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Submitted Electronically

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

Re: Margin Requirements for Uncleared Swaps for Swap
Dealers and Major Swap Participants, RIN 3038-AC97

Dear Mr. Stawick:

The American Petroleum Institute (“API”) appreciates the opportunity to submit these comments in response to the notice of proposed rulemaking (“NOPR”) issued by the Commodity Futures Trading Commission concerning margin requirements for uncleared swaps for swap dealers and major swap participants under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).¹

API is a national trade association representing more than 450 oil and natural gas companies. API’s members transact in physical and financial, exchange-traded, and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers. Associated with the hedging of physical exposures, API members enter into swap transactions to offset credit risks and to facilitate physical transactions. API members range from the largest major oil company to the

¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010). The proposed rules are set forth in Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (proposed April 28, 2011) (to be codified at 17 C.F.R. pt. 23). The Commission extended the comment period for this rulemaking in Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,621 (May 12, 2011).

smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry. Because API members rely on the integrity of markets under the Commission's jurisdiction, we appreciate the opportunity to comment.

I. Introduction

API appreciates that Dodd-Frank requires the Commission to set margin requirements on swap dealers and major swap participants ("swap entities") with respect to uncleared swaps. Congress did not, however, intend these requirements to apply to, or impose new costs and regulatory burdens on, end users that enter into bilateral, uncleared swaps to hedge their commercial risk. API therefore supports the Commission's effort to distinguish commercial end users from riskier entities in prescribing margin requirements. Although commercial end users will be able to negotiate margin thresholds with swap entities, the proposed rules nevertheless impose new substantive requirements for credit support arrangements, types of collateral, and valuation of margin that would raise transaction costs and regulatory burdens on end users. API opposes the extension of these requirements to commercial end users because Congress intended to preserve end users' ability to hedge risk through uncleared swaps.

API believes that end users hedge risk most efficiently and effectively when they are able to negotiate customized terms with their counterparties free of undue regulatory intervention. Recognizing that Dodd-Frank preserves end users' ability to enter into uncleared swaps with customized contract terms, API offers the following comments:

- The language, structure, and legislative history of Dodd-Frank clearly indicate that regulators are not authorized to adopt margin requirements that apply to commercial end users. Accordingly, API supports the Commission's proposal not to impose minimum margin requirements on commercial end users.
- The final margin rules should preserve the ability of commercial end users to negotiate appropriate forms of collateral and valuation timeframes with counterparties. The Commission should not impose a standard for non-cash collateral that would limit the ability of commercial end users to negotiate appropriate collateral arrangements with their counterparties.
- Any new documentation requirements should not impose substantive regulatory compliance obligations on uncleared, bilateral swaps involving end users. End users must be able to negotiate customized terms without unnecessary regulatory restrictions.

II. Dodd-Frank Does Not Authorize Regulators to Adopt Margin Requirements that Apply to Commercial End Users

API supports the Commission's proposal not to impose minimum margin requirements on commercial end users. API agrees that, in directing regulators to set margin requirements for swap dealers and major swap participants, Congress did not authorize margin requirements that apply to commercial end users. Any such requirements would be contrary to Dodd-Frank's language, Dodd-Frank's structure including the end-user clearing exception, and congressional intent.

Dodd-Frank adds Section 4s(e) to the Commodity Exchange Act ("CEA"). New Section 4s(e)(1) states that "[e]ach registered swap dealer and major swap participant for which there is not a prudential regulator *shall meet such . . . minimum initial and variation margin requirements* as the Commission shall by rule or regulation prescribe under paragraph (2)(B)."² New Section 4s(e)(2)(B), in turn, requires the Commission to:

adopt rules for swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant, for which there is not a prudential regulator imposing --

(i) capital requirements; and

(ii) both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization.³

Thus, by their plain language, these sections, which do not even discuss end users, impose minimum margin requirements on only swap dealers and major swap participants.

The legislative history confirms that Congress intended margin requirements to apply only to swap dealers and major swap participants -- not to end users. As the following statements in the *Congressional Record* show, Congress did not intend or understand Dodd-Frank to authorize regulators to require end users to post margin:

- Senators Dodd and Lincoln: "The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end user

² Dodd-Frank § 731 (CEA § 4s(e)(1)(B)) (emphasis added).

³ *Id.* § 731 (CEA § 4s(e)(2)(B)) (emphasis added).

transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.

“Again, Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but *rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction*. In cases where a Swap Dealer enters into an uncleared swap with an end user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the Congressional intent to protect end users from burdensome costs.”⁴

- Senator Lincoln: “[I]t is clear in this legislation that the 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.”⁵
- Senator Dodd: “There is no authority to set margin on end users, only major swap participants and swap dealers.”⁶
- Representative Peterson: “[W]e have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant.”⁷
- Representative Frank: “We do differentiate between end users and others. The marginal requirements are not on end users. They are only on the financial and major swap participants. And they are permissive. They are not

⁴ Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson (June 30, 2010), in 156 Cong. Rec. S6192 (daily ed. July 22, 2010) (emphasis added).

⁵ 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

⁶ *Id.* (statement of Sen. Dodd).

⁷ 156 Cong. Rec. H5248 (daily ed. June 30, 2010) (statement of Rep. Peterson).

mandatory, and they are going to be done, I think, with an appropriate touch.”⁸

The statutory text and legislative history therefore show that Congress carefully drafted Dodd-Frank to avoid imposing costly new margin requirements on end users. These requirements would, as Senators Dodd and Lincoln stated, actually increase risk by raising the cost of hedging transactions. Consistent with congressional intent and Dodd-Frank’s design, it is critical that neither the Commission nor the prudential regulators require swap dealers and major swap participants to collect margin from end users. Congress intended to preserve the ability of end users to negotiate bilaterally for credit terms that are more appropriate and economical than the minimum margin requirements. API therefore commends the Commission for not proposing that minimum amounts of initial or variation margin be collected from non-financial end users.⁹

API further agrees that margin requirements should weigh the specific risk associated with particular categories of swaps and swap market participants. Swaps entered into by end users to hedge commercial risk pose less risk to the safety and soundness of swap entities and to the United States financial system than swaps entered into between two Wall Street swap dealers. Accordingly, API urges the Commission to adopt final rules that continue to reflect a risk-based approach that recognizes that commercial end users should not be subject to restrictive new regulation that would raise costs and impair their ability to hedge risk.

III. The Commission Should Not Impose Specific Documentation Standards and Collateral Restrictions on Contracts with Commercial End Users

Even though Congress did not permit regulators to impose margin requirements on commercial end users, the Commission has proposed a new set of regulations that would govern the relationship between commercial end users and their swap entity counterparties. Specifically, the proposed rules potentially limit forms of non-cash collateral that end users may post as margin, impose extensive new documentation requirements that will potentially impair end users’ ability to tailor bilateral swap contracts to meet their hedging needs, and ultimately involve regulators in all aspects of the bilateral relationship between counterparties. API is concerned that these requirements are not warranted for commercial end users, which Congress did not intend to be subject to new margin requirements and which the Commission has correctly recognized pose little risk to the safety and soundness of their counterparties or the United States financial system.

⁸ *Id.* (statement of Rep. Frank).

⁹ NOPR, 76 Fed. Reg. at 23,736.

A. The Commission Should Not Limit Forms of Non-Cash Collateral that Commercial End Users May Post as Margin

API supports the Commission's proposal to treat commercial end users differently from swap dealers, major swap participants, and financial entities with respect to the types of assets that may be posted as initial or variation margin.¹⁰ Because commercial end users pose less risk, API agrees that permitting non-cash collateral is consistent with both preserving the financial integrity of swap markets and preserving the stability of the United States financial system. API is concerned, however, about the proposed standard that the value of non-cash assets posted by commercial end users must be "reasonably ascertainable on a periodic basis."¹¹ Based on the experience of API members, API believes that current market practice with respect to non-cash collateral has worked well to mitigate risk. API therefore requests that the Commission provide commercial end users with the flexibility to post various forms of collateral acceptable to counterparties. The Commission should permit commercial end users to reach appropriate agreements with their counterparties about the type and periodic valuation of non-cash collateral without excessive regulatory intervention.

Currently, many commercial end users, including API members, post non-cash collateral to counterparties. For example, instead of posting cash or highly liquid securities, an end user might post a lien on property equal to the value of the agreed margin amount. This approach allows end users to use cash in their business -- in the case of API members, to explore for oil and gas, to drill new wells, and to provide energy to consumers at lower prices. Cash margin requirements would tie up money that could be used more productively for investment and exploration, to lower energy prices, and to create jobs. As the legislative history described above reveals, Congress did not impose margin requirements on commercial end users precisely to avoid taking funds out of productive use in the economy. And Dodd-Frank further provides that regulators "shall permit the use of noncash collateral."¹²

Notwithstanding that Congress did not intend to impose margin requirements on end users and did not limit the forms of non-cash collateral that they may post as margin, the Commission has proposed to require that the value of non-cash assets posted as margin must be "reasonably ascertainable on a periodic basis."¹³ API does not disagree in principle with this standard. API believes, however, that valuation decisions should be negotiated between counterparties and not prescribed by regulators. Counterparties that have longstanding

¹⁰ *See id.* at 23,738-39.

¹¹ *Id.* at 23,747 (proposed 17 C.F.R. § 23.157(a)(3), (b)(3)).

¹² Dodd-Frank § 731 (CEA § 4s(e)(3)(C)).

¹³ NOPR, 76 Fed. Reg. at 23,747 (proposed 17 C.F.R. § 23.157(a)(3), (b)(3)).

relationships with API members are familiar and comfortable with the value and appropriateness of collateral used to margin swaps. The final margin rules should preserve the ability of commercial end users to negotiate appropriate forms of collateral and valuation timeframes with counterparties.

B. The Commission Should Not Use Margin Rules or Documentation Standards to Prescribe Extensive New Substantive Requirements that Apply to Commercial End Users

Although the Commission determined that margin requirements for commercial end users were not necessary and not permitted by Congress, the Commission has nevertheless imposed extensive new substantive requirements on bilateral swaps involving end users. For example, the proposed rules require commercial end users transacting with swap entities to enter into credit support arrangements that specify the methodology used to calculate margin and the applicable thresholds below which initial and variation margin will not be collected.¹⁴ The proposed rules further require that initial and variation margin be calculated in a manner consistent with specified requirements.¹⁵ Finally, the proposed rules require calculation of “hypothetical” margin amounts that would be required if the commercial end user counterparty was another swap entity.¹⁶ API is concerned that these requirements will unnecessarily raise transaction costs and limit the ability of commercial end users to customize swaps to meet their hedging needs, without materially reducing systemic risk.

API believes that end users and the market are best served by allowing counterparties to negotiate contracts, often with customized terms, that are tailored to meet the specific needs and circumstances of the parties. API further believes that reciprocal evaluation of each counterparty’s credit and proposed collateral is more efficient than specific regulatory prescriptions. End users should therefore be free, as they are now, to negotiate the type of collateral and relevant valuation method, the applicable credit thresholds, and other credit management requirements. Although Dodd-Frank requires the Commission to “adopt rules governing documentation standards for swap dealers and major swap participants,”¹⁷ API does not think Congress intended to impose substantive requirements as to these negotiated contract terms on end users. Any such requirements would be inconsistent with Congress’s recognition that new margin-related requirements could increase risk by raising the cost or regulatory burdens of hedging transactions.

¹⁴ See *id.* at 23,744 (proposed 17 C.F.R. § 23.151).

¹⁵ See *id.* at 23,746 (proposed 17 C.F.R. § 23.155).

¹⁶ See *id.* at 23,746 (proposed 17 C.F.R. § 23.154(a)(7), (b)(6)).

¹⁷ Dodd-Frank § 731 (CEA § 4s(i)(2)).

Beyond the transaction costs associated with these new requirements, API is concerned about potential regulatory involvement in bilateral contract relationships. By mandating that commercial end users enter into credit support arrangements satisfying certain criteria and specifying certain terms, the proposed rules potentially convert ordinary breaches of contract into regulatory violations subject to Commission enforcement. The Commission should therefore clarify that the proposed rules only create compliance obligations for swap entities and will not trigger enforcement action against commercial end users. Further, the proposed rules give the Commission substantial authority to interfere with counterparties' negotiated contracts, including, in some cases, to require counterparties to replace posted margin assets with different margin assets mandated by the Commission.¹⁸ Although API supports the proposal that this latter requirement would not apply to swaps with non-financial end users,¹⁹ API is concerned about additional proposed Commission authority. For example, the proposed rules would permit the Commission "at any time" to "require a covered swap entity to provide further data or analysis concerning any margin asset posted or received."²⁰ API respectfully submits that, consistent with congressional intent and the proposal not to impose margin requirements on end users, these provisions for Commission action should not apply to swaps involving commercial end users.

IV. Conclusion

For the reasons described in these comments, API believes that Dodd-Frank does not permit the Commission to impose margin requirements on commercial end users. Accordingly, API supports the Commission's proposed risk-based approach, which consistent with congressional intent, would not impose minimum margin requirements on commercial end users. API is concerned, however, that the Commission would impose a new set of substantive obligations on end-user transactions -- including restrictions on collateral, documentation, and valuation -- that would raise transaction costs and impair end users' ability to negotiate swaps with their counterparties. These requirements are inconsistent with Congress's intent to preserve end users' ability to hedge risk, as they do now, with non-cash collateral and customized, negotiated contracts. Accordingly, API respectfully requests that the Commission clarify that these new substantive requirements will not apply to commercial end users.

¹⁸ NOPR, 76 Fed. Reg. at 23,748 (proposed 17 C.F.R. § 23.157(d)).

¹⁹ See *id.* (proposed 17 C.F.R. § 23.157(d)(3)) ("The Commission may at any time require a covered swap entity to require a *counterparty that is a swap dealer, a major swap participant, or a financial entity* to replace a margin asset posted with the covered swap entity with a different margin asset to address potential risks posed by the asset." (emphasis added)).

²⁰ *Id.* at 23,748 (proposed 17 C.F.R. § 23.157(d)(2)).

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API appreciates the opportunity to provide these comments. We would be pleased to provide additional information regarding our views on the proposed rule, and would welcome the opportunity to work with the Commission. Please contact me or Brian Knapp at (202) 682-8172 if you have any questions.

Sincerely yours,



Kyle B. Isakower
Vice President
Regulatory and Economic Policy
American Petroleum Institute

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner