
Paraquat methosulfate	10/10,000
Parathion	100
Parathion-Methyl	100/10,000
Paris green	500/10,000
Pentaborane	500
Pentadecylamine	100/10,000
Peracetic acid	500
erchloromethylmercaptan	500
Phenol	500/10,000
Phenol, 2,2’-Thiobis[4-Chloro-6-Methyl]-	100/10,000
Phenol, 3-(1-Methylethyl)-, methylcarbamate	500/10,000
Phenoxarsine, 10,10’-Oxydi-	500/10,000
Phenyl Dichloroarsine	500
Phenylhydrazine Hydrochloride	1,000/10,000

Chemical Name	Threshold Planning Quantity (pounds)
Phenylmercury Acetate	500/10,000
Phenylsilatrane	100/10,000
Phenylthiourea	100/10,000
Phorate	10
Phosacetim	100/10,000
Phosfolan	100/10,000
Phosgene	10
Phosmet	10/10,000
Phosphamidon	100
Phosphine	500
Phosphonothioic Acid, Methyl-, O-Ethyl 0-(4-Methylthio)Phenyl)Ester	500
Phosphonothioic Acid, Methyl-, S-(2-(Bis(1-methylethyl)Amino)Ethyl)o-Ethyl Ester	100
Phosphonothioic Acid, Methyl-,0-(4- Nitrophenyl) O-Phenyl Ester	5,000
Phosphoric Acid, Dimethyl 4-(Methylthio)Phenyl Ester	500
Phosphorothoic Acid, 0,0-DiMethyl-S-(2- Methylthio) Ethyl Ester	500
Phosphorus	100
Phosphorus Oxychloride	500
Phosphorus Pentachloride	500
Phosphorous Trichloride	1,000
Physostigmine	100/10,000
Physostigmine, Salicylate (1:1)	100/10,000
Picrotoxin	500/10,000
Piperidine	1,000
Pirimifos-Ethyl	1,000
Potassium arsenite	500/10,000
Potassium Cyanide	100
Potassium Silver Cyanide	500
Promecarb	500/10,000
Propargyl Bromide	10
Propiolactone, Beta	500
Propionitrile	500
Propionitrile, 3-Chloro-	1,000
Propiophenone, 4-Amino- 100/500	
Propyl Chloroformate	500
Propylene Oxide	10,000
Propyleneimine	10,000
Prothoate	100/10,000
Pyrene	1,000/10,000
Pyridine, 2-Methyl-5-Vinyl-	500

Chemical Name	Threshold Planning Quantity (pounds)
Pyridine, 4-Amino-	500/10,000
Pyridine, 4-Nitro-, 1-Oxide	500/10,000
Pyriminil	100/10,000
Salcomine	500/10,000
Sarin	10
Selenious acid	1,000/10,000
Selenium Oxychloride	500
Semicarbazide Hydrochloride	1,000/10,000
Silane, (4-Aminobutyl) Diethoxymethyl-	1,000
Sodium Arsenate	1,000/10,000
Sodium Arsenite	500/10,000
Sodium Azide (Na[N3])	500
Sodium Cacodylate	100/10,000
Sodium Cyanide (Na(CN))	100
Sodium Fluoroacetate	10/10,000
Sodium Selenate	100/10,000
Sodium Selenite	100/10,000
Sodium Tellurite	500/10,000
Stannane, Acetoxytriphenyl	500/10,000
Strychnine	100/10,000
Strychnine sulfate	100/10,000
Sulfotep	500
Sulfoxide, 3-Chloropropyl octyl	500
Sulfur Dioxide	500
Sulfur Tetrafluoride	100
Sulfur Trioxide	100
Sulfuric Acid	1,000
Tabun	10
Tellurium Hexafluoride	100
TEPP	100
Terbufos	100
Tetraethyllead	100
Tetraethyltin	100
Tetramethyllead	100
Tetranitromethane	500
Thallium Sulfate	100/10,000
Thallous Carbonate	100/10,000
Thallous Chloride	100/10,000
Thallous Malonate	100/10,000
Thallous Sulfate	100/10,000
Thiocarbazide	1,000/10,000
Thiofanox	100/10,000
Thionazin	500

Chemical Name	Threshold Planning Quantity (pounds)
Thiophenol	500
Thiosemicarbazide	100/10,000
Thiourea, (2-Chlorophenyl)-	100/10,000
Thiourea, (2-Methylphenyl)-	500/10,000
Titanium Tetrachloride	100
Toluene 2,4-Diisocyanate	500
Toluene 2,6-Diisocyanate	100
Trans-1,4-dichlorobutene	500
Triamiphos	500/10,000
Triazofos	500
Trichloroacetyl Chloride	500
Trichloroethylsilane	500
Trichloranate	500
Trichlorophenylsilane	500
Trichloro (Chloromethyl) Silane	100
Trichloro (Dichlorophenyl) Silane	500
Triethoxysilane	500
Trimethylchlorosilane	1,000
Trimethylolpropane Phosphite	100/10,000
Trimethyltin Chloride	500/10,000
Triphenyltin Chloride	500/10,000
Tris (2-Chloroethyl) amine	100
Valinomycin	1,000/10,000
Vanadium Pentoxide	100/10,000
Vinyl Acetate (monomer)	1,000
Warfarin	500/10,000
Warfarin sodium	100/10,000
Xylene Dichloride	100/10,000
Zinc, Dichloro (4,4-Dimethyl-5(methylamino) carboynl) oxy) lmino) Pentanenitrile)-,(T-4)	100/10,000
Zinc Phosphide	500

APPENDIX C

LIST OF CRUDE OIL AND REFINED PETROLEUM PRODUCTS[1]

(DOCKET NO. R-11547; RIN 7100AE-58)

Chemical Name
Alkanes (C6-C9)
n-Alkanes (C10+)
iso- & cyclo-Alkanes (C10-C11)
Alkylbenzenes (C9+)
Alkylbenzene, Alkylindane, Alkylindene mixture (each C12-C17)
Asphalt
Asphalt: cutback
Asphalt: emulsion
Asphalt blending stocks: Roofers flux
Asphalt blending stocks: Straight run residue
Aviation alkylates
Cobalt naphthenate in Solvent naphtha
p-Cymene
Diisopropyl naphthalene
Distillates: Flashed feed stocks
Distillates: Straight run
Ethyl cyclohexane
Gas oil: Cracked
Gasoline: Automotive (not over 4.23g Pb/gal)
Gasoline: Aviation (not over 4.86g Pb/gal)
Gasoline: Casinghead (natural)
Gasoline: Polymer
Gasoline: Straight run
Gasoline blending stocks: Alkylates
Gasoline blending stocks: Reformates
Heptane (all isomers)
Heptene (all isomers)
Hexane (all isomers)
Hexene (all isomers)
Jet fuel: Jet A-1
Jet fuel: Jet A
Jet fuel: Jet B
Jet fuel: JP-4

[1] *See, e.g.,* U.S. Coast Guard, List of Petroleum and Non-petroleum Oils, *available at* https://www.uscg.mil/hq/cg5/cg5215/docs/2013.03.18_OPA90_Oils_and_oil-likes.pdf.

Chemical Name
Jet fuel: JP-5 (Kerosene, heavy)
Jet fuel: JP-8
Kerosene
Methylcyclohexane
Mineral spirits
Naphtha: Heavy
Naphtha: Paraffinic
Naphtha: Petroleum
Naphtha: Solvent
Naphtha: Stoddard solvent
Naphtha: VM & P (75% Naphtha)
Nonane (all isomers)
Nonylbenzene
Octane (all isomers)
Oil, fuel: No. 1
Oil, fuel: No. 1-D
Oil, fuel: No. 2
Oil, fuel: No. 2-D
Oil, fuel: No. 4
Oil, fuel: No. 5
Oil, fuel: No. 6
Oil, misc: Aliphatic
Oil, misc: Aromatic
Oil, misc: Clarified
Oil, misc: Coal
Oil, misc: Crude
Oil, misc: Diesel
Oil, misc: Gas, low pour
Oil, misc: Gas, low sulfur
Oil, misc: Heartcut distillate
Oil, misc: Lubricating
Oil, misc: Mineral
Oil, misc: Mineral seal
Oil, misc: Motor
Oil, misc: Penetrating
Oil, misc: Residual
Oil, misc: Road
Oil, misc: Seal
Oil, misc: Spindle
Oil, misc: Transformer
Oil, misc: Turbine
Olefin mixtures (C5-C7)
alpha-Olefins (C6-C18) mixtures
Olefins (C13+)

Chemical Name
Pentene (all isomers)
1-Phenyl-1-xylyl ethane
iso-Propylcyclohexane
Tetrahydronaphthalene
White spirit (low (15-20%) aromatic)