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David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC MAIL

Re: *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Dealer" and "Eligible Contract Participant"*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter in response to the Commodity Futures Trading Commission (the "CFTC") and Securities Exchange Commission (the "SEC," and together with the CFTC, the "Commissions") request for comment concerning the Commissions' Notice of Proposed Rulemaking on *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Dealer" and "Eligible Contract Participant"* (the "Proposed Rules").[1] This comment letter provides the Working Group's comments regarding the proposed definition of "major swap participant."

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") vests the Commissions with new and expanded authority to regulate a wide array of participants in swap markets. Swap dealers, security-based swap dealers, major swap participants and major security-based swap participants in particular, will be required to develop and implement comprehensive measures to assure compliance with both substantive and

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[1] 75 Fed. Reg. 80,174 (Dec. 22, 2010).

procedural requirements under the Commissions' new regulations set forth under the Act. Such regulations have been the subject of several key proposed rulemakings for which the Working Group has previously submitted comments. The Working Group anticipates submitting comments on the subjects of additional key proposed rulemakings.

The Working Group appreciates the opportunity to provide these comments in response to the Proposed Rules and respectfully requests that the Commissions consider the comments set forth herein. The Working Group looks forward to working with the Commissions to further define the term "major swap participant" prior to the effective date of Title VII of the Act. Because the Commissions have not finalized the regulatory definition of the terms that are the subject of the Proposed Rules, members of the Working Group have commented on proposed rulemakings applicable to swap dealers and major swap participants. They are concerned about the potential that one or more aspects of the proposed definitions, which are unclear in material respects, could be interpreted such that they are deemed to be swap dealers or major swap participants. The Working Group would also note that the comments supplied herein are incomplete. Without a definition of "swap," the Working Group is unable to provide complete comments on the proposed definition of "major swap participant."

I. COMMENTS OF THE WORKING GROUP.

The Working Group is generally supportive of the objective approach taken by the Commissions in further defining "major swap participant." The use of objective criteria and tests will provide swap market participants with needed clarity and regulatory certainty with regard to their status as a potential major swap participant. However, multiple aspects of the proposed definition of "major swap participant" are vague in material respects and must be clarified so market participants can properly and consistently apply these aspects of the proposed definition to their own swap positions and related business activities.

A. PROPOSED DEFINITIONS MUST REFLECT CONGRESSIONAL INTENT TO CAPTURE ONLY ENTITIES PRESENTING SIGNIFICANT RISK TO THE U.S. FINANCIAL SYSTEM.

Congress clearly intended the definitions of "major swap participant" and "major security-based swap participant" to cover entities with swap portfolios that result in such entities presenting risk to the United States financial system. The first prong of the definition of "major swap participant," as set forth in Commodity Exchange Act ("CEA") Section 1a(33)(A)(i), deems any entity that "maintains a substantial position in swaps," excluding, among other things, positions "held for hedging or mitigating commercial risk" of a major swap participant.[2] In CEA

[2] CEA Section 1a(33)(A)(i).

Section 1a(33)(B), Congress directed the Commissions to define the term "substantial position" at "the threshold that the Commission[s] determine to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States."[3] In general, this prong identifies as "major swap participants" those entities that have amassed speculative positions in swaps that are sufficiently large such that losses on these positions could have a materially adverse effect on the financial system of the United States.

The second prong of the definition of "major swap participant" set forth in CEA Section 1a(33)(A)(ii) defines a "major swap participant" as a party whose "outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets." Congress clearly intended this standard to be a <u>substantial</u> threshold. This prong addresses the risk that an entity could inject huge losses into the financial network by defaulting on its swap portfolio, whether or not the default is particular to swaps.[4] In contrast to the first prong of the definition, the second prong contemplates potential losses beyond those inherent with an entity's actual swap positions.

Implicit in both of these prongs of the definition of "major swap participant" is Congress' intent for the definition to capture those entities that are not swap dealers, but that pose a systemic risk as a consequence of their swap activities. An entity is systemically risky if its default would significantly impact the financial system. The degree of systemic risk an entity poses, therefore, is a function of (a) the potential size of its default, (b) the degree to which its default would be distributed through out the financial system, and (c) the probability of its default. Accordingly, any definition intended to capture systemically risky entities should take into account all of those factors.

The tests proposed by the Commissions in the definitions of "major swap participant" and "major security-based swap participant" only consider the size of an entity's swap portfolio and, to some extent, the degree to which its swaps are margined. To capture only those entities whose swap activities can significantly impact the financial system, the Commissions should also factor in (a) the assets an entity has available to cure any potential default on its swap

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[3] As discussed below, when determining whether a position is a "substantial position" if a position creates "substantial counterparty exposure," the following swaps should be excluded: (a) swaps that are centrally cleared, (b) swaps to the extent their market value is collateralized and (c) swaps entered into between affiliates. These swaps do not have any significance to the stability of the financial system of the United States or any such risk can be better addressed elsewhere, such as the regulation of derivatives clearing organizations and clearing agencies.

[4] *E.g.*, a major swap participant that becomes insolvent upon suffering massive losses on its portfolio of residential mortgage investments.

portfolio and (b) the degree to which an entity's potential swap exposures are concentrated among systemically important market participants. Consideration of those factors might result in the application of any potential definitions of "major swap participant" and "major security-based swap participant" being more difficult for the Commissions and market participants. However, that additional burden is justified. If such definitions account for these additional factors, they will be less likely to unduly burden less risky entities than the proposed definitions.[5] Inclusion in the final rule of the additional factors would capture only entities that truly pose a systemic risk as a result of their swap activities.

1. DIFFERENT THRESHOLDS ACROSS CATEGORIES DOES NOT REFLECT SYSTEMIC RISK.

The degree of systemic risk posed by an entity's swap activities generally is not a function of the markets or products in which it transacts. So, the threshold level of swap activities to determine whether an entity is a major swap participant should not be different for different markets or classes of swaps. An entity, for example, is not more systemically risky because it has $1 billion in current outward exposure in "other commodities" swaps rather than $1 billion in current outward exposure in "rate" swaps. However, under the Proposed Rule, in the first circumstance, the entity is treated as systemically important and in the second instance, it is not.

The Commissions might have made market-by-market distinctions in the Proposed Rules because Section 1a(33)(C) of the CEA and Section 3(a)(67)(C) of the Securities Exchange Act of 1934 contemplate that a person may be designated as a major swap participant or major security-based swap participant for one or more categories of swaps or security-based swaps without being classified as such for all classes of swaps or security-based swaps. Congress likely understood that an entity might be a systemically significant participant because of its activity in one category of swaps, but might enter into other types of swaps from time to time. Prudential regulation would be unnecessary with respect to the entity's truly ancillary swap activities. However, the need for regulation is triggered by the exposure inherent in an entity's portfolio, not which markets a portfolio might cover.

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[5] *See* proposed CFTC Rule 1.3(sss). The Commissions recommend a threshold of $3 billion of current unsecured outward exposure or $6 billion in current outward and potential future unsecured exposure for an entity to have a substantial position in rate swaps and $1 billion in current outward unsecured exposure or $2 billion in current and future potential future unsecured exposure for an entity to have a substantial position in each of the other swap categories. For an entity's swap positions to constitute a substantial counterparty exposure, the Commissions proposed a threshold of $5 billion of current uncollateralized exposure and $8 billion of current and potential future uncollateralized exposure.

Accordingly, the Working Group believes that the exposure thresholds for the determination of substantial positions should be the same for each swap category. Alternatively, if the thresholds differ across swap categories, the Commissions must provide sufficient rationale to support such differences and such reasons should be solely based on concerns about the risk to the U.S. financial system.

2. PROPOSED THRESHOLDS DO NOT REFLECT SYSTEMIC RISK.

The objective standards outlined in the current definitions, as set out in the Proposed Rules, likely will capture entities that do not present systemic risk. While the Working Group supports the use of objective standards, it respectfully submits that the objective standards associated with proposed definitional tests have been set too low and should not be set as a static number.

Though the Commissions conclude otherwise, the proposed thresholds used to determine whether an entity holds a substantial position or if its positions create substantial counterparty exposure do not fully reflect Congress' desire for major swap participants to be limited to only those entities that are "systemically important or can significantly impact the financial system of the United States." The Commissions state:

> The proposed thresholds are intended to be low enough to provide for the appropriately early regulation of an entity whose swap or security-based swap positions have a reasonable potential of posing significant counterparty risks and risks to the market that stress the financial system, while being high enough that it would not unduly burden entities that are materially less likely to pose these types of risks.[6]

The instruction of Congress to the Commissions in the Act was to set definitions for "major swap participant" and "major security-based swap participant" that capture entities that *are* systemically important. The definition was intended to capture those entities that (a) for the purposes of the substantial position test "are systemically important or can significantly impact the financial system of the United States" and (b) for the purposes of the substantial counterparty exposure test whose swaps and resulting exposures "could have serious adverse effects on the financial stability of the United States banking system or financial markets."[7] The Act does not establish visibility thresholds at which entities *might potentially be* systemically important. The Commissions should correct their interpretation of the Act to correctly reflect the statutory text and Congress' true intent. Otherwise, the Commissions might regulate entities as major swap

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6 *Proposed Rules* note 105.

7 CEA Section 1a(33).

participants or major security-based swap participants that do not have swap portfolios that present risks to the U.S. financial system. There is no evidence to show this was Congress's interest.

The Commissions offer no evidence to support why the above thresholds were selected. The proposed thresholds do not appear to have any direct relationship to systemic risk. There are numerous examples of entities sustaining losses well in excess of the proposed limits. These entities not only did not cause a financial crisis, but also, in some cases, survived such losses. For example, the collapse of Enron is cited as an example of a high profile default that did not have a substantial systemic impact.[8] Prior to its collapse, Enron had approximately $18.7 billion in derivatives exposure, which constituted approximately 3% of the notional outstanding in the global market for derivatives on "other commodities."[9] Enron's share of the market for derivatives on "other commodities" was more than ten times larger than the Commission's proposed threshold. Despite this scale, the collapse of Enron did not trigger any systemic failure in the U.S. financial system.

Another example of an entity sustaining massive losses in the energy derivatives markets, yet not causing the energy markets or U.S. financial system to collapse is Amaranth Advisors, LLC. On one trading day, September 14, 2006, Amaranth experienced losses of approximately $560 million in natural gas futures positions. Amaranth is believed to have experienced total losses in connection with such position in excess of $4.35 billion.[10]

The Commissions should adopt substantial position and substantial counterparty exposure tests that account for current conditions in swap markets. Setting thresholds that utilize static numbers will require the Commissions to revisit such thresholds over time in order to ensure they continue to reflect Congressional intent. For example, prices in energy markets are correlated to macroeconomic conditions. So, if the U.S. economy were to return to strong

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8 *See, e.g.,* Darryl Hendricks, John Kambhu, and Patricia Mosser, *Systemic Risk and the Financial System*, Background Paper presented at Federal Reserve Bank of New York and the National Academy of Sciences Conference on New Directions in Understanding Systemic Risk, May, 2006 and James Bullard, Christopher J. Neely, and David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, 91 FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, Sep./Oct. 2009, Sec. 5, Part 1 at 403-17.

9 Diana B. Henriques, *Enron's Collapse: The Derivatives Market That Deals in Risks Faces a Novel One*, N.Y. Times, Nov. 29, 2001. Available at : http://www.nytimes.com/2001/11/29/business/enron-s-collapse-the-derivatives-market-that-deals-in-risks-faces-a-novel-one.html, and Bank of International Settlements Press Release: *The global OTC derivatives market at end-June 2001 Second part of the triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, December 20, 2001.

10 Ludwig B. Chincarini, *The Amaranth Debacle: A Failure of Risk Measures or a Failure of Risk Management?*, The Journal of Alternative Investments, Winter 2007, at 93.

growth, the notional size of energy swap markets would grow as the prices of the underlying commodities rise. Though commercial energy firms' absolute positions will rise, their relative positions will remain constant. On the other hand, other factors, such as the use of portfolio compression, might shrink the notional size of a market while the actual market value increases. The recent trend in the credit default swap market is an example.[11] In short, rising energy prices could push many commercial energy firms over the proposed major swap participant determination thresholds or shrinking notional amounts in other markets could allow entities to avoid designation as a major swap participant. In both cases, those entity's relative positions in their markets will remain unchanged and the risk they pose to the financial system will generally remain constant as well.

The Working Group respectfully suggests that the Commissions set the following limits with respect to a substantial position in other commodities:

- a daily average aggregate uncollateralized outward exposure in excess of 1% of the gross market value of other commodity swaps; or

- a daily average aggregate uncollateralized outward exposure *plus* daily average aggregate potential outward exposure in excess of 2% of the gross market value of other commodity swaps.[12]

Such limits would better reflect Congress' desire for the "major swap participant" definition to capture entities whose swap activities pose a systemic risk and that those limits will not require frequent modification as they are a relative measure of an entity's systemic risk.

3. SPECULATION, INVESTING AND TRADING ARE DIFFERENT CONCEPTS.

Proposed CFTC Rule 1.3(ttt)(2)(i)[13] provides that any swap "held for a purpose that is in the nature of speculation, investing or trading" will not be considered a hedging transaction for

[11] *See* Nicholas Vause, *Counterparty risk and contract volumes in the credit swap market*, BIS Quarterly Review, December 2010.

[12] The Working Group respectfully suggests that the Commissions base these determinations on the BIS' market size data until the Commissions determine the size of the swap markets they will regulate.

[13] *Proposed Rules* at 80,215.

purposes of the definitional tests.[14] The Working Group recommends that this provision be deleted in the final rule.[15]

Proposed subparagraph (ttt)(1),[16] the operative provision, describes certain hedging and credit mitigation activities. If a firm uses swaps for these activities, then such swaps are deemed to be held for "hedging or mitigating commercial risk" and excluded when determining whether a firm's swap portfolio constitutes a substantial position. As hedges, they are not speculative.

Proposed subparagraph (ttt)(2)(i) also should be deleted because it regulates swaps in connection with "investing or trading."[17] While Congress was clearly concerned with speculation, it showed no similar concern for investing or trading. In fact, no where in Title VII do the terms "speculation, investing, or trading" appear together. Also, the phrasing "investing or trading" does not appear in Title VII. The Commissions have not defined "investing" or "trading" in the Proposed Rules. Thus, there are open questions about what activity constitutes investing or trading. For example, even if such terms were to be defined, does Title VII require the same treatment for swaps done for investing and trading purposes as it does for swaps entered into for speculative purposes?

Trading and investing, as vernacular concepts, include both speculation and hedging. Use of such terms might suggest that hedging swaps, which constitute trading or investing activity, would not be afforded treatment as hedges under the definitional tests. This treatment of hedging swaps would effectively nullify the statutory provisions that exclude swaps for hedging purposes when determining whether a swap portfolio might constitute a "substantial position."

The Working Group also is concerned that the word "trading," in particular, might impermissibly include the buying and selling of commodities by parties that are primarily in the business of producing, delivering, storing, marketing and managing physical commodities. This is traditional "commercial activity." Yet, it might also come within the meaning of "trading."

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[14] Such categorization is also used in determining whether or not the end user exception from the mandatory clearing requirement is available to certain market participants.

[15] The Working Group suggests that the CFTC adopt one provision in its regulations that defines when swaps are hedges or mitigate commercial risk. We note that the CFTC proposes a similar definition in proposed CFTC regulation 39.6.

[16] *Id*. at 80,214-15.

[17] In the alternative, the Commissions should redraft it to read, "Not held for a purpose that is in the nature of speculation."

Swaps executed in connection with this trading likely would constitute *bona fide* hedging transactions. It would make no sense for language in the Commissions' regulations to disqualify such swaps from being hedges for purposes of the definitional tests.

4. THE COMMISSIONS SHOULD NOT RECLASSIFY SWAPS THAT HEDGE NON-SWAP SPECULATIVE POSITIONS.

The Commissions, in the release to the Proposed Rules, introduced uncertainty as to the treatment of swaps entered into by a firm to hedge physical market positions. This may simply be a drafting issue, but the Working Group would respectfully request the Commissions to provide clarification.

In footnote 128 to the Proposed Rules,[18] the Commissions state that, "[s]wap positions that hedge **other positions** that themselves are held for the purposes of speculation or trading are also speculative or trading positions." (emphasis added). There is no clarity as to what the Commissions meant by "other positions." Perhaps it was an error, and the Commissions meant "other swap positions."

If the Commission intended to suggest that the hedge of a physical market position that is a "trading" position (*i.e* held as a merchant or merchandiser in the commodity) would not qualify for treatment as "hedging or mitigating commercial risk" under the MSP definition, this would have serious consequences to physical market participants. All physical market participants, from car manufacturers, to toy stores, to merchant energy companies, are in the business of trying to sell a commodity for more than the cost of producing or procuring the commodity. An energy company procuring supply in advance of the summer driving season or a toy store stocking its shelves in advance of a holiday are each arguably taking a position in a physical market to trade based on speculation that there will be increased demand. If the phrase "other positions" is interpreted as applying to physical market positions, it could have the perverse result of treating certain bona fide hedges of positions as outright speculative swap positions. Thus, firms would be unable to exclude these swaps from the exposure calculations.

On the other hand, if the footnote was intended to use the phrase "other swap positions," the sentence in question would be consistent with what the Working Group believes the Commission's intent to be.

Such an interpretation of footnote 128 also is consistent with proposed CFTC Rule 1.3(ttt)(2)(ii). This subparagraph, in describing swaps that are not hedging or mitigating commercial risk, reads:

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[18] *Proposed Rules* at 80,195. *See, also, Proposed Rules* footnote 131 at same.

> (ii) Not held to hedge or mitigate the risk of another swap or securities-based swap position, unless that other position itself is held for the purpose of hedging or mitigating commercial risk as defined by this rule of § 350.4s67-4 of this title.

In this subparagraph, "other position" clearly references another swap or security-based swap. Unlike footnote 128, subparagraph (ttt)(2)(ii) does not refer to swaps held to hedge "other position," just those to hedge swaps or securities-bases swaps.

Accordingly, the Working Group requests that the Commission clarify or correct (as appropriate) the phrase "other positions" in footnote 128 to mean "other swap positions."

Separately, the Working Group supports the inclusion of subparagraph (ttt)(2)(ii) in the Proposed Rules as it facilitates as firm's effective management of it hedge portfolio when that portfolio includes swaps entered into in connection with commercial activity (*e.g.*, the physical delivery of energy products). We note, however, that it prevents a swap intended to offset a speculative swap from being considered a hedge for purposes of the definitional tests. Yet, entering into an offsetting swap is a very common and efficient way in which market participants exit or limit a derivatives position. When considered in the context of systemic risk mitigation, the Working Group believes that all hedges should be treated as hedges.

5. <u>THE COMMISSIONS SHOULD PROVIDE MORE SUPPORT FOR THEIR CONCLUSIONS WITH RESPECT TO ADMINISTRATIVE LAW MATTERS</u>.

The Commissions, in the release to the Proposed Rules, largely conclude that the requirements under several administrative statutes are satisfied because the Proposed Rules only concern definitional matters. As the definitions covered by the Proposed Rules are the keystone for Title VII, this conclusory approach to applicable administrative statutes is wanting.

For example, the Commissions do not provide supporting discussion about the various thresholds contained in the Proposed Rule. There is no analysis as to why any particular threshold represents the best selection. There is no discussion of the impact to the U.S. economy from the selection of one threshold over another. These definitions simply cannot be made in a vacuum. Quantitative, economic analysis is required to understand how and why the Commissions fashioned the definitions as they appear in the Proposed Rule.

Title VII and the rules to be promulgated by the Commissions thereunder will fundamentally effect the U.S. financial system and the U.S. economy. In the energy markets, they will effect the cost of electricity, natural gas and heating oil received by nearly every U.S. tax payer. The definitions are central to derivatives reform. Without them, the other statutory and regulatory provisions largely are inoperative. To hold that the definitional rules have little or no associated costs or economic impact (perhaps on the theory that it is the other statutory

provisions or rules that actually impose the obligations and constraints) is to truly subvert substance to legal finery.

Thus, among other things, the Working Group does not support the Commissions' conclusion under the Small Business Regulatory Enforcement Fairness Act of 1996 that the definitions do not constitute a "major" rule. The Commissions offer no support behind their conclusions that the Proposed Rules do not result in or are likely to result in the following:

- an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effect on competition, investment or innovation.

The Working Group believes that the Proposed Rules will cause each of the foregoing to occur.[19]

The Commissions should provide economic analysis as to the import of the definitions they have selected. This information, however, should not appear solely in the final rule. The Working Group therefore requests that the Commissions (i) consider the costs and benefits associated with the Proposed Rules in the manner prescribed by CEA Section 15(a), (ii) issue a supplemental rule in this proceeding setting forth empirical data supporting its conclusions regarding the costs and benefits of the Proposed Rules, and (iii) notice the supplemental rule in the Federal Register for public comment.

B. SUGGESTED IMPROVEMENTS TO EXPOSURE TESTS.

The definitional tests in the Proposed Rules are highly technical. They also are more challenging to use than may appear at first glance. Given the potential complexity of and likely interpretive issues with any tests set forth under the final definitions of "major swap participant" and "major security-based swap participant," the Working Group requests that the Commissions solicit additional feedback from market participants prior to the issuance of a final rule. The Commissions also might request volunteers to walk-through the determination of whether they

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[19] The Working Group has given notice to Congress and the CFTC on several occasions of the potential impact to energy markets and the U.S. economy from reform of the energy swap markets. *See for example,* Comments of the Working Group on the CFTC's proposed rule on *Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant*, filed with the CFTC on January 18, 2011, Comments of the Working Group on the CFTC's proposed rule on *Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants*, filed with the CFTC on December 15, 2010, and January 24, 2011.

are a major swap participant or major security-based swap participant to ensure that the proposed tests actually function in practice.

Attached as Exhibit A is an exercise through which members of the Working Group attempted to perform the definitional tests for major swap participant. The Proposed Rule, as described below, leaves certain matters open to interpretation or, in other cases, require entities to "fill in the blanks." Accordingly, Exhibit A reflects some subjective interpretation. Thus, it is possible that the exercise is not how the Commissions intended the definitional tests to apply. Accuracy, however, was not the primary point of the exercise. Instead, the Working Group wants to demonstrate by example the need for the Commissions to (a) build and run such models to assure the definitional tests work in practice, (b) establish a step-by-step procedure for applying the definitional tests and (c) publish a "worksheet," perhaps like Exhibit A, to facilitate the definitional analysis by market participants.

1. CLARIFICATIONS ARE NECESSARY FOR THE EXPOSURE DETERMINATIONS.

Certain aspects of the proposed definitional tests must be further clarified or revised to ensure proper and consistent application of these tests by market participants. As stated above, the definitions should be styled to provide a clear step-by-step method for evaluating any given swap portfolio and must include clear definitions of critical terms and related calculations.

There are several instances where descriptions of calculations related to the definitional tests are not clear. For example, proposed CFTC Rule 1.3(sss)(3)(ii)(A)(1), as currently styled, could be interpreted to require notional amounts be summed and then multiplied by the appropriate multiplier. However, when the entire regulation is read together, it appears that the notional amount of each swap is multiplied by the appropriate multiplier, a cap is applied with respect to credit default swaps, and then the products are summed. As another example, the adjustment for netting agreements in proposed CFTC Rule 1.3(sss)(3)(ii)(B) is not entirely clear. Is "NGR" (a) the net outward exposure (after netting) divided by gross outward exposure (before netting) or (b) the net exposure regardless of its direction divided by the gross exposures without regard to direction? (The detailed and technical nature of these examples underscores the need for active participation of industry representatives beyond submission of prose commentary.)

To further illustrate, in determining the aggregate potential outward exposure of a swap portfolio under the Proposed Rules, the aggregate notional amount of a class of swaps in the portfolio is multiplied by a factor depending on duration.[20] What is not clear from the text of the

[20] *Proposed Rule* at 80,193.

Proposed Rules is whether individual swaps spanning multiple time horizons should be bifurcated for reporting purposes so that the notional amount of the swap is split appropriately between applicable time horizons (as the Working Group believes would be appropriate), or if the entire notional amount of the swap should be reported only in the time horizon corresponding to the final maturity of the swap.

There are additional instances in which the Commissions must further define some of the more basic elements included in prescribed calculations. For example, the Proposed Rules do not define the terms "notional principal amount" or "notional amount," which appear to be used interchangeably and are integral to the calculation of potential outward exposure. Notional amounts for swaps, as understood by members of the Working Group, are not always established in dollars, but can also be established by reference to units of commodities. Thus, when determining an "aggregate notional amount" of a "notional principal amount" of swaps in a market participant's portfolio, some conversion is necessary to transform notional amounts measured in units of commodities to dollar amounts. In addition, the Commissions should clarify whether or not outward exposure includes unpaid amounts under a swap. The final rule further defining "major swap participant" should provide sufficient technical guidance to answer seemingly basic questions such as these and provide clarity on the specific mechanics and the order in which the calculations in the Proposed Rule 1.3(sss) are to be performed.

Exhibit B provides some specific recommendations of the Working Group with respect to language as it appears in the CFTC proposed Rule 1.3(sss).

2. THE COMMISSIONS SHOULD AFFORD FAVORABLE TREATMENT OF CLEARED SWAPS AND SWAPS SUBJECT TO DAILY MARGINING.

The Proposed Rules consider both cleared and daily margined swaps in the determination of potential outward exposure. The notional value of these swaps is effectively discounted by 80% when they are included in the potential outward exposure calculation to account for the risk mitigation benefits of central clearing and daily margining.[21] The Working Group applauds the Commissions for accounting for the risk mitigation benefits of central clearing and daily margining, although the proposed 80% discount potentially overstates the risk posed by daily swings in the value of such swaps.

Cleared swaps, in particular, should not be considered in the determination of whether an entity is a major swap participant. Daily settlement of gains and losses on cleared swaps shortens the time horizon for exposure to changing market prices to a single day, and initial

[21] Proposed CFTC Rule 1.3(sss)(3)(iii).

margin required by rules of derivatives clearing organizations ("DCOs") ensures that sufficient funds will be available for settlement of daily losses in almost any conceivable circumstance. If the Commissions are concerned about the potential risk posed by daily price swings of cleared swaps, then the proper place to address this concern is in the regulations pertaining to initial margin requirements for DCOs and clearing agencies.

Swaps that are subject to daily margining should also be discounted heavily in calculations of potential outward exposure. While the Proposed Rules state that "a swap shall be considered to be subject to daily mark-to-market margining if, and for so long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the swap," the Working Group believes that the existence of contractual margining provisions should be sufficient justification for the discount contemplated in the proposed rule in the absence of evidence that the applicable party has consistently chosen not to enforce margin provisions contained in its agreements. Absent such evidence, the Working Group believes that a discount of 98% is appropriate to account for the risk that a counterparty cannot meet its daily margin call.[22] [23]

3. UNUSED UNSECURED THRESHOLDS SHOULD NOT BE INCLUDED IN DEFINITIONAL TESTS.

The method for determining aggregate potential outward exposure, as set forth in proposed CFTC Rule 1.3(sss)(3), appears to account for a portion of the potential exposure twice.[24] The calculations require any uncollateralized threshold to be added to the aggregate uncollateralized outward exposure, which is then added to potential outward exposure to reach a representation of potential future exposure. It is entirely unclear why any unused unsecured threshold is equated to exposure, as it more accurately represents the absence of exposure. This proposed treatment is onerous and inconsistent with other standard financial measurements of exposure. For example, when calculating an entity's debt-to-equity ratio, the indebtedness component of the calculation does not incorporate undrawn portions of revolving credit facilities or other forms of available but undrawn debt. At best, any unused unsecured threshold is a reserve for potential outward exposure.

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[22] The Working Group notes that it is unable to fully evaluate the proper risk discount for swaps subject to daily margining without knowing the parameters of margin requirements imposed on major swap participants.

[23] This proposed discount is appropriate to address systemic risk concerns, particularly in respect of the energy swap markets. As discussed elsewhere, the Working Group does not know of an example of a default in energy swaps triggering a systemic event to the U.S. financial system.

[24] *Proposed Rule* at 80,188.

The unworkable nature of the proposed inclusion of unused unsecured thresholds is even more apparent when considered in the context of master agreements under which there are no trades in place in the calculation of potential outward exposure. Dormant master agreements represent an agreement as to the parameters that will govern any future trades between two parties. Such agreements do not represent an active credit relationship between the parties. Accordingly, unsecured thresholds contained in dormant master agreements should not be included in any measure of current or potential future exposure.[25] The Proposed Rules should be clarified to exclude any unsecured thresholds under dormant master agreements from the calculation of current or potential future exposure. Additionally, the Proposed Rules should not require the inclusion of any unsecured threshold amount in excess of calculated outward exposure.

The consideration of unsecured thresholds creates further complications in two other significant ways. *First*, for the purposes of determining whether an entity has a substantial position, positions entered into to hedge commercial risk are removed from the calculations. By including unused unsecured thresholds in the determination of substantial position, the CFTC is potentially reading the exclusion of hedge positions out of the Proposed Rules. If an entity has entered into both speculative and hedge positions under the same master agreement, how would an entity determine what portion of any unused unsecured threshold should be allocated to hedge positions?

Second, commercial energy firms often enter into master agreements that cover both physical and financial positions. Including both in one agreement is done for efficiency purposes. Only one agreement must be negotiated, and more importantly, counterparties are able to net physical and financial exposures. If unused unsecured exposure is required to be included in the determination of whether an entity is a major swap participant, then it is uncertain how that unused unsecured threshold should be allocated between potential physical positions and potential swap positions. A more fundamental legal question is how physical positions that are outside the CFTC's jurisdiction should be considered.

The Commissions might have added unused unsecured thresholds to the definitional formulas to discourage the use of unsecured trading. The Working Group believes that the loss of unsecured trading will result in a diminution of liquidity in the overall market. Many

[25] Inclusion of dormant trading relationship in the major swap participant definition would also serve as an incentive to terminate dormant master agreements. Master agreements are left in place even if there are no active trades between the counterparties, because, as the terms of the trading relationship are already in place, they allow the counterparties to enter into new trades quickly and efficiently.

commercial energy firms rely on some amount of unsecured trading, both for administrative considerations and for allocation of cash resources. If unsecured trading is removed or receives punitive treatment under the Commissions' regulations, then such firms might limit their trading or even exit the market all together. This would reduce liquidity for the entire market. Accordingly, the Working Group suggests that the Commissions not include unused unsecured thresholds in the definitional tests.

4. INITIAL MARGIN SHOULD BE DEDUCTED FROM AGGREGATE POTENTIAL OUTWARD EXPOSURE.

In the release to the Proposed Rules, the Commissions specifically ask "if an entity currently has posted excess collateral in connection with a position, should the amount of that current overcollateralization be deducted from its measure of potential future exposure?"[26] The Working Group believes that such excess collateral should be deducted from potential outward exposure. In particular, any initial margin posted on a swap should be factored into the determination of aggregate potential outward exposure. If initial margin, as the CFTC's own definition of the term states, is "money, securities, or property posted by a party to a swap as performance bond to cover potential future exposures arising from changes in the market value of the position,"[27] then the risk mitigation effects of any initial margin should logically be considered in the calculation of aggregate potential outward exposure under the proposed definition of "major swap participant."

5. ADJUSTMENTS FOR NETTING AGREEMENTS IN THE CALCULATION OF AGGREGATE POTENTIAL OUTWARD EXPOSURE SHOULD BE REVISED.

The Proposed Rules provide an adjustment for netting in the calculation of aggregate potential outward exposure that relies on a specified formula referencing the ratio of net current exposure to gross current exposure derived from the calculation of aggregate uncollateralized outward exposure. The Working Group believes that this formula-based adjustment for netting is unnecessary because off-setting positions could be easily reflected directly in calculations of net total notional principal amount prior to application of conversion factors specified in the Table to § 1.3 (sss) - Conversion Factor Matrix for Swaps.[28] This approach has been incorporated into example calculations provided in Exhibit A.

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[26] *Proposed Rules* at 80,183.

[27] Proposed CFTC Rule 23.600.

[28] Proposed CFTC Rule 1.3(sss).

C. COLLATERAL CONSIDERATIONS.

The Working Group supports the broadest definition of collateral for determining whether an "out-of-the-money" swap is secured for purposes of the definition of "major swap participant." The Commissions should recognize in the Proposed Rules that collateral for a swap might be in forms such as liens on assets and parent guarantees.

Swaps that are secured by sufficient liens on property should be afforded the same discount as swaps subject to daily margining. Often, the value of collateral supporting the lien is several times greater than the exposure. Given the adequacy of this collateral, the Commissions should afford the same treatment to swaps collateralized in such a manner. Even if such swaps were subject to daily margining, the counterparty effectively would not be subject to delivery obligations because it had already delivered collateral far exceeding the exposure.

D. TREATMENT OF AFFILIATES.

1. AGGREGATION ACROSS ENTERPRISES.

The Commissions state that it would be appropriate to attribute a majority-owned subsidiary's swap positions to a parent for the determination as to whether the parent is a major swap participant.[29] In many circumstances aggregation would not be consistent with "the concepts of 'substantial positions' and 'substantial counterparty exposure.'"[30] Positions of affiliates should not be aggregated to the extent that such affiliates are independently controlled and capitalized. Under these circumstances, the affiliate's trading is not being coordinated with swap activities of other entities and only the assets of that entity are at risk in the event of a default. If an entity is independently controlled it is unlikely that such entity was created in an attempt for a parent to evade classification as a major swap participant, and if an affiliate is independently capitalized then there is no recourse to the parent entity or another affiliate.

The market treats an independently controlled and capitalized entity as distinct from its parent and affiliates, so only its positions should be considered when attempting to determine if it is a major swap participant and should not be considered when determining if its parent company or affiliates are major swap participants. This approach is consistent with the treatment of

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[29] *Proposed Rules* at 80,202.

[30] The Working Group acknowledges that under certain unusual circumstances such aggregation would be appropriate. For example, it would be appropriate to aggregate positions of affiliated entities if an entity were attempting to evade registration as a major swap participant by trading swaps out of multiple subsidiaries under common control.

affiliated companies under bankruptcy law where such companies are considered individually so as to not prejudice the rights of creditors to one entity by allowing recourse to the assets of such entity to creditors of an affiliate. This distinction allows subsidiaries to obtain favorable financing independent of any concerns of a corporate parent. The Commissions should give deference to the separateness of affiliates so long as they are managed as distinct entities.

If the Commissions choose to aggregate the swap portfolios of affiliated entities for the purposes of the major swap participant determination, the Working Group respectfully requests that the Commissions not aggregate the positions of an entity that on its own is a swap dealer or major swap participant with those of its affiliates. To do so would eliminate an enterprise's ability to segregate all of its regulated swap activities in one entity, and would thereby potentially subject that entire enterprise to prudential regulation. To the extent that an ultimate parent would be considered a major swap participant as a result of aggregation of positions of its subsidiaries, the designation should only apply to the parent itself and not to individual subsidiaries. Such designation should only apply to individual subsidiaries if the positions of such individual subsidiaries warrant such designation on a stand-alone basis.

If the Commissions elect to aggregate swap portfolios of affiliated entities, the Commissions should provide a clear process by which entities might petition one or both of the Commissions to permit the petitioning entities to not aggregate positions. The petitioner should be permitted to provide evidence to the applicable Commission that the swap portfolios of its affiliates do not reflect a scheme to avoid registration as a major swap participant. This approach is consistent with the CFTC's Notice of Proposed Rulemaking on Position Limits for Derivatives.[31] In that notice, the CFTC provided a mechanism by which certain non-financial entities can disaggregate certain positions if the parent company can demonstrate that the owned non-financial entity is independently controlled and managed. The Working Group will comment separately on specific aspects of the proposed rule on Position Limits.

Aggregation of swap portfolios also introduces issues with the extraterritorial application of the Commissions' jurisdiction.[32] Many of the Working Group members have affiliates that are not incorporated in and do not operate in the United States. These affiliates often trade in swaps outside of the United States. The Working Group recommends that the swap portfolios of such off-shore affiliates not be aggregated with swap portfolios of companies in the same enterprise that operate within the U.S.

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[31] 76 Fed. Reg. 4,752 (January 26, 2011).

[32] The Working Group has submitted comments to the CFTC with respect to the extraterritorial application of its rules and regulation under Title VII of the Act. Working Group of Commercial Energy Firms comments to the CFTC's Proposed Rule on *Registration of Swap Dealers and Major Swap Participants*, filed with the CFTC on January 24, 2011.

2. TREATMENT OF INTER-AFFILIATE SWAPS.

Inter-affiliate swaps should not be considered when determining if an entity is a major swap participant. Transactions between two affiliated entities result in the same corporate family taking both sides of the swap. The corporate family's net credit exposure from the trade is zero. Given that the net credit exposure is zero, consideration of inter-affiliate swaps when determining if an entity is a major swap participant would be counting swaps with no counterparty risk to the market in tests meant to arrive at some indication of the level of risk an entity poses to the U.S. financial system.

E. LEGACY PORTFOLIOS.

For many market participants, a large number of swaps in their portfolios were entered into prior to the enactment of the Act. These positions were entered into in the ordinary course of business before parties to these swaps could reasonably anticipate the possibility of being subject to prudential regulation because of these swap positions. The Working Group respectfully requests that the Commissions allow market participants whose current portfolios would make them a major swap participants to maintain their current positions and allow such positions to expire on their own terms without regulating the entities as major swap participants.[33]

Any entity that might be deemed a major swap participant should be permitted to not register as such if each of its relevant existing transactions expire according with their terms and such entity does not enter into any new swaps that would cause it to be deemed a major swap participant. This "grandfathering" of legacy portfolios would allow a smooth regulatory transition and would avoid any market disruption caused by entities closing-out a significant number of legacy positions in a short period of time to avoid being a major swap participant. We anticipate that any entity electing to grandfather a legacy portfolio would submit a brief petition to the applicable Commission.

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[33] For discussion of the treatment of legacy portfolios and how they should be considered with regards to registration as a major swap participant please see the Working Group's comments on the CFTC's proposed rule on *Registration Requirements for Swap Dealers and Major Swap Participants*, filed with the CFTC on January 24, 2011.

F. NETTING OF PHYSICAL POSITIONS.

The Working Group strongly supports the Commissions' decision to consider the risk mitigation effects of netting agreements when determining whether an entity is a major swap participant. The Commissions recognized that because (a) swaps are not necessarily hedged with other swaps and (b) swaps are also used to hedge non-swaps exposure, certain other positions should be considered for netting purposes. The Commissions state:

> When calculating the net exposure the entity may take into account offsetting positions with that particular counterparty involving swaps, security-based swaps and securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements) to the extent that is consistent with the offsets provided by the master netting agreement.[34]

The Working Group respectfully requests that the Commissions consider the netting of physical positions in commodities and offsetting swaps when calculating net exposure for the purposes of the major swap participant definition. Specifically, master netting agreements that cover entire trading relationships, not just uncleared energy-based swaps and the other listed products, should be considered. It is common practice for commercial energy firms to enter into a transaction for a physical energy commodity and then enter into a related uncleared energy-based swap transaction with the same counterparty as a risk mitigation tool. Any multi-transaction netting agreement between the two counterparties will typically net obligations under both the physical energy transaction and the uncleared energy-based swap. Moreover, trades in physical energy commodities and uncleared energy-based swaps are often inextricably linked, and counterparties should be able to consider their entire trading relationship when determining net exposure for the purposes of the definition of major swap participant. If the Commissions were to exclude physical positions from the netting calculations under the proposed major swap participant definition, then the unsecured exposure of many commercial energy firms would be substantially overstated, potentially causing such commercial energy firms to incorrectly be deemed major swap participants.

G. LIMITED PURPOSE DESIGNATIONS.

Section 1a(33)(C) of the CEA clearly states and Congress intended that entities can be designated as a major swap participant for only one category of swaps. Proposed CFTC Rule 1.3(qqq)(2) requires entities to make an affirmative application to the CFTC to be treated as a major swap participant for less than all of the major categories of swaps. However, the statute expressly presumes that an entity may be deemed a major swap participant for one category of

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[34] *Proposed Rules* at 80,189.

swaps without being considered a major swap participant for other categories, thus creating a presumption in favor of the market participant, meaning an entity deemed to be a major swap participant for a category of swaps should be presumed to be a major swap participant only for that particular category. The Commissions have effectively flipped the statute on its head, establishing a presumption in direct contrast to the express statutory language. As such, the Working Group respectfully requests the Commissions to abandon proposed CFTC Rule 1.3(qqq)(2).

If the Commissions choose to retain proposed CFTC Rule 1.3(qqq)(2), the Working Group believes that it will impose an unnecessary and potentially substantial burden on both (a) major swap participants that are clearly a major swap participant for one category of swap and (b) the Commissions which must process petitions to limit the scope of description. In the event that proposed CFTC Rule 1.3(qqq)(2) is retained, the Working Group respectfully suggests that the Commissions adopt a presumption that if 50% or more of a major swap participant's swaps fall within one category of swaps and that entity's swaps in other categories would not separately exceed any of the proposed thresholds, then that entity is a major swap participant for only that one category of swap. For example, the swap portfolios of many commercial energy firms that might be major swap participants are likely to be predominantly comprised of energy swaps, and the remainder of the portfolio are likely to be positions such as foreign exchange or interest rate swaps entered into to hedge commercial risk. Accordingly, such an entity should not have to file an application to have the scope of the application of the major swap participant definition limited.

By adopting the recommended presumption, the Commissions will avoid placing a costly and unnecessary burden on entities that are clearly only a major swap participant for one class of swaps. In addition, the presumption would eliminate the need for the Commissions to process applications that are likely a mere formality.

H. TIMING CONCERNS.

The Working appreciates that the Commissions recognize exogenous market conditions could temporarily force a potential major swap participant over a threshold during one quarter. Allowing an entity that exceeds a threshold by twenty percent or less in one quarter an additional quarter as a reevaluation period will avoid market disruptions that could result from deeming as major swap participants entities that, through factors beyond their control, temporarily exceed a given threshold.[35]

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[35] Proposed CFTC Rule 1.3(qqq)(4).

An entity that potentially meets the definition of a major swap participant should be given two quarters to register as such. As discussed more completely in the Working Group's comments to the CFTC's Proposed Rule on *Registration of Swap Dealers and Major Swap Participants,*[36] the determination of whether an entity is in fact a major swap participant will be a complex one. Further, coming into compliance with the regulatory obligations imposed on major swap participants will likely require a substantial expenditure of compliance and risk management resources and might require corporate restructuring as well as the restructuring of existing trading relationships. This compliance burden will be greatest for commercial entities that have never been subject to prudential regulation by a financial regulator. Accordingly, the Working Group believes that two quarters is the minimum amount of time an entity would need to register as a major swap participant.[37]

I. OPEN COMMENT PERIOD.

As the Commissions have proposed the definitions contained herein towards the end of releasing proposed rules under Title VII of the Act, and have yet to propose a definition of "swap," market participants have not been able to offer fully informed comments on the CFTC's and SEC's proposed rules, especially comments regarding the cost implications of such rules. In addition, given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commissions hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on all of the proposed rules. The resulting comprehensive comments will allow the Commissions to better understand how their proposed rules will impact swap markets.

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[36] Working Group of Commercial Energy Firms comments to the CFTC's Proposed Rule on *Registration of Swap Dealers and Major Swap Participants*, filed with the CFTC on January 24, 2011.

[37] The Working Group notes that this suggested time frame differs from the more extended time frame recommended in its comments to the CFTC's Proposed Rule on *Registration of Swap Dealers and Major Swap Participants*. The time frame suggested herein assumes that an entity becomes a major swap participant once the entire new regulatory regime imposed by Title VII of the Act is in place. Under these circumstances, an entity that is not a major swap participant from the outset can undertake some, but not all of the requirements imposed on major swap participants prior to exceeding the proposed thresholds.

II. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets in the United States. We appreciate the balance the Commissions must strike between effective regulation and not hindering the uncleared energy-based swap markets. The Working Group offers its advice and experience to assist the Commissions in implementing the Act. Please let us know if you have any questions or would like additional information.

Respectfully submitted,

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Exhibit A

Calculation of Aggregate Uncollateralized Outward Exposure

a.	*b.*	*c.*	*d.*	*e.*	*f.*	*g.*	*h.*
	Current Mark-to-Market			**Master**		**Posted**	**Uncollateralized**
Counterparty	**Positive Value**	**Negative Value**	**Net Swap Value**	**Netting**	**Net Exposure**	**Collateral**	**Exposure**
Example Portfolio:							
Counterparty 1	$15,000,000	($20,000,000)	($5,000,000)	$0	($5,000,000)	$0	($5,000,000)
Counterparty 2	$5,000,000	($35,000,000)	($30,000,000)	$5,000,000	($25,000,000)	$5,000,000	($20,000,000)
Counterparty 3	$35,000,000	($5,000,000)	$30,000,000	$0	$30,000,000	$0	$0
Counterparty 4	$1,000,000	($16,000,000)	($15,000,000)	$0	($15,000,000)	$0	($15,000,000)
Counterparty 5	$5,000,000	($165,000,000)	($160,000,000)	$10,000,000	($150,000,000)	$100,000,000	($50,000,000)
Aggregate Uncollateralized Outward Exposure							($90,000,000)

a. Legal entitity that is contractual counterparty to swaps

b. Sum of mark-to-market value for all individual swaps with a respective counterparty that have a positive mark-to-market value (in-the-money swaps). Amount will be >= $0.

c. Sum of mark-to-market value for all individual swaps with a respective counterparty that have a negative mark-to-market value (out-of-the-money swaps). Amount will be <= $0.

d. Sum of mark-to-market value for all individual swaps with a respective counterparty.

e. Amount under valid master netting agreement with a respective counterparty available to offset negative net swap value reported in column d. Amount will be >= $0.

f. Net Exposure for a respective counterparty should be calcualted as the lesser of $0 and the sum of columns d. and e.

g. Amount of collateral posted to a respective counterparty and available to offset negative net exposure reported in column f. Amount will be >= $0.

h. Uncollateralized Exposure for a respective counterparty should be calculated as the lesser of $0 and the sum of columns f. and g.

***Aggregate Uncollateralized Outward Exposure* equals the sum of column h. for entire portfolio of swap counterparties.**

Calculation of Potential Outward Exposure

Notional Principal Amount = notional underlying quantity in units (i.e. MWh, MMBtu, gallons, etx.) multiplied by current market price per unit.

a. Indicator (Y/N) of daily margining

b. Applicable collateral threshold with respect to each counterparty. Amount will be <= $0

c. Collateral threshold less uncollateralized exposure

d. Sum of Notional Principal Amount for all long swaps with a respective counterparty, categorized by applicable time period. For swaps that span multiple applicable time periods, report Notional Principal Amount that would be applicable for each time period. Amount reported will be >= $0.

e. Sum of Notional Principal Amount for all short swaps with a respective counterparty, categorized by applicable time period. For swaps that span multiple applicable time periods, report Notional Principal Amount that would be applicable for each time period. Amount reported will be <= $0.

f. Sum of amounts reported in ***d.*** and ***e.***

g. Product of amounts for each respective time period in column ***f.*** and factors in matrix presented in the proposed rule.

h. Absolute value of amount calculated for each counterparty in column ***g.***

i. Net Swap Value from Aggregate Uncollateralized Outward Exposure calculation.

j. Column ***i.*** plus column **h.**

k. Column ***i.*** minus column ***h.***

l. Lesser of $0 and minimum value from columns ***j.*** and ***k.***

m. Amount under valid master netting agreement with a respective counterparty available to offset negative net swap value reported in column ***l.*** Amount will be >= $0.

n. Amount of collateral posted to a respective counterparty and available to offset potential negative net exposure reported in column ***l.*** Plus additional collateral representing initial margin, independent amounts, and the like. Amount will be >= $0.

o. Margining Adjustment (see below)

p. Sum of columns ***l., m., n.,*** and ***o.*** Amount will be <= $0.

Margining Adjustment:

If Daily Margining = "Y" and Adjusted NSV (column **l.**)<0
Multiply the amount by which PFE Factor (column ***h.***) exceeds Available Threshold (column ***c.***) by 0.8

Net effect is that only the PFE factor that exceeds available unsecured credit gets discounted.

Calculation of Potential Outward Exposure

See calculation detail for Aggregate Uncollateralized Outward Exposure									*a.*	*b.*	*c.*
Counterparty	**Current Mark-to-Market**			**Master Netting**	**Net Exposure**	**Posted Collateral**	**Uncollateralized Exposure**		**Daily Margining**	**Collateral Threshold**	**Available Threshold**
	Positive Value	**Negative Value**	**Net Swap Value**								
Example Portfolio:											
Counterparty 1	$15,000,000	($20,000,000)	($5,000,000)	$0	($5,000,000)	$0	($5,000,000)		**N**	$0	$0
Counterparty 2	$5,000,000	($35,000,000)	($30,000,000)	$5,000,000	($25,000,000)	$5,000,000	($20,000,000)		**Y**	($20,000,000)	$0
Counterparty 3	$35,000,000	($5,000,000)	$30,000,000	$0	$30,000,000	$0	$0		**Y**	($20,000,000)	($20,000,000)
Counterparty 4	$1,000,000	($16,000,000)	($15,000,000)	$0	($15,000,000)	$0	($15,000,000)		**Y**	($20,000,000)	($5,000,000)
Counterparty 5	$5,000,000	($165,000,000)	($160,000,000)	$10,000,000	($150,000,000)	$100,000,000	($50,000,000)		**Y**	($50,000,000)	$0
Aggregate Uncollateralized Outward Exposure							($90,000,000)				

d.			*e.*			*f.*			0.1
Notional Principal Amount - Long Swaps			**Notional Principal Amount - Short Swaps**			**Net Aggregate Notional Principal Amount**			**Cc**
<= One Year	**1-5 Years**	**> 5 Years**	**<= One Year**	**1-5 Years**	**> 5 Years**	**<= One Year**	**1-5 Years**	**> 5 Years**	**<= One Year**
$35,000,000	$20,000,000	$15,000,000	($25,000,000)	($15,000,000)	($5,000,000)	$10,000,000	$5,000,000	$10,000,000	$1,000,000
$45,000,000	$25,000,000	$20,000,000	($15,000,000)	($5,000,000)	($1,000,000)	$30,000,000	$20,000,000	$19,000,000	$3,000,000
$15,000,000	$5,000,000	$1,000,000	($45,000,000)	($25,000,000)	($20,000,000)	($30,000,000)	($20,000,000)	($19,000,000)	($3,000,000)
$250,000,000	$100,000,000	$50,000,000	($25,000,000)	($10,000,000)	($5,000,000)	$225,000,000	$90,000,000	$45,000,000	$22,500,000
$950,000,000	$550,000,000	$450,000,000	$0	$0	$0	$70,000,000	$34,000,000	$15,000,000	$7,000,000

g.			h.	i.	j.	k.	l.	m.	n.
0.12	0.15								
onverted Amount per Table to § 1.3(SSS)			PFE Factor	Net Swap Value (NSV)	NSV Plus PFE Factor	NSV Minus PFE Factor	Adjusted NSV	Master Netting	Posted Collateral
1-5 Years	> 5 Years	Total							
$600,000	$1,500,000	$3,100,000	$3,100,000	($5,000,000)	($1,900,000)	($8,100,000)	($8,100,000)	$0	$0
$2,400,000	$2,850,000	$8,250,000	$8,250,000	($30,000,000)	($21,750,000)	($38,250,000)	($38,250,000)	$5,000,000	$5,000,000
($2,400,000)	($2,850,000)	($8,250,000)	$8,250,000	$30,000,000	$38,250,000	$21,750,000	$0	$0	$0
$10,800,000	$6,750,000	$40,050,000	$40,050,000	($15,000,000)	$25,050,000	($55,050,000)	($55,050,000)	$0	$0
$4,080,000	$2,250,000	$13,330,000	$13,330,000	($160,000,000)	($146,670,000)	($173,330,000)	($173,330,000)	$10,000,000	$100,000,000

o.	*p.*
Margining Adjustment	**Pot. Outward Exposure**
$0	($8,100,000)
$6,600,000	($21,650,000)
$0	$0
$28,040,000	($27,010,000)
$10,664,000	($52,666,000)
	($109,426,000)

Exhibit B

Proposed Language Changes

Proposed CFTC Rule 1.3(sss)(2)

(2) *Aggregate uncollateralized outward exposure.*

(i) *In general*. Aggregate uncollateralized outward exposure in general means the sum of the current exposure, obtained by marking-to-market using industry standard practices, of each of the person's swap positions with negative value in a major swap category, less the value of the collateral the person has posted in connection with those positions.

(ii) *Calculation of aggregate uncollateralized outward exposure*. In calculating this amount the person shall, with respect to each of its swap counterparties in a given major swap category:

(A) Determine the dollar value of the aggregate current exposure arising from each of its swap positions with negative value (subject to the netting provisions described below) in that major category by marking-to-market using industry standard practices; and

(B) Deduct from that dollar amount the aggregate value of the collateral the person has posted with respect to the swap positions.

The aggregate uncollateralized outward exposure shall be the sum of those uncollateralized amounts across all of the person's swap counterparties in the applicable major category.

(iii) *Relevance of netting agreements*.

(A) If the person has entered into multiple swaps under a single master agreement with a particular counterparty, or has a master netting agreement in effect with a particular counterparty to provide for netting of positions entered into under multiple master agreements, the person may measure the current exposure arising from its swaps in any major category on a net basis, as applicable, applying the terms of ~~the~~ each respective agreement. Calculation of net exposure may take into account offsetting positions entered into with that particular counterparty involving swaps (in any swap category) as well as security-based swaps, ~~and~~ securities financing transactions (consisting of securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements), forward contracts, and any other qualified contracts to the extent these are consistent with the offsets permitted by the respective master agreement or master netting agreement, as applicable.

(B) Such adjustments may not take into account any offset associated with positions that the person has with separate counterparties.

Comments:

Calculations of aggregate outward exposure should reflect two types of netting:

First, current exposure should be calculated on a net basis for all swap positions entered into under the same master agreement with a particular counterparty.

Second, to the extent that the person has a master netting agreement in effect with a particular counterparty [as described in (iii)(A) above], current exposure for that counterparty should be calculated net of any potential offsetting positions under other agreements pursuant to the master netting agreement. The Commission should not limit the types of offsetting positions that may be taken into account to those specifically described in (iii)(A).

Proposed CFTC Rule 1.3(sss)(3)

(3) Aggregate potential outward exposure.

(i) *In general*. Aggregate potential outward exposure in any major swap category means the sum of:

(A) The aggregate potential outward exposure for each of the person's swap positions in a major swap category that are not subject to daily mark-to-market margining and are not cleared by a registered clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (sss)(3)(ii); and

(B) The aggregate potential outward exposure for each of the person's swap positions in such major swap category that are subject to daily mark-to-market margining or are cleared by a registered clearing agency or derivatives clearing organization, as calculated in accordance with paragraph (sss)(3)(iii) of this section.

(ii) *Calculation of potential outward exposure for swaps that are not subject to daily mark-to-market margining and are not cleared by a registered clearing agency or derivatives clearing organization*.

(A) *In general*.

(1) For positions in swaps that are not subject to daily mark-to-market margining and are not cleared by a registered clearing agency or a derivatives clearing organization, potential outward exposure equals the total notional ~~principal~~ amount of those positions~~,~~ calculated on a net basis for swaps entered into under a single master agreement with a particular counterparty, adjusted by the following multipliers on a position-by-position basis reflecting the type of swap. For any swap that does not appropriately fall within any of the specified categories, the ''other commodities'' conversion factors are to be used. If a swap is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the swap is zero, the remaining maturity equals the time until the next reset date. In the same respect, if a swap is structured with periodic settlement periods that occur over the life of the swap, where the parties calculate a settlement amount applicable only to that specific settlement period, the total notional amount of such swap should be bifurcated in calculations such that each settlement period constitutes a residual maturity for the notional amount applicable to that settlement period.

TABLE TO § 1.3 (SSS)—CONVERSION FACTOR MATRIX FOR SWAPS

Residual maturity	Interest rate	Foreign exchange rate and gold	Precious metals (except gold)	Other commodities
One year or less	0.00	0.01	0.07	0.10
Over one to five years	0.005	0.05	0.07	0.12
Over five years	0.015	0.075	0.08	0.15

Residual maturity	Credit	Equity
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

(2) Use of effective notional amounts. If the stated notional amount on a position is leveraged or enhanced by the structure of the position, the calculation in paragraph (sss)(3)(ii)(A)(1) of this section shall be based on the effective notional amount of the position rather than on the stated notional amount.

Comments:

The Commission should clarify that "notional amount" simply means the product of the notional underlying quantity in units (i.e. MWh, MMBtu, gallons, etc.) of the applicable commodity with respect to each swap multiplied by current market price per unit of the applicable commodity. The term "notional amount" should be used consistently throughout the description of calculations. Notional amount should be calculated on net basis among all swaps entered into with a particular counterparty under a single master agreement. Additionally, the Commission should clarify that, for a swap that spans multiple time horizons specified in the Table to §1.3 (sss) – Conversion Factor Matrix for Swaps, the total notional amount for that swap should be bifurcated among applicable time periods when calculating potential outward exposure and not simply reported in the last applicable time period.

(3) Exclusion of certain positions. The calculation in paragraph (sss)(3)(ii)(A)(1) of this section shall exclude:

(i) Positions that constitute the purchase of an option, such that the person has no additional payment obligations under the position; and

(ii) Other positions for which the person has prepaid or otherwise satisfied all of its payment obligations.

(4) Adjustment for certain positions. Notwithstanding paragraph (sss)(3)(ii)(A)(1) of this section, the potential outward exposure associated with a position by which a person buys credit protection using a credit default swap or index credit default swap is capped at the net present value of the unpaid premiums.

(B) *Adjustment for master netting agreements*. Notwithstanding paragraph (sss)(3)(ii)(A) of this section, for positions subject to master netting agreements the potential outward exposure associated with the person's swaps with each counterparty may be reduced by amounts applicable to offsets permitted by the respective master netting agreement. If such offsets represent physically settled forward contracts pertaining to a nonfinancial commodity or security for deferred shipment or delivery or similar such contract that is not a swap, total notional amount of those positions calculated on a net basis for such forward contracts entered into under a single master agreement with a particular counterparty, adjusted by the multipliers specified in the Conversion Factor Matrix for Swaps specified above, on a position-by-position basis reflecting the type of swap that would me most applicable to such forward contract. For any forward contract that does not appropriately compare to any of the specified categories for swaps, the ''other commodities'' conversion factors are to be used. The total notional amount of each forward contract should be bifurcated in calculations such that each delivery period constitutes a residual maturity for the notional amount applicable to that delivery period. For other permitted offsets, potential outward exposure may only be reduced by amounts in excess of amounts included in calculations of aggregate uncollateralized outward exposure. ~~equals a weighted average of the potential outward exposure for the person's swaps with that counterparty as calculated under paragraph(sss)(3)(ii)(A), and that amount reduced by the ratio of net current exposure to gross current exposure, consistent with the following equation as calculated on a counterparty-by-counterparty basis:~~

~~$PNet = 0.4 * PGross + 0.6 * NGR * PGross$~~

~~Note to paragraph (sss)(3)(ii)(B): *PNet* is the potential outward exposure, adjusted for bilateral netting, of the person's swaps with a particular counterparty; *PGross* is that potential outward exposure without adjustment for bilateral netting; and *NGR* is the ratio of net current exposure to gross current exposure.~~

Comments:

The proposed methodology for calculating offsets attributable to master netting agreements is overly simplistic and would not likely produce reasonable results. Because the most likely type of offset to swaps exposure applicable to a valid and enforceable master netting agreement will be exposure related to forward contracts, the proposed methodology would produce a more reasonable result.

(iii) *Calculation of potential outward exposure for swaps that are subject to daily mark-to-market margining or are cleared by a registered clearing agency or derivatives clearing organization.* For positions in swaps that are subject to daily mark-to-market margining or cleared by a registered clearing agency or derivatives clearing organization:

(A) Potential outward exposure equals the potential exposure that would be attributed to such positions using the procedures in paragraph (sss)(3)(ii) of this section multiplied by 0.2.

(B) For purposes of this calculation, a swap shall be considered to be subject to daily mark-to-market margining if, and for so long as, the counterparties follow the daily practice of exchanging collateral to reflect changes in the current exposure arising from the swap (after taking into account any ~~other financial positions addressed by a~~offsets related to a master netting agreement between the counterparties and the existence of any thresholds for which a party is not required to post collateral). If the person is permitted by agreement to maintain a threshold for which it is not required to post collateral, only the ~~total~~ amount of that person's potential outward exposure that, when added to the person's aggregate outward exposure (prior to deducting aggregate value of the collateral the person has posted) would exceed~~of~~ that threshold, ~~(regardless of the actual exposure at any time)~~ shall be ~~added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (sss)(1)(i)(B), (ii)(B), (iii)(B) or (iv)(B) of this section, as applicable~~multiplied by 0.2. In addition, i~~I~~f the minimum transfer amount under the agreement is in excess of $1 million,

the entirety of the minimum transfer amount shall be added to the person's aggregate uncollateralized outward exposure for purposes of paragraph (sss)(1)(i)(B), (ii)(B), (iii)(B) or (iv)(B), as applicable.

(C) For purposes of this calculation, the dollar amount the aggregate value of collateral the person has posted with respect to the swap positions in excess of aggregate outward exposure, including amounts that represent initial margin, independent amounts, and the like, may be deducted when calculating potential outward exposure.

Comments:

The proposed methodology for addressing master netting agreements should be revised to clarify that the lesser of (i) measured exposure related to swaps, and (ii) specified threshold amounts, will be included in calculations at 100%. Only measured exposure in excess of specified amounts will be afforded the 80% discount (0.2 multiplier). This would also clarify that threshold amounts with respect to dormant master agreements would not be included in calculations. The proposed methodology should also be revised to include a deduction for initial margin, independent amounts, and the like since these amounts would be available to offset potential future exposure on applicable swaps.