AMERICAN PUBLIC GAS ASSOCIATION

July 7, 2011

Submitted Electronically

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 76 *Fed. Reg.* 23732; RIN 3038—AC97 (April, 28, 2011); and "Capital Requirements of Swap Dealers and Major Swap Participants," 76 *Fed. Reg.* 27802; RIN 3038—AD54 (May 12, 2011).

Dear Mr. Stawick:

The American Public Gas Association ("APGA") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 76 *Fed. Reg.* 23732; RIN 3038—AC97 (April, 28, 2011) ("Margin Notice") and "Capital Requirements of Swap Dealers and Major Swap Participants," 76 *Fed. Reg.* 27802; RIN 3038—AD54 (May 12, 2011) ("Capital Notice"). These Notices propose to implement margin and capital requirements as mandated by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[1] ("Dodd-Frank Act"), for certain swap dealers ("SDs") and major swap participants ("MSPs"). The Margin Notice proposes to implement initial and variation margin requirements for SDs and MSPs on all swaps that are not cleared by a registered derivatives clearing organization ("DCO"). The Capital Notice proposes capital requirements and related financial condition reporting and recordkeeping requirements for SDs and MSPs. Both proposals would apply only to uncleared swaps executed after the final effective date of the proposed rules.

Section 731 of the Dodd-Frank Act, among other things, added Section 4s(e) to the Commodity Exchange Act, 7 U.S.C. §1 *et seq.* ("Act"), requiring the Commission to promulgate capital and initial and variation margin requirements for SDs and MSPs for which there is no "prudential regulator" ("covered swap entities"). The prudential regulators—the banking regulators—are required jointly to adopt rules for the SDs and MSPs subject to their prudential

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

201 Massachusetts Avenue, NE, Suite C-4 • Washington, DC 20002 • 202.464.2742 • 202.464.0246 (fax)

regulation.[2] Section 764 of the Dodd-Frank Act requires comparable implementing rules from the Securities and Exchange Commission ("SEC") with respect to security-based swap dealers and major security-based swap participants. The regulators are required under the Dodd-Frank Act to consult with each other regarding capital and margin rules and to establish and maintain "to the maximum extent practicable, comparable" requirements. The Commission and the prudential regulators have separately issued proposed rules on margin and capital requirements for covered swap entities.[3] The SEC has not yet issued its proposed rules.

I. APGA

APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities. Our members are nonfinancial end-users under the Dodd-Frank Act and thus will have available to them the end-user exemption from clearing established by Section 731.

Public gas systems depend upon both the physical commodity markets as well as the markets in OTC derivatives to help meet the natural gas needs of their consumers. Together, these markets play a critical role in the hedging strategies many systems utilize to ensure a reliable supply of natural gas. Many natural gas distributors use swaps to hedge very long-term agreements for the physical delivery of natural gas. It is doubtful that gas suppliers would be willing to enter into such contracts for physical delivery of gas without the ability to convert from a fixed prices to floating prices. In addition to these hedging uses, many of our members also use exchange-traded or OTC derivatives to hedge their short and medium-term price risk associated with potential price volatility in the markets for the coming heating season, enabling them to provide their customers with more stable rates.

II. APGA Supports the Commission's Proposed Exemption From Margin Rules

The Commission proposes initial and variation margin requirements for certain SDs and MSPs on all swaps that are not cleared by DCOs. The proposal would not impose initial or variation margin requirements on "nonfinancial entities," *i.e.,* on counterparties to SDs or MSPs that are not themselves an SD, MSP or financial entity. The parties to a swap transaction would be "free to set initial margin and variation margin requirements in their discretion and any thresholds agreed upon by the parties would be permitted."[4] Covered swap entities—SDs and MSPs subject to the Commission's regulations—would, however, be required to pay and collect any initial and variation margin as set forth in their agreements with their counterparties.

---

[2] "Prudential regulator" is defined in Section 1a(39) of the Act, and includes the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Company, the Farm Credit Administration, and the Federal Housing Finance Agency. *See* Capital Notice at 27802.

[3] *See* Prudential Regulators Proposed Rule, "Margin and Capital Requirements for Covered Swap Entities," 76 *Fed. Reg.* 27564 (May 11, 2011) [hereinafter "Agencies Proposed Rule"].

[4] Margin Notice at 23736.

Accordingly, the Commission's proposed margin rules neither require that nonfinancial entities post either initial or variation margin, nor do they prohibit covered swap entities from requiring such margin in their agreements with end-users. Thus, the Commission's proposal allows covered swap entities and nonfinancial end-users to set the terms of any initial and variation margin in their own discretion pursuant to their credit support agreements.

APGA supports the proposed margin requirements which provide that nonfinancial end-users will not be required to post initial or variation margin for transactions with covered swap entities beyond any margin that might be required pursuant to negotiated credit support arrangements between the parties. A nonfinancial end-user includes a counterparty that is not an SD, MSP or financial entity[5] that uses swaps to hedge or mitigate commercial risk.[6] As the Commission explains in the Margin Notice, these entities pose less risk to covered swaps entities than do financial entities.[7]

III. The Proposed Capital Rules Are Contrary to the End User Exemption of the Dodd-Frank Act

The Commission also proposes capital rules that would apply to covered swap entities.[8] APGA is very concerned with the effect that the proposed capital rules will have on nonfinancial end-users choosing to avail themselves of the exemption from the mandatory clearing requirement ("end-user exemption") pursuant to the Dodd-Frank Act. Many of the swap transactions that APGA members currently enter into to hedge their commercial risks, and likely will enter in the future under the end user exemption, are non-margined and uncleared.

Despite the end-user exemption, end-users will face increased costs to engage in swap transactions to the extent that the proposed rules would apply a capital charge to the covered swap entity in connection with its transactions with a nonfinancial end-user transactions, and the covered swap entity passes-on these increased costs to the end-user. Specifically, under the Commission's proposed rules, a covered swap entity will be required to take a charge to capital associated with its uncleared swap transactions regardless of whether the transaction is with a nonfinancial end user under the end user exemption. It is reasonable to assume that the covered swap entity would shift the cost of its capital charge back to the nonfinancial end-user.

Even more troubling, the Commission is imposing a higher capital charge on covered entities that do not require margin from their (nonfinancial end user) counterparties. Assuming that this increased cost is also passed-on to the end-user by the covered swap entity, these

---

[5] The proposed rule for margin requirements for SDs and MSPs defines a financial entity as a counterparty that is not an SD or MSP and that is: a commodity pool; private fund; employee benefit plan; person predominantly engaged in activities that are in the business of banking or that are financial in nature; the government of any foreign country or a political subdivision, agency, or instrumentality thereof; or any other person the Commission may designate. Margin Notice at 23743-44.

[6] Margin Notice at 23736.

[7] Margin Notice at 23736.

[8] As explained above, these are any SD or MSP[8] that is (i) not subject to regulation by a prudential regulator, (ii) not designated by the Financial Stability Oversight Council as a systemically important non-bank financial institution subject to oversight by the Federal Reserve Board under Title I of the Dodd-Frank Act, or (iii) not registered as a futures commission merchant ("FCM"). SDs and MSPs that are subject to regulation by a prudential regulator would have their capital requirements set by that regulator. Capital Notice at 27804-05.

requirements effectively punish nonfinancial end users for being permitted by a covered entity to enter into a non-margined, uncleared transaction. This will impede the ability of nonfinancial end users effectively to engage in transactions to hedge or mitigate commercial risk at a reasonable price. Placing such increased capital charges on such non-financial end user transactions would negate the effectiveness of the end-user exemption, and is contrary to the intent of Congress in including the end user exemption within the Dodd-Frank Act.

Placing capital charges on nonfinancial end user transactions is contrary to the Dodd-Frank Act and Congressional Intent

The legislative record clearly evidences that the drafters of the Dodd-Frank Act recognized the significance and critical importance of allowing nonfinancial end-users, which played no role in the financial crisis and pose minimal, if any, risk to U.S. financial stability, to continue to hedge their commercial risk without having to bear the added costs of capital charges. The legislative history is absolutely clear as to the intent of Congress to create an exemption for nonfinancial end-users from the burdens and costs related to Title VII of the Dodd-Frank Act.

Before the Dodd-Frank Act went to conference, both the original Senate and House versions provided that margin requirements would not apply to swaps where one of the parties was a nonfinancial end-user.[9] Although these provisions were omitted from the base conference text, the omission was reportedly inadvertent.[10] Congress also understood that capital requirements in connection with end-user transactions were within the end-user exemption. The Dodd-Lincoln Letter explains that "Congress clearly stated in this bill that the margin *and capital* requirements are not to be imposed on end users."[11] Finally, a colloquy between Senators Lincoln and Hagan further reinforces the intent that capital and margin requirements not apply to nonfinancial end-users. Senator Lincoln stated "As we point out, it is clear in this legislation that regulators only have the authority to set *capital* and margin requirements on swap dealers and major swap participants for uncleared swaps, not on end users who qualify for the exemption from mandatory clearing."[12]

Congress recognized that nonfinancial end-users need access to derivatives to enable them to "increase certainty in their businesses" and to engage in "prudent risk management activities" through hedging transactions.[13] The Commission has recognized the minimal risks

---

9 Section 731 of the version of Dodd-Frank originally passed in the Senate provided that the initial and variation margin requirements would not apply "for swaps in which 1 of the counterparties is not (A) a swap dealer; (B) a major swap participant; or a financial entity as described in section 2(h)(9)(A)(ii), and such counterparty is eligible for and utilizing the commercial end user clearing exemption under section 2(h)(9)." New Section 4s(e)(8) of the Act.

10 *See, e.g.*, "Dodd-Frank bill sparks end-user margin fears," Risk.net, Financial Risk Management News and Analysis (June 28, 2010), *available at:* http://www.risk.net/risk-magazine/news/1719587/dodd-frank-raises-fresh-questions-derivatives-users ("According to an industry source, congressional staffers charged with drafting the bill admitted in private the omission was an oversight.").

11 Letter from Senator Dodd and Senator Lincoln to Representative Frank and Representative Peterson (June 30, 2010) [hereinafter "Dodd-Lincoln Letter"].

12 Senate Report, 156 CONG. Rec. S5907 (July 15, 2010) (colloquy of Senators Hagan and Lincoln).

13 Letter from Senator Stabenow, Senator Johnson, Representative Lucas, and Representative Bachus (Apr. 16, 2011).

that nonfinancial end-users pose to the safety and soundness of covered swap entities and to financial stability in the United States.[14] The Commission followed this Congressional directive with respect to its proposal relating to margin, which permits the parties to establish margin as they agree. However, the Commission's proposed capital rules, by failing to exempt transactions involving nonfinancial end user transactions entered into to mitigate commercial risk from capital requirements, fails to adhere to the Congressional directive to refrain from placing additional financial burdens on such transactions. Higher capital charges for such end user transactions have the potential to render the end user exemption so economically unattractive as to cause it to be an empty promise. The result may be that nonfinancial end users, such as APGA's members, will have the choice of either redirecting significant amounts of capital from their business to their hedging operations, or foregoing hedging. Congress, by including the end-user exemption in the Dodd-Frank Act, intended that nonfinancial end users should not be faced with this choice.

For all these reasons, APGA respectfully requests that the Commission modify its proposed capital rules to exempt transactions involving nonfinancial end users from any capital charge.

IV. Conclusion

As we have noted in the past, natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their needs. APGA has long been supportive of the Commission's efforts to bring greater transparency to the over-the-counter ("OTC") swaps markets, including implementing measures designed to reduce risk, increase transparency and to promote market integrity within the U.S. financial system. We appreciate the Commission's efforts to build a comprehensive framework on the foundation of the Dodd-Frank Act.

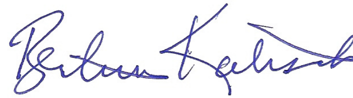
APGA supports the Commission's proposed rules on margin. We believe that by leaving the decision on establishing initial and variation margin to the negotiation of the nonfinancial end user and a covered entity and by permitting non-cash collateral, the Commission has hued to the letter and spirit of the Dodd-Frank Act. However, APGA believes that the Commission's proposed capital rules in essence will penalize nonfinancial end users for choosing to avail themselves of the end user exemption. It is critical that APGA's members be able to continue to hedge their commercial risks without incurring undue and unnecessary additional costs. As hedgers, it is critical that public gas systems can fully realize the benefit inherent in the end-user exemption from the mandatory clearing requirement, as Congress intended. Only in this way can they continue to reduce their exposure to commercial risk and provide their customers with natural gas at stable rates. Accordingly, we respectfully request that the Commission alter the proposed capital rules as necessary to preserve for nonfinancial end user transactions the full benefit of the end user exemption.

[14] Agencies Proposed Rule at 27570.

*   *   *   *   *

We would be happy to discuss our comments at greater length with the staff. Please feel free to contact Bert Kalisch, President and CEO of APGA, David Schryver, Executive Vice President at 202-464-2742, or Paul M. Architzel of Wilmer Cutler Pickering Hale and Dorr LLP, outside counsel to APGA, at 202-663-6240.

Respectfully submitted,



Bert Kalisch,
President and CEO