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VIA ELECTRONIC SUBMISSION

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

Re: *Proposed Margin and Capital Requirements: RIN 3038—AC97 and RIF 3038-AD54*

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's (the "Commission") request for comment concerning its Notice of Proposed Rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" (the "Proposed Margin Rules")[1] and on "Capital Requirements of Swap Dealers and Major Swap Participants" (the "Proposed Capital Rules", and together with the Proposed Margin Rules, the "Proposed Rules").[2] 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.

The Working Group believes that its members are not swap dealers. However, the Working Group offers the following comments on the Proposed Rules (i) in case the yet to be finalized definition of "swap dealer" is construed so broadly that it captures commercial end

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1 Notice of Proposed Rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" 76 Fed. Reg. 23732 (Apr. 28, 2011) (the "Margin Proposing Release").

2 Notice of Proposed Rulemaking on "Capital Requirements of Swap Dealers and Major Swap Participants" 76 Fed. Reg. 27802 (May 12, 2011) (the "Capital Proposing Release").

users of swaps,[3] (ii) because members of the Working Group will be counterparties to swap dealers and major swap participants (together, "Covered Swap Entities") and (iii) because the Proposed Rules will have a substantial impact on swap markets.

I. GENERAL COMMENTS REGARDING CAPITAL AND MARGIN.

A. Proposed Rules Have Substantial Cost Implications.[4]

i. Cost to the U.S. Economy Will be Significant.

The Working Group acknowledges that the basic parameters of the Proposed Rules are mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). However, the Proposed Rules, as currently drafted, will impose new capital and margin requirements on Covered Swap Entities in a manner not well attuned to the specific risks inherent in swaps. The result of the Proposed Rules will be significant costs for not only Covered Swap Entities, but also the U.S. economy and financial system, especially when coupled with the Prudential Regulators'[5] proposed rule on margin and capital requirements for Covered Swap Entities (the "Prudential Regulators' Proposed Rules").[6]

First, the Proposed Rules and Prudential Regulator's Proposed Rules will impose significant direct costs on Covered Swap Entities and their counterparties. The Office of the Comptroller of the Currency (the "OCC") estimates that the Prudential Regulators' Proposed Rules will result in swap market participants posting over $2 trillion in the form of initial margin, with an associated annual cost of $20 billion per 1% of forgone potential return[7] on such margin.[8] In fact, one bank holding company estimates that it will have to post as well as receive

[3] *See* 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'". 75 Fed. Reg. 80,174 at 80,183 (Dec. 22, 2010) ("Proposed Definitions").

[4] The Working Group is conducting its own study of the total cost of compliance with the Commission's proposed rules set forth under the Act. The Working Group anticipates submitting the study to the Commission by the end of this fiscal quarter.

[5] Collectively, the Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration and the Federal Housing Finance Agency (together, the "Prudential Regulators").

[6] Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. Reg. 27,564 (May 11, 2011) ("Prudential Regulators' Proposed Rules").

[7] This cost is most easily expressed as the difference between a Covered Swap Entity's cost of capital and its potential return on collateral posted as initial margin. The cost is likely substantial. Given the forms of collateral permitted under the Prudential Regulators' Proposed Rules, the lost return is essentially a Covered Swap Entity's cost of capital as returns on cash and cash equivalents are minimal.

[8] *See* Office of the Comptroller of the Currency, "Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule", at 5 (Apr. 15, 2011).

at least $1.4 trillion in initial margin, most of which will be segregated.[9] If the Proposed Rules and the Prudential Regulators' Proposed Rules require swap market participants to post over $2 trillion in initial margin, then it will be the equivalent of reallocating over 7% of U.S. GDP.[10] That could have a significant impact on the U.S. economy.

Second, the Proposed Rules and Prudential Regulators Proposed Rules will likely lead to higher per transaction costs for swap market participants. These costs reflect higher margin requirements, but also additional operational expenses and associated fees. Increased costs will likely reduce the number of transactions, lowering liquidity and, consequently, increasing volatility in swap markets. Covered Swap Entities and their counterparties will likely pass on the associated higher costs and price volatility to their customers.

Third, the Proposed Rules will materially affect the use of cash and short-term lending facilities by commercial firms. The imposition of capital and margin requirements may reduce counterparty credit risk, but it will not eliminate risk altogether. The reduction in counterparty credit risk achieved through capital and margin requirements results from transformation of such risk into increased liquidity risk. As observed during the recent financial crisis, requiring firms to deliver substantial amounts of margin can cause liquidity issues or even crises at such firms. In the case of non-financial Covered Swap Entities, liquidity risk might actually pose a greater risk than credit risk, given the nature of their balance sheets.

Fourth, the Proposed Rules set capital and margin requirements that could drive smaller swap dealers out of swap markets and serve as substantial barriers to entry for new swap dealers. The swap dealing function in swap markets would likely be concentrated in the entities who, in part because of their derivatives exposures, were deemed "too-big-to-fail." Under such an outcome, the swap markets will lose depth and liquidity would likely decrease, increasing price volatility and transaction costs.

Fifth, the Proposed Rules will impose substantial indirect and opportunity costs upon commercial firms. If margin requirements are improperly constructed many non-financial entities, such as commercial energy firms that are members of the Working Group, will be left with the unenviable choice of leaving certain risks unhedged or paying inordinately high prices for appropriate and necessary risk management. It is likely that some or all of the associated increased costs and price volatility will be passed on to ultimate consumers of energy commodities.

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[9] *See* comments of J.P. Morgan Chase & Co. filed in response to the Prudential Regulators' Proposed Rules on June 24, 2011.

[10] U.S. GDP for FY 2010 was $14.66 trillion. Central Intelligence Agency World Fact Book, updated June 14, 2011. Available at: https://www.cia.gov/library/publications/the-world-factbook/geos/us.html.

ii. The Commission Should Do a Separate Economic Study on the Costs of its Capital and Margin Rules.

While the imposition of margin and capital rules on swap markets can reduce risk, if such requirements are too onerous or are imposed improperly, the rules could substantially limit the viability of the over-the-counter derivative markets. Given the seriousness of the adverse consequences of improperly constructing capital and margin requirements for Covered Swap Entities, the Commission should conduct a study of the costs associated with the Proposed Rules similar to the study undertaken by the OCC. The study should include a thorough quantitative review of the potential benefits associated with the Proposed Rules. In short, the Working Group urges the Commission to take the time and expend the resources necessary to know the economic costs and benefits of setting margin and capital rules.

iii. General Suggestions to Lower Potential Cost of the Proposed Rules.

The Working Group believes the Proposed Rules, as currently constructed, are unnecessarily expensive. However, there are steps that the Commission can take to reduce the burden imposed by the Proposed Rules while properly accounting for the risks associated with uncleared swaps.

The Commission should allow all Covered Swap Entities subject to its jurisdiction to use proprietary capital models for determining both capital and margin requirements. In addition, the Commission's non-model-based capital requirements should be dynamic and risk-based. As discussed further in Section IV, the Proposed Capital Rules do not properly account for the market and credit risk posed by a Covered Swap Entity's swaps. If the Proposed Capital Rules were amended to allow the use of a Value-At-Risk ("VaR") approach to capital adequacy and allow all Covered Swap Entities to use capital models, then the cost imposed by the Proposed Capital Rules would likely decrease, while still accounting for the risk posed by a Covered Swap Entity's swap portfolio.

Further, the Commission should ensure that the Proposed Margin Rules permit the netting and offset of margin requirements to the fullest extent possible. The use of reasonable netting and offset arrangements across physical and financial trades reduces counterparty credit risk and lowers the cost of trading by allowing the efficient use of capital. According to the OCC, legally enforceable netting agreements allowed banks to reduce gross positive fair value derivatives exposures by 90.4% in the first quarter of 2011.[11] As discussed further in Section II.C., the Proposed Margin Rules should be amended to allow Covered Swap Entities and their counterparties to net and offset their counterparty exposure to the largest degree appropriate.

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[11] *See* OCC at 5.

Additionally, the Commission should permit all categories of market participants to deliver non-cash collateral to meet their margin obligations. Limiting eligible collateral to mostly cash and cash equivalents eliminates forms of collateral widely accepted in today's swap markets. There are several forms of non-cash collateral that are accepted in today's markets, such as liens on physical and financial assets and letters of credit. These other instruments and legal rights provide the credit support that trading relationships require and help firms lower costs by reducing a counterparty's funding obligations. So long as the collateral delivered can cover the exposure in the event of a termination of the swaps and the liquidation of the collateral, then the Commission should permit the use such assets by any market participant, including financial entities and Covered Swap Entities.

Finally, the Commission should remove the segregation requirement for all initial margin posted with regards to swaps between Covered Swap Entities. Congress recognized that certain swap market participants value the ability to segregate initial margin posted with regards to uncleared swaps. Accordingly, Section 724 of the Act provides counterparties of Covered Swap Entities with the option to elect to segregate initial margin posted to an uncleared swap. Imposing mandatory segregation of initial margin on swaps between Covered Swap Entities will prove extremely costly and will serve as a massive liquidity drain.[12] Removing the segregation requirement from the Proposed Margin Rules will substantially lower the costs imposed by such rules, and because swap market participants have the option to elect segregation, those entities that deem it desirable will still have the ability to segregate initial margin.

iv. Treatment of Non-Financial Covered Swap Entities.

The Proposed Rules, as required by the Act, will impose prudential regulation on non-financial Covered Swap Entities. While the Proposed Rules make certain accommodations for the unique nature of non-financial Covered Swap Entities, the Commission should amend them further to ensure non-financial Covered Swap Entities are regulated in a manner that will not materially limit their participation in swap markets and in a manner that is "appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant." [13]

Commercial energy firms that are deemed to be Covered Swap Entities will be engaged in trading mainly energy-based swaps as part of their larger business of delivering energy-related products to their customers and counterparties. The knowledge gained from this larger business makes commercial energy firms an important source of price information and liquidity in energy-swap markets. However, because swap trading is only a part of a larger commercial business, the balance sheet of a commercial energy firm that is deemed a Covered Swap Entity

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[12] *Infra* at Section I.A.i.

[13] Section 4s(e)(3)(A)(ii) of the Commodity Exchange Act (the "CEA"). 7 U.S.C. §1 *et seq.*

will likely have a higher concentration of fixed assets and a lower level of liquid assets than the balance sheets of other Covered Swap Entities.

When crafting margin and capital rules applicable to non-financial Covered Swap Entities, the Commission should not only consider the unique role played by such entities in physical commodity-based swap markets and the composition of their balance sheets, but should also take into account the nature of the commodity-based swap markets. The market for "other commodities" constitutes only 0.4% of the $600 trillion notional global over-the-counter derivatives market.[14] The likelihood that swaps activity in these markets will reach the level of systemic importance is remote.

Within the energy-based swap markets, there are numerous examples of entities sustaining significant losses without causing a financial or economic crisis. For example, the collapse of Enron is cited as a high profile default that did not have a substantial systemic impact.[15] 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."[16] 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.

When taken together, the unique nature of non-financial Covered Swap Entities and the low level of systemic risk posed by the "other commodities" markets, the Commission, to accomplish Congress' desire that margin and capital requirements "be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant"[17] should allow the use of credit thresholds and non-cash collateral in a transaction between a non-financial Covered Swap Entity and another Covered Swap Entity. Allowing the use of credit thresholds and non-cash collateral will reduce the costs of the Proposed Rules by easing liquidity

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14 Data retrieved from the Bank of International Settlements.
Available at: http://www.bis.org/statistics/derstats.html.

15 *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.

16 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.

17 Section 4s(e)(3)(A)(ii) of the CEA.

constraints on non-financial Covered Swap Entities while still accounting for the risk posed by such entities.

B. Capital and Margin Requirements for Uncleared Swaps Should Not Be Constructed to Force Centralized Clearing.

The Commission's capital and margin requirements should not be set with the intent of moving all over-the-counter swaps to centralized clearing, as many uncleared swaps cannot be cleared. The capital and margin requirements should reflect Congress' intent that such requirements "be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."[18] Intentionally driving swap markets to centralized clearing could increase risk for commercial energy firms and the financial system as a whole. Less risk is posed when entities are able to diversify and manage overall risk by optimizing and balancing the counterparty credit risk associated with uncleared transactions and the liquidity risk associated with cleared transactions.

Congress clearly contemplated and accounted for the continued existence of an uncleared swap market.[19] There are certain swaps that are either too customized or are not liquid enough to be centrally cleared. The former are often hedging tools designed to address the specific hedging needs of end users. The latter are common in energy swap markets where, for example, certain delivery points for natural gas have only episodic liquidity. These swaps are necessary risk management tools and are not designed to avoid centralized clearing.

As these swaps by their nature cannot be cleared, imposing margin requirements on such swaps with the intent of driving them to centralized clearing will only increase risk and costs to entities that rely on these swaps to manage risk. These entities, many of whom are end users, will be left with the unenviable choice of leaving certain risks unhedged or paying inordinately high prices for the necessary swaps. As noted above, it is likely that these end users will be forced to pass on the associated higher costs and price volatility to consumers.

Congress clearly intended "to protect end users from burdensome costs associated with margin requirements and mandatory clearing."[20] Imposing non-risk based margin and capital requirements on uncleared swaps would run counter to that directive. If margin requirements are set with the intent of driving uncleared swaps to centralized clearing, those requirements will

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[18] *Id.*

[19] S. Rep. No. 111-176 at 34.

[20] *See* Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

undermine the Congressional intent underlying the end user exception from centralized clearing (the "End User Exception").[21]

Like the Proposed Margin Rules, the Proposed Capital Rules should not be constructed with the goal of moving uncleared swaps to centralized clearing. Each component of a capital requirement should be directly related to the risk posed by a swap or counterparty. As it is likely that the costs of the Proposed Capital Rules will be passed through to Covered Swap Entities' counterparties, incorrectly constructed capital requirements, could have an impact similar to that of improperly constructed margin rules on the ability of swap market participants to hedge.

C. The Commission Should Implement the Proposed Margin and Capital Rules After Mandatory Centralized Clearing is Available.

The Act's centralized clearing requirement and margin and capital requirements were intended to work in conjunction with one another to reduce systemic risk.[22] The centralized clearing requirement is intended to address the risk of those swaps that are liquid and standardized enough to be centrally cleared. The margin and capital requirements for uncleared swaps are intended to address the risk posed by swaps that are not capable of being cleared.[23] Accordingly, the clearing, margin and capital requirements should be implemented in a logical order.

If the Commission imposes the Proposed Rules prior to the implementation of the Act's mandatory clearing requirement, then it will subject that portion of the market that is liquid enough to be readily clearable but is not currently cleared to higher margin requirements than if it were subject to mandatory centralized clearing.[24] This higher margin requirement could potentially remove the liquidity from certain classes of swaps that makes them capable of being cleared.

In addition, the Proposed Margin Rules, under certain circumstances, require the initial margin requirement for uncleared swaps to be based on comparable cleared swaps or futures.[25]

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[21] Section 2(h)(7) of the CEA.

[22] S. Rep. No. 111-176 at 33 (2010), available at http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf.

[23] As Congress did not provide the Commission, the Securities and Exchange Commission ("SEC") and the Prudential Regulators with the authority to impose margin requirements on non-financial end users, the only swaps subject to the margin requirements for uncleared swaps should be those that are too customized or illiquid to be deemed not subject to mandatory clearing.

[24] Under the Commission's proposed rules, Initial margin requirements will have to account for 99% of price changes within a five day period for cleared swaps and 99% of price changes within a ten day period for uncleared swaps.

[25] Proposed CFTC Rule 23.155(c).

In the absence of the mandatory clearing requirement, it is far less likely that a comparable cleared swap will exist, leaving swap market participants with the option of basing margin on a comparable future, the existence of which is far from guaranteed. As such, the Working Group suggests that the Commission implement the Proposed Rules in conjunction with the Act's mandatory clearing requirement.

D. <u>Interaction of Proposed Rules With the Proposed Definition of Futures Commission Merchant</u>.

The Commission must carefully account for the interaction between the Proposed Rules and the Commission's proposed definition of "futures commission merchant" ("FCM"). Specifically, the Commission needs to clarify that the definition of "FCM" only applies to persons who accept and hold collateral on behalf of customers for purposes of satisfying their margin requirements with a derivatives clearing organization ("DCO"). In comments filed previously with the Commission,[26] the Working Group noted that the definition of "FCM" as set forth in the Act would capture an entity that engages in one trade as a swap dealer and receives collateral with regard to such uncleared swap.[27] However, Congress also gave the Commission the authority to exclude entities from the definition of "FCM." The Commission did not use that authority to clarify the scope of the definition of "FCM" in its proposed rule on the Adaptation of Regulations to Incorporate Swaps.[28] By not doing so, the Commission has most likely created a swap market where all swap dealers, even those that do not offer cleared swap products, and entities that engage in a *de minimis* level of swap dealing, will be required to register as FCMs. In that event, such swap dealers would be subject to the FCM capital rules, which are different from and more burdensome than the Proposed Capital Rules' paradigm for non-financial entities. In short, the interaction between the proposed definition of FCM and the Proposed Rules would result in all swap dealers being subject to regulation, including capital regulation, as FCMs.

The definitions of "FCM" and "swap dealer" should be mutually exclusive, as FCMs and swap dealers play distinct roles in swap markets. Although each entity is an intermediary and acts on behalf of customers, intermediation activities by FCMs are oriented specifically towards the technical aspects of trade execution and satisfying clearing requirements. The Working Group respectfully requests the Commission further define "FCM" to exclude swap dealers who only collect margin in connection with uncleared swaps.

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[26] Comments of the Working Group on "Definitions and Required Rulemakings Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act - Definition of Futures Commission Merchant, Floor Broker, and Floor Trader," filed with the Commission on September 20, 2010.

[27] Section 1a(28) of the CEA.

[28] Notice of Proposed Rulemaking on "Adaptation of Regulations to Incorporate Swaps; Proposed Rule," 76 Fed. Reg. 33,066 (Jun. 7, 2011) ("Proposed Adaptation Rule").

Moreover, unlike FCMs, commercial entities that might be swap dealers typically are not clearing members of an exchange or a clearinghouse. In the event that a non-financial swap dealer agrees to centrally clear a trade with a counterparty, each counterparty to that transaction is responsible for ensuring that its own initial and variation margin requirements are satisfied through its own FCM. The counterparties to such transactions do not accept and hold collateral on behalf of the other for purposes of satisfying their counterparty's margin requirements with the clearinghouse. Because neither counterparty accepts collateral from the other as margin for posting to the clearinghouse, they do not owe any fiduciary obligation to the other and, as a result, should not fall within the definition of an FCM.

If the Commission adopts an overly expansive definition of "FCM," commercial firms and other non-intermediary traders would be subject to the registration, reporting and, most importantly, the capital requirements applicable to FCMs. The tangible net equity capital paradigm will most likely only be available for use by major swap participants that do not engage in a *de minimis* amount of swap dealing. In light of the foregoing, the treatment of non-financial swap dealers that will be required to accept margin under the Proposed Margin Rules as FCMs is unnecessary and will disrupt the efficient operation and liquidity of swap markets.

II. COMMENTS ON THE PROPOSED MARGIN RULES.

A. Application of Proposed Margin Rules to Transactions With Non-Financial Entities.

The Working Group believes that the Commission's decision to not impose margin requirements on non-financial entities is consistent with the stated intent of Congress.[29] The Commission's approach to the exchange of margin between Covered Swap Entities and non-financial counterparties places the issue in the correct context. The determination of the parameters of a credit relationship should be undertaken as a bilateral negotiation, without a

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[29] *See* Dodd-Lincoln Letter. Senators Dodd and Lincoln stated:

"The legislation does not authorize the regulators to impose margin on end users…If regulators raise the cost of end user 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…Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end user counterparties-especially if those requirements will discourage the use of swaps by end users or harm economic growth."

See also, Floor colloquy between Congressman Frank, Chairman, Committee on Financial Services and Congressman Peterson, Chairman, Committee on Agriculture in response to the letter from Sen. Dodd and Sen. Lincoln. 156 Cong. Rec. H 5248 (daily ed. June 30, 2010) (colloquy between Cong. Frank and Cong. Peterson). Congressman Frank and Congressman Peterson state that the Act does not give regulators the authority to impose margin requirements on end users and that margin requirements imposed on Swap Dealers and Major Swap Participants should be structured in a way to minimize the impact on end users.

presumption favoring one party.[30] The Working Group respectfully requests the Commission amend the Proposed Margin Rules as set forth in Exhibit A to clarify, consistent with the intent of Congress and the Commission, that with respect to swaps between Covered Swap Entities and non-financial entities, the requirements of each party to post collateral, or to require the other party to post collateral, shall be exclusively governed by the applicable credit support arrangement entered into between the relevant counterparties.[31]

B. The Prudential Regulators' Proposed Margin Rules Should Align With the Proposed Margin Rules.[32]

Without consistent valuation and margin methodology and with inconsistent approaches to netting and permissible forms of collateral there will likely be a number of discrepancies in swap markets that will be the product of the divergent regulatory regimes. At best those differences will impose additional burdens on swap market participants. At worst, such differences may lead to substantive market distortions. To avoid potential market abnormalities that could result from different regulatory regimes, the Working Group respectfully requests that the Commission work with the Prudential Regulators to better align their proposed rules with the contours set forth in the Proposed Margin Rules.

The Prudential Regulators' Proposed Rules impose an express obligation on Covered Swap Entities to collect collateral from non-financial entities.[33] The bilateral negotiation expressly contemplated by the Commission's proposed margin regime for swaps between Covered Swap Entities and non-financial entities is the more appropriate method for the determination of the credit relationship between such entities, as it is consistent with Congressional intent and because the counterparties are best situated to make the necessary credit determinations. As such, the Working Group respectfully suggests that the Proposed Margin Rules serve as the foundation of the aligned Commission and Prudential Regulator margin rules.

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[30] By placing an affirmative obligation on Covered Swap Entities to collect, but not post, collateral, with regards to swaps with non-financial entities, the Prudential Regulators' Proposed Rules create a presumption that it is not necessary for Covered Swap Entities to post collateral.

[31] Exhibit A also incorporates changes necessary to implement the single threshold concept discussed below in Section II.E..

[32] The Working Group notes that the SEC has yet to propose capital and margin requirements. However, such requirements will likely not have a substantive impact on commodity swap markets.

[33] Proposed Prudential Regulator Margin Rules 3 and 4.

C. Netting Under the Proposed Rule.

The Working Group appreciates that the Proposed Margin Rules clearly permit the netting of variation margin.[34] However, the Commission should amend the netting provisions of the Proposed Margin Rules to permit Covered Swap Entities and their counterparties to net counterparty exposures in the most efficient manner possible. Permitting Covered Swap Entities and their counterparties to net and offset collateral requirements across a wide variety of exposures, including swap and non-swap positions, would: (i) allow entities to make efficient use of their capital; (ii) provide market participants and regulators with transparency as to the actual amount of risk in a given swap market; and (iii) reduce complexity and settlement risk.[35]

Currently, master netting agreements and certain master trading agreements allow counterparties to net both swap and non-swap exposures with the same counterparty or affiliated counterparties. For example, a commercial energy firm may have physical natural gas trades in place with a certain counterparty. At the same time, the commercial energy firm may have financial trades with the same counterparty, such as a basis trade effectively converting the price of natural gas determined at one commonly-referenced location (*e.g.*, Henry Hub) into the price at the location where the gas is actually delivered.[36] A master netting agreement allows the commercial energy firm to evaluate credit risk on a consolidated basis and make efficient use of capital.[37]

The Commission must clarify whether, and to what extent, netting and offsets of initial margin is permitted when Covered Swap Entities use an initial margin model. Proposed CFTC Rule 23.155(b)(2)(v) states that "any portfolio offsets or reductions shall have a sound theoretical basis and significant empirical support." This would indicate that netting and offset are permitted. However, the extent to which netting and offset are permitted is not clear. Under this approach, each Covered Swap Entity's initial margin model could treat netting and offset differently. Without a clear delineation of what forms of netting are permitted for initial margin models and without the transparency discussed below in Section II.H., swap market participants

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[34] Proposed CFTC Rule 23.154(b)(5).

[35] The Working Group would note that both the Proposed Rules appear to allow the netting of swap and non-swap positions in order to arrive at an accurate representation of exposure. However, the definition of "major swap participant" does not allow swap market participants to net swap positions with physical positions. The Working Group requests that the exposure determinations under the definition of "major swap participant" be amended to permit the netting of swap positions with physical positions.

[36] Another common example in energy-swap markets is the use of an ISDA Master Agreement with a gas annex and a power annex. With such documentation in place, the counterparties can trade both physical and financial gas and power positions under the same master agreement.

[37] It is possible that the commercial energy firm trades physical natural gas through one affiliate, but financial positions through another affiliate, each facing the same customer. Master netting agreements are also utilized under this circumstance.

would not know the potential universe of options, making it difficult to evaluate each Covered Swap Entity's approach to initial margin. The Working Group respectfully requests that the Commission amend the Proposed Margin Rules to clearly define the parameters of the forms of netting and offset that can be included in an initial margin model.

Covered Swap Entities and their counterparties should be permitted to offset initial margin requirements to the fullest extent possible under the alternative initial margin method set forth in proposed CFTC Rule 23.155(c) (the "Alternative Method"). The Alternative Method only allows Covered Swap Entities and their financial entity and Covered Swap Entity counterparties to offset positions in the same asset class, with one exception,[38] and that reduction cannot "exceed 50% of the amount that would be required for the uncleared swap in the absence of a reduction."[39] The Proposed Margin Rules would result in a market participant with two fully offsetting uncleared swaps with the same swap dealer posting 50% of the initial margin requirement on two swaps when their net counterparty exposure would always be zero. The Working Group respectfully requests that the Commission amend the Proposed Margin Rules to allow Covered Swap Entities and their counterparties, to offset initial margin requirements to the fullest extent possible when there is a sound theoretical basis and significant empirical support, regardless of asset class.[40]

The Proposed Margin Rules allow the netting of variation margin for swaps executed under the same compliant swap trading relationship documentation. However, netting is permissible upon a "retroactive toll charge," meaning netting is only available if the parties net variation margin for all swaps under the same master agreement regardless of when any such swap was executed. Thus, to net swaps entered into after the effective date of the Commission's final rules on margin a party must apply the Commission's new margin rules to swaps entered into before the effective date. It is uncertain why the Commission believes this retro-active toll charge is warranted, particularly as netting reduces counterparty credit risk. If the Commission retains the "retroactive toll charge," the Working Group respectfully requests that the Commission make clear that the decision to structure netting between two counterparties in a manner that will incur the "retroactive toll charge" must be agreed to by both counterparties and not just required by the Covered Swap Entity.

D. Negotiated Margin Agreements.

The Working Group notes that the Proposed Margin Rules allow the Commission to override negotiated arrangements regarding the amount and type of initial and variation

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[38] To a limited extent, parties can net initial margin associated with interest rates and foreign currency swaps.

[39] Proposed CFTC Rule 23.155(c)(2)(iii).

[40] The term asset class is not defined in the Proposed Margin Rules. We request that the Commission clarify what is meant by the term.

margin.[41] The margin requirements requested by a Covered Swap Entity are an agreed upon and negotiated contractual term and the Commission should not supersede a contract and impose a penalty on a Covered Swap Entity's counterparties if that Covered Swap Entity does not meet its regulatory obligations. Similarly, if a counterparty fails to post an additional amount required by a Covered Swap Entity at the request of the Commission, the Covered Swap Entity should not be subject to a penalty.

E. Single Measure of Exposure.

The Act does require the Commission to distinguish between initial and variation margin.[42] However, the Act does not obligate the Commission to require counterparties to treat their net credit exposure as two distinct components; initial and variation margin. Swap market participants generally view credit exposure to counterparties in the aggregate. Exposure is treated as a single number. Swap market participants do not distinguish between initial and variation margin. Initial margin and variation margin should be thought of as measures of exposure to be compared against a single threshold. Parties should be permitted (though not required) to treat the sum of current exposure (*i.e.*, variation margin) and potential future exposure (*i.e.*, initial margin) as one exposure and to have one threshold, where permitted, against which to apply the exposure.

Under the default provisions in Paragraph 3 of the Credit Support Annex to the ISDA Master Agreement, exposure is treated in the aggregate. In the event that a counterparty is required to post an independent amount (similar to initial margin) that amount is factored into the exposure calculation as a buffer. For example, if one counterparty to a swap has an independent amount of $250,000 and the net mark-to-market exposure between the counterparties is zero, then that counterparty would be obligated to post $250,000 in collateral. In the event that the net mark-to-market exposure placed the counterparty obligated to post an independent amount in-the-money by $100,000, then it would be obligated to post $150,000 in collateral. Finally, in the event that a counterparty was out-of-the-money by $100,000, then it would be obligated to post $350,000 in collateral.

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[41] Proposed CFTC Rule 23.155(b)(4)(iii) would allow the Commission to require an initial margin model to be modified at any time. If the Alternative Model is used, Proposed CFTC Rule 23.155(c)(4) would allow the Commission to require a Covered Swap Entity to post or collect additional initial margin to compensate for the risk posed by and instrument or counterparty. Proposed CFTC Rule 23.156(c)(2) would allow the Commission to require a Covered Swap Entity to amend the methods by which it calculates variation margin. Finally, Proposed CFTC rule 23.157(d)(2) would allow the Commission to require a Covered Swap Entity to replace any margin asset posted as collateral to "address potential risks posed by the asset."

[42] Section 4s(e)(1) of the Commodity Exchange Act requires the Commission to set both initial and variation margin requirements for Covered Swap Entities.

One benefit of a single threshold is that it is more efficient with regards to liquidity and capital management. In the example above, only the aggregate net exposure (including the independent amount) between the counterparties is exchanged. When initial margin and variation margin are treated as separate exposures, then both counterparties are required to post initial margin (if applicable) and exchange variation margin. The latter paradigm requires a higher amount of gross capital to operate, making it less efficient and more costly.

The use of a single exposure approach reduces the settlement risk to an in-the-money counterparty in the event of a default. The single exposure paradigm allows a counterparty to account for potential movements in credit exposure to another counterparty by building in an exposure buffer beyond actual current exposure in the form of an independent amount. However, it does not result in the unwarranted result of a party that is extremely in-the-money having to post collateral to a party to which it has a large credit exposure. If the out-of-the-money counterparty were to default under the initial and variation margin paradigm, it would owe the in-the-money party the close out amount (*e.g.* the difference between the mark-to-market value of the swap and the aggregate amount of variation margin posted) **and** any initial margin posted by the in-the-money counterparty. Though in this circumstance the initial margin is the property of the in-the-money counterparty, the recovery of such margin can prove difficult.

The treatment of variation and initial margin as one exposure and the use of a single threshold, where appropriate, would allow for the efficient use of capital without permitting the build up of excessive uncollateralized counterparty credit exposure. The Working Group respectfully requests that the Commission amend the Proposed Margin Rules to allow counterparties to treat exposure in the aggregate and to use a single margin threshold.

F. Use of Non-Cash Collateral.

Proposed CFTC Rules 23.157(a)(3) and (b)(3) allow Covered Swap Entities and non-financial counterparties to treat "assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements" as eligible collateral. The Working Group appreciates the Commission recognizing the important role that non-cash collateral plays with regards to non-financial entities' use of swaps. Further, the Working Group appreciates the Commission correctly leaving the determination of appropriate forms of non-cash collateral to Covered Swap Entities and their non-financial counterparties.

To provide certainty to the validity of collateral arrangements between such parties, the Working Group respectfully requests that the Commission provide further guidance as to what it means for the value of an asset to be "reasonably ascertainable on a periodic basis." Such guidance should allow counterparties to determine if their collateral arrangements meet the standards required by the Proposed Margin Rules. The Working Group respectfully suggests that assets such as letters of credit and liens on assets like commodity reserves and production facilities, all of which are currently common forms of collateral in energy-swap markets, be

permitted as forms of non-cash collateral as the value of such assets is "reasonably ascertainable on a periodic basis."

In addition, the flexibility afforded non-financial entities should not be effectively nullified by the Commission's ability to require a Covered Swap Entity to request another type or amount of collateral at any given time.[43] The forms of margin to be provided between counterparties are an agreed upon and negotiated contractual term and the Commission should not supersede a contract and impose a penalty on a Covered Swap Entity or its counterparties with regards to the use of non-cash collateral.

G. Treatment of Inter-Affiliate Swaps.

Requiring Covered Swap Entities to post collateral with regards to inter-affiliate swaps is unnecessary. Inter-affiliate swaps are generally risk allocation tools and do not increase a corporate enterprise's outward counterparty risk exposure. As the Commission states, inter-affiliate swaps generally are an "allocation of risk within a corporate group" and therefore need not be considered with regards to Proposed Margin Rules.[44] Since the same corporate enterprise ultimately retains both sides of the exposure, posting margin on such swaps would have little to no risk mitigation benefit and would be an inefficient and costly use of capital. The Working Group respectfully requests that the Commission not require margin be posted with regards to inter-affiliate swaps.[45]

H. Use of Initial Margin Models.

The Proposed Margin Rules allow Covered Swap Entities to use proprietary models to determine initial margin amounts.[46] The use of proprietary models will likely make it difficult for Covered Swap Entities' counterparties to anticipate potential changes in initial margin amounts and, consequently, difficult to manage working capital and liquidity.

The Working Group respectfully requests that the Commission require that Covered Swap Entities provide their counterparties, upon request, with access to the model that will be used to assign initial margin requirements.[47] It is necessary for counterparties of Covered Swap

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[43] *See e.g.* Proposed CFTC Rule 23.156(c)(2) and Proposed CFTC Rule 23.157(d)(2).

[44] *See* Proposed Definitions at 80,183.

[45] For further discussion of the treatment of inter-affiliate swaps and other affiliate issues see the letter to be submitted shortly to the Commission by the Working Group and the Commodity Markets Council.

[46] Proposed CFTC Rule 23.155(a).

[47] The Working Group notes that access to the model would not include access into the Covered Swap Entity's credit determination regarding the relevant counterparty. The credit determination should be made separate and apart from the analysis of the amount of initial margin necessary to account for the risk associated with a particular swap. In other words, a Covered Swap Entity should make a transparent determination as to the initial

Entities to have such access to adequately anticipate their working capital needs. Such transparency will also allow counterparties to make more informed choices as to their preferred trading counterparties and allow them to monitor and dispute initial margin calculations if they prove to be contrary to agreed upon terms.

The Working Group also respectfully requests that the Commission clearly outline the steps needed to gain approval for the use of initial margin models. Without clarity on the model approval process, Covered Swap Entities will be unable to take the steps necessary to develop or acquire a permitted initial margin model prior to the effective date of the Commission's margin rules and will be forced to use the alternative method, which will impose less appropriate and likely higher initial margin requirements.

I. Implications of the Proposed Margin Rules for Covered Swap Entities.

i. Initial Margin Calculations Under the Alternative Method.

The Alternative Method would require Covered Swap Entities to set initial margin requirements for other Covered Swap Entities and for financial entities by using a reference-based approach. Covered Swap Entities would be required to identify the cleared swap or futures contract, if no comparable cleared swap exists, that "most closely approximates the terms and conditions of the uncleared swap."[48] The initial margin requirement for the identified cleared swap would be multiplied by 2, or 4.4 if a comparable futures contract is used, to determine the initial margin requirement for the uncleared swap. The Working Group is concerned that the Proposed Margin Rules do not provide an adequate solution for uncleared swaps that have no readily comparable cleared swap or future.

In lieu of the reference-based paradigm, the Working Group advocates that the Commission adopt a grid-based approach similar to the method proposed by the Prudential Regulators. However, the Working Group believes the grid, as proposed by the Prudential Regulators, warrants further refinement.[49] It applies initial margin requirements without sufficient granularity. For example, all commodity contracts are assessed the same initial margin requirement, without regard to duration. As a result, the margin requirements for uncleared commodity-based swaps are not risk-based. The Commission and the Prudential Regulators should provide separate initial margin requirements for different commodities (*e.g.*, wheat, gasoline, electricity, etc.) and add further delineation for the duration of any uncleared swap.

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margin required to cover the risk inherent in the swap and would then increase that amount by an agreed upon percentage to account for the credit risk posed by the counterparty.

[48] Proposed CFTC Rule 23.155(c)(1)(i).

[49] *See* Comments of the Working Group to the Prudential Regulators' Proposed Rules, filed with the Prudential Regulators on July 11, 2011.

Further, the Prudential Regulators' proposed grid-based method does not allow for initial margin offsets. The Working Group recommends that the Prudential Regulators' proposed grid-based method be amended to allow for initial margin offsets, where appropriate. Using the same grid-based method across the Commission's and Prudential Regulators' rules would create consistency among margin paradigms and add certainty and predictability with respect to margin determinations.

ii. Ten-Day Liquidation Time Horizon for Initial Margin Determinations.

Under the Proposed Margin Rules, an initial margin model is required to set initial margin at a level that covers at least 99% of price changes over at least a ten-day liquidation time horizon.[50] We understand that such requirements arguably must be equal to or greater than margin requirements for comparable cleared swaps,[51] and that proposed DCO margin requirements would require a five-day time horizon.[52] However, the Commission provides little explanation as to why a ten-day time horizon (*i.e.,* double the time horizon for cleared swaps) is appropriate for all uncleared swaps.

The Commission states the longer time horizon for uncleared swaps is necessary because of such swap's lower liquidity. The function of initial margin, according to the Commission, is to serve as a buffer against market movements in between variation margin calls. Initial margin serves to compensate a counterparty for the risk posed by price movements if a swap has to be replaced in the event of a counterparty default.

It is highly unlikely that it will take ten days to replace a swap. Under the ISDA Master Agreement, failure to provide variation margin, when required, is an event of default after one business day. The non-defaulting counterparty then must wait one more business day before it is permitted to terminate all swaps between the counterparties. After such termination, the non-defaulting counterparty is the owner of any initial margin, assuming it is the in-the-money counterparty. Under this paradigm it is highly unlikely that a counterparty will need ten days to replace its swaps. Therefore, the Working Group respectfully requests that the Commission clarify why a ten-day time horizon is appropriate as the basis for the initial margin requirements for uncleared swaps.

iii. Timing of Valuation and Collateral Exchange.

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[50] Proposed CFTC Rule 23.155(b)(2)(vi).

[51] Section 4s(e)(3)(A) of the Commodity Exchange Act states: "to offset the greater risk …arising from swaps that are not cleared, the [capital] requirements imposed under paragraph (2) shall…"

[52] *See* CFTC Notice of Proposed Rulemaking on "Risk Management Requirements for Derivatives Clearing Organizations", 76 Fed. Reg. 3698, 3704–05 (Jan. 20, 2011). The Working Group would note that a five-day time horizon is already high when compared to current time horizon for cleared swaps which can range from three to five days.

The Working Group respectfully requests that the Commission clarify the collateral transfer timing requirements of the Proposed Margin Rules with regards to swaps between Covered Swap Entities and between Covered Swap Entities and financial entities. The Proposed Margin Rules require a Covered Swap Entity to comply with the initial margin requirements for the duration of the swap, starting on or before the execution date.[53] The Proposed Margin Rules also require a Covered Swap Entity to collect variation margin from Covered Swap Entities and financial entity counterparties on a daily basis, starting on the day after execution.[54]

The Working Group is worried that, as drafted, it will not be operationally possible to comply with the Proposed Margin Rules under certain circumstances. Requiring initial margin be in place at execution of a swap does not comport with general market practice. For example, once counterparties enter into a swap there are multiple back office steps that must be completed before the transfer of initial margin can take place. Depending on the timing of a trade, it can take up to two business days before initial margin is received by a counterparty. If counterparties were required to have initial margin in place at execution, counterparties would essentially be required to agree upon the terms of a swap and then wait for up to two business days before executing such swap. After a two business day period that swap may no longer make sense for the counterparties at the previously agreed upon terms.

Further, common market practice is to exchange variation margin on a staggered or time-delayed basis. A counterparty will typically measure exposure based on the previous day's price and then request collateral to be delivered the following business day. This creates a natural lag between execution and the first delivery of variation margin.

The Proposed Margin Rules also do not appear to contemplate a scenario such as a force majeure. The Proposed Margin Rules provide a safe harbor to a Covered Swap Entity whose counterparties do not deliver the required variation margin as long as the Covered Swap Entity makes "necessary efforts to attempt to collect the required variation margin."[55] However, the safe harbor does not appear to apply if the Covered Swap Entity is unable to make necessary efforts to collect variation margin and does not apply to the collection of initial margin.

In the examples above, the counterparties to a swap fully intend to comply with the Proposed Margin Rules, but are unable to because of operational constraints. The Working Group respectfully requests that the Commission provide a limited safe harbor for counterparties that are temporarily unable to comply with the requirements of the Proposed Rule for operational reasons.

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[53] Proposed CFTC Rule 23.152(a)(1) and Proposed CFTC Rule 23.153(a)(1).

[54] Proposed CFTC Rule 23.152(b)(1) and Proposed CFTC Rule 23.153(b)(1).

[55] Proposed CFTC Rule 23.152(b)(6)(ii)(A) and Proposed CFTC Rule 23.153(b)(6)(ii)(A).

III. GENERAL COMMENTS ON THE PROPOSED CAPITAL RULES.

A. Role of the National Futures Association's Capital Rules.

Under the Proposed Capital Rules, Covered Swap Entities that are non-financial entities and not FCMs must comply with the higher of the capital requirement determined under the Commission's Proposed Capital Rules or the capital requirements imposed by the registered futures association of which it is a member, which will in all likelihood be the National Futures Association (the "NFA").[56] The NFA has yet to propose its capital requirements.

The Proposed Capital Rules provide for two methods to calculate capital requirements: a model-based approach and a non-model based approach derived from an old version of the Basel capital requirements that, as discussed in Sections IV.A. and IV.B. does not properly account for risk.[57] However, as discussed below in Section III.H., non-financial Covered Swap Entities currently are only permitted to use the non-model based approach as the Commission does not feel it has the resources necessary to approve capital models for Covered Swap Entities.[58] If Covered Swap Entities regulated by the Commission are only able to use the proposed non-model-based approach they will be at a severe competitive disadvantage when compared to other Covered Swap Entities.

If the Commission feels it does not have the resources necessary to approve initial margin models and develop its own risk-based non-model approach, then the Commission should task the NFA with creating both. Consistent with its traditional principles-based approach to regulation, the Commission could provide general guidance to the NFA as to the parameters and requirements and ask them to develop both approaches.

It will likely be onerous and costly for Covered Swap Entities to comply with the Proposed Capital Rules and then adopt the improved capital requirements promulgated by the NFA. Accordingly, the Working Group requests that the Commission stay the effective date of the Proposed Capital Rules until the NFA has completed the development of its alternative capital methodologies.

Finally, given the complexity and cost implications associated with capital requirements, swap market participants should have the opportunity to provide comments and insight on any NFA capital requirements prior to their adoption. The Working Group respectfully requests that the Commission, regardless of whether it takes the above suggestions, subject any capital regime proposed by the NFA to a formal notice and comment period prior to Commission approval.

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[56] Proposed CFTC Rule 23.101(a)(1) and (b)(1).

[57] Capital Proposing Release at 27,809.

[58] Capital Proposing Release at 27,808.

B. Scope of the Application of the Proposed Capital Rules.

The Proposed Capital Rules are intended to "include swap transactions and related hedge positions that are part of the SD's swap activities in the over-the-counter derivatives credit risk requirement and market risk exposure requirement, and not swap positions or related hedges that are part of the SD's commercial operations."[59] The Working Group interprets this language to mean that the Proposed Capital Rules will only apply to a swap dealer's swap dealing activity. The Commission, however does not provide further guidance as to what activity is subject to the Proposed Capital Rules.[60] Additionally, proposed CFTC Rule 23.104(b)(2) states that the market risk exposure calculation will apply to (i) swaps that are not cleared and (ii) debt instruments, equities, commodities or foreign currency, including derivatives of the same, that hedge such swaps.

The Working Group submits that, depending on the scope of its physical and financial trading operations, a Covered Swap Entity may find it difficult to identify or isolate the portfolio of uncleared swaps that are associated with its swap dealing activity and it may find it difficult to identify or isolate the specific transactions and instruments that may offset the risks of such uncleared swaps. Consequently, the Working Group requests that the Commission, consistent with its traditional principles-based approach to regulation, allow a Covered Swap Entity to elect to consider a certain defined portion of its uncleared swaps portfolio and related positions when determining its capital requirement. For example a Covered Swap Entity could consider (i) its entire swap portfolio and related positions, (ii) just its entire swap portfolio, (iii) its portfolio of "swap dealing" swaps and related positions or (iv) just its portfolio of "swap dealing" swaps.[61] Leaving the offsetting positions out of the capital calculation or including an entire swap portfolio (*i.e.* not just the portfolio of "swap dealing" swaps) would likely result in a more conservative (higher) market risk exposure, but could be operationally easier for certain Covered Swap Entities. To limit any potential abuse of this election, the Commission could prohibit Covered Swap Entities from changing their election more than once over a specific period of time.

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[59] Capital Proposing Release at 27,806.

[60] The Working Group respectfully requests that the Commission follow the Working Group's previously submitted comments regarding the proper approach to the determination of what activity constitutes swap dealing when applying the Proposed Capital Rules. *See* the Working Group's supplemental comments on the definition of "swap dealer" filed with the Commission on June 3, 2011.

Available at: http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933

[61] This list is illustrative and not exhaustive of the possible manners in which Covered Swap Entities could decide to consider their uncleared swaps and related positions.

C. **Treatment of Inter-Affiliate Swaps.**

Inter-affiliate swaps are largely internal risk transfers and have little to no systemic consequences. Accordingly, the Working Group urges the Commission to consider inter-affiliate swaps on a limited basis for the purposes of the Proposed Capital Rules. With respect to commodity positions, inter-affiliate swaps should be subject to a VaR-based market risk determination, or if the Commission elects to retain the proposed market risk methodology, the net open position calculations in the market risk determination. They should also be subject to the credit risk determination, but at a credit risk factor of 10%. The credit integration between affiliated entities, the better-than-arms-length knowledge with regards to the creditworthiness of affiliated entities and the fact that inter-affiliate swaps are predominantly risk allocation trades all justify a 10% credit risk factor. In addition, for those reasons, inter-affiliate swaps should not be subject to either the individual counterparty concentration charge or the portfolio credit charge.

D. **Application of Proposed Capital Rules to Limited Designation Entities.**

As the Working Group noted in its June 9, 2011 comment letter on limited designation entities,[62] it appreciates the Commission providing potential Covered Swap Entities the ability to elect to register a limited portion of an entity as a Covered Swap Entity.

To allow potential Covered Swap Entities to better assess the viability of the limited designation model, the Working Group requests that the Commission clarify how the Proposed Capital Rules would apply to a limited designation entity. The determination of the capital base of a regulated portion of a larger entity will be difficult in most circumstances. The Working Group suggests that a limited designation Covered Swap Entity should be permitted to designate the assets, through the use of guarantees or other support arrangements, within the larger entity that comprise the regulatory capital of the Covered Swap Entity. However, the dedication of such assets should not lead to other portions of the larger entity being regulated as a Covered Swap Entity. Allowing the Covered Swap Entity to designate the assets that comprise its asset base is a simple solution to a difficult issue and will make the concept of limited designation workable.

E. **Treatment of Subsidiaries.**

In the event that a Covered Swap Entity includes the assets and liabilities of an affiliate in its calculation of tangible net equity, then those other entities should not be regulated as Covered Swap Entities because of such inclusion. The Proposed Capital Rules require that a Covered Swap Entity, for the purposes of the determination of tangible net equity, aggregate the assets

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[62] See comments of the Working Group filed with the Commission on June 9, 2011 available at: http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933

and liabilities of any affiliate to which it supplies a guarantee. In addition, subject to certain requirements, Covered Swap Entities may include the assets and liabilities of controlled subsidiaries in their tangible net equity. The Working Group would note that in most circumstances, if a Covered Swap Entity is a member of a larger corporate enterprise, it is likely to be at the bottom of the corporate structure, with few, if any, subsidiaries.

F. Definition of "Tangible Net Equity" Should Be Clarified and Expanded to Include Parental Guarantees and Other Forms of Support.

As proposed, the Commission's definition of "tangible net equity" is unclear and does not properly account for the manner in which swaps are often transacted and the corporate structure of many corporate enterprises that may contain Covered Swap Entities. In many cases, the entity within a corporate enterprise that trades swaps is not the entity in which most of the corporate enterprise's assets reside. Often, it is most efficient for the swap trading entity's transactions to be backed by a guarantee of an affiliate. This type of arrangement allows a corporate enterprise to locate assets in the part of the business that is most efficient and allows it to limit the overall enterprise's exposure to swaps-related risk.

Accordingly, the Working Group requests that the Commission include parent guarantees, subordinated debt, and other hybrid capital in the definition of "tangible net equity." In addition, the Commission should also make clear that providing a guarantee to a Covered Swap Entity does not result in the guarantor being subject to regulation as a Covered Swap Entity.

G. Base Tangible Net Equity Requirement Should be Amended.

The Proposed Capital Rules require a Covered Swap Entity to hold $20 million in regulatory capital in addition to the amount of capital related to its swaps activity.[63] That is to say a Covered Swap Entity with swap positions that would require it to hold $10 million of regulatory capital would be obligated to hold $30 million in regulatory capital.

This requirement appears to be designed to provide a minimum capital requirement for Covered Swap Entities, a legitimate policy goal. However, as currently drafted it effectively requires a non-risk-based performance bond, which is costly and unnecessary for Covered Swap Entities that are properly capitalized and hold capital in excess of the $20 million minimum. The Working Group respectfully requests that the Commission amend the Proposed Capital Rules to require that Covered Swap Entities hold at least $20 million in regulatory capital. Such a requirement would provide a base capital requirement, but would not impose a non-risk based capital requirement on Covered Swap Entities that hold capital in excess of the $20 million floor.

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[63] Proposed CFTC Rule 23.101(a)(1)(i).

H. Use of Proprietary Capital Models.

Proposed CFTC Rule 23.103(e) limits the use of proprietary capital models to (i) Covered Swap Entities that are subsidiaries of bank holding companies and (ii) Covered Swap Entities that are registered with the SEC. By limiting the use of proprietary capital models to such types of entities, the Commission will likely place other Covered Swap Entities, at a competitive disadvantage as capital models will likely be a more efficient method of determining regulatory capital than the other methods in the Proposed Capital Rules.

The Commission provides itself the authority to allow all Covered Swap Entities to use proprietary capital models.[64] The Working Group requests that the Commission exercise its authority under proposed CFTC Rule CFTC 23.103(f) on the effective date of the Proposed Capital Rules. If the Commission chooses not to do so, the Working Group requests that it not allow Covered Swap Entities regulated by the Commission to use proprietary capital models until it exercises its authority under proposed CFTC Rule 23.103(f), to provide a competitive market environment for all commodity-swap market participants.

I. The Proposed Capital Rules' Accounting Requirements.

i. The Proposed Capital Rules Must Allow for the Use of Other Accounting Standards.

The Proposed Capital Rules require non-FCM Covered Swap Entities subject to regulation by the Commission to calculate tangible net equity according to U.S. GAAP.[65] However, many entities that might be Covered Swap Entities regulated by the Commission do not use U.S. GAAP and requiring them to do so for the purposes of preparing financial statements solely to comply with the Proposed Capital Rules will impose significant costs. The Working Group requests that the Commission amend the Proposed Capital Rules to allow Covered Swap Entities to use other generally accepted accounting principles, in particular International Financial Reporting Standards ("IFRS").

IFRS is widely used by non-U.S. companies, including many companies doing business in the U.S. commodity markets and their parents. Although some may "translate" their IFRS-based statements to U.S. GAAP for their annual reports, they typically do not prepare monthly or quarterly financials on a U.S. GAAP basis. The SEC has allowed registrants to submit financial

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[64] Under proposed CFTC Rule 23.103(f), "at any time after the effective date of this rule, the Commission may … determine … that swap dealers or major swap participants not described in paragraph (e) [Covered Swap Entities that are subsidiaries of bank holding companies and Covered Swap Entities that are registered with the Securities Exchange Commission]…also may apply for approval…to calculate the amount of their market risk exposure requirements or over-the counter derivatives credit risk requirements using proprietary internal models."

[65] Proposed CFTC Rule 23.102 (a).

statements prepared pursuant to IFRS since 2008,[66] and in fact, is currently considering whether to require U.S. companies to move to IFRS.[67] The SEC's decision was based on several factors including the advantages of moving towards a global accounting standards system and the fact that over 100 countries have adopted IFRS.[68] Notably, the SEC does not require financial statements prepared pursuant to IFRS to be reconciled to U.S. GAAP. The CFTC's acceptance of IFRS as an alternative to U.S. GAAP for purposes of calculating tangible net equity would reduce the costs of Covered Swap Entities that prepare their financial statements on the basis of IFRS, and would also be consistent with the requirements and policy direction of the SEC.

ii. Treatment of Subsidiaries.

The Working Group would also note that many Covered Swap Entities are part of larger corporate entities. As such, they often do not have audited, U.S. GAAP compliant financial statements at the entity level. Requiring them to have such statements will be costly and unnecessary. The Working Group requests that the Commission allow Covered Swap Entities to comply with the annual and monthly reporting requirements by providing financial reports that provide a fair and accurate representation of the Covered Swap Entity's financial condition.

IV. RECOMMENDED CAPITAL CALCULATIONS.

A. Market Risk Calculations.

With regards to commodities positions, the Proposed Capital Rules require a Covered Swap Entity to hold regulatory capital equal to the sum of 15% of net open positions in each commodity and 3% of gross notional positions in each commodity. This proposed calculation treats each commodity position equally and, consequently, does not account for the actual market risk of a particular swap.

The Working Group believes that the capital requirement should be risk sensitive, rather than a simple percentage of the open and gross positions. One simple way to accomplish this goal would be to calculate a VaR on a Covered Swap Entity's portfolio and require Covered Swap Entities to hold capital against this measure. A VaR metric would replace the proposed

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[66] *See* "Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP", 73 Fed. Reg. 986 (Jan. 4, 2008).

[67] "Accounting Move Pits Big vs. Small" Wall Street Journal, July 6, 2001; page C1.

[68] *See* "Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP" at 986. "The Commission [SEC] has undertaken several measures to foster the use of International Financial Reporting Standards (''IFRS'') as issued by the International Accounting Standards Board (''IASB'') and fully supports the efforts of the IASB and the Financial Accounting Standards Board (''FASB'') to converge their accounting standards.

non-risk sensitive requirement with an easily validated and calculated, risk-sensitive metric. In addition, a VaR approach would better harmonize the Proposed Capital Rules with current and future Basel requirements and could be implemented in a manner that is much simpler than Basel.

A VaR approach would link directly to the actual risk posed by a Covered Swap Entity's swaps, and, therefore, it would be relatively easy to understand and manage from a risk-management perspective, especially considering many Covered Swap Entities already use some form of VaR to manage risk. On the other hand, the proposed non-model approach to capital requirements is not risk-based, likely making it difficult to integrate into many Covered Swap Entities existing risk management programs and, thus, making it difficult to manage compliance with the Proposed Capital Rules. The Working Group intends on submitting additional specific comments on the use of VaR and may submit a basic VaR approach for the Commission's consideration. The Working Group would be pleased to make its members available to the Commission and NFA to discuss how a simple VaR approach to capital requirements can be implemented.

In the event that the Commission does not adopt a VaR metric, the Working Group still believes that the market risk requirements should measure the swaps-related risk posed to a Covered Swap Entity by the movement of market prices. Requiring the holding of an additional capital in the amount of 3% of gross notional in each commodity in addition to capital in the amount of 15% of net open positions, does not address market risk, nor is it in any way sensitive to the actual risks in the positions. Accordingly, the Working Group requests that the additional 3% of gross notional capital charge be removed.

i. Notional Determinations Should Be Based on Contract Prices.[69]

The proposed market risk requirement methodology would require all commodity positions to be converted to notional positions using the "current spot rates."[70] The Working Group believes that non-spot commodity positions and derivatives should be converted to notional positions using the contract prices.[71] The value and therefore the exposure associated with such positions is a function of the applicable contract price associated with the position, which is likely correlated to, but far from equivalent to, a spot rate (assuming the position is not a spot position).

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[69] The Working Group also notes that it is unclear as to how a basis swap (*e.g.* a swap of the price of a commodity at two delivery locations) can be converted into a notional position. Under a VaR based approach such a conversion is not necessary and the risk associated with a basis swap can be properly accounted for.

[70] Proposed CFTC Rule 23.104(d)(6).

[71] It should be noted that in calculating a risk-sensitive market risk capital measure, such as the VaR calculation suggested above, variations in forward rates must be used to measure the volatility in book value of forward contracts and spot rates cannot be used.

In certain situations there is little relation between the spot and forward prices of a commodity and requiring forward contracts to be converted to notional positions at spot rates will present a very distorted picture of a Covered Swap Entity's portfolio's market risk. For example, spot oil prices can be sensitive to short term market disruptions such as weather events that temporarily delay delivery. However, long-term forward rates are only marginally impacted by such temporary events. The Working Group suggests that the Commission allow Covered Swap Entities to convert forward positions to notional positions using applicable contract prices.

If the Commission chooses to move forward with the use of spot rates, the Commission must clarify which prices are applicable. For a commodity such as electricity, there are many "spot" rates. There are, at any given point, hourly prices, on-peak and off-peak averages, day ahead, spot week and spot month, all of which are known in the industry as spot prices. Many of the near-term competitive market "spot" electricity rates can be highly volatile during certain weather events. For example, a recent winter storm moved prices from $30 to $3000 for a brief period and then reverted to $30. In addition, near-term competitive market "spot" electricity rates can actually turn negative.[72] This short term volatility in "spot" rates would make calculating and complying with capital requirements extremely difficult. In the event that the Commission elects to still use a spot rate, then the Working Group suggests that the Commission use the prompt month rate.[73]

ii. The Commission Must Clarify the Term "Proprietary Positions."

The Proposed Capital Rules' market risk calculations require a Covered Swap Entity to include all "proprietary positions" in such calculations.[74] However that term is not defined. Is it something other than positions held through a "proprietary account" as defined in CFTC Rule 1.17? The Working Group requests that the Commission provide further guidance as to what positions are considered "proprietary positions."

iii. The Commission Should Provide Clarity Regarding the Offsets Between Categories of Commodities.

The Proposed Capital Rule contemplates that certain commodity positions can be offset against one another before calculation of the market risk charge. The Proposed Capital Rules

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72 Electricity cannot be stored and must be used and not disposed of. For certain forms of generation, such as wind power, hydro-electric power or nuclear power, there are occasions when production exceeds demand as the production of wind energy and hydro-electric energy cannot be controlled by the producer and nuclear power plants cannot be brought off-line. Under these circumstances, commercial energy firms will actually pay customers to consume electricity.

73 The prompt month rate is the price of a commodity to be delivered the next month.

74 Proposed CFTC Rule 23.104(d).

state "positions in different categories of commodities may not be offset *unless deliverable against each other*" (emphasis added).[75] No further information about the Commission's view of which commodities are deliverable against each other is provided. Accordingly, in the event that the Commission does not accept the Working Group's proposal to use a VaR-driven approach to market risk, the Working Group respectfully requests the Commission provide clarification as to which offsets are acceptable. For example, are two contracts for the same commodity with different delivery points "deliverable against each other"? Are similar grades of the same commodity "deliverable against each other"? Are two contracts for the same commodity and same delivery location, but different delivery month "deliverable against each other"?

B. Credit Risk Calculations.

i. Credit Risk Calculations Should be Risk Sensitive.

As with the market risk calculations, the counterparty credit risk capital calculations should use a simple risk-sensitive approach. Such approach should take into account the credit risk of each counterparty, the variability of the Covered Swap Entity's exposure to that counterparty and the "wrong-way risk" or risk that the counterparty will fail when the Entity's swap positions are in the money. This could be accomplished by using either a probability of default multiplied by loss-given-default approach, or a simple history of loss rates. Historical ratings-based data can be easily retrieved from Rating Agency cites. Unrated counterparties can be mapped to ratings via third party credit evaluation or in-house credit models.[76]

ii. Individual Concentration Charge is Flawed.

While the concept of a concentration charge on a Covered Swap Entity's exposure to a single customer makes sense, determining that concentration charge based on tangible net equity does not, as it is conceptually flawed. An individual concentration charge that determines concentration based on the ratio of the exposure to a counterparty to a Covered Swap Entity's tangible net equity is internally inconsistent. Concentration risk should be thought of as the risk that any given exposure grows too large in relation to the overall swap portfolio, not too large in relation to the capital requirement which already takes into consideration the risks embedded in that portfolio. The Working Group therefore proposes that the individual concentration charge calculation be based on the individual exposure to a counterparty as a percentage of the overall positive credit exposure in the portfolio.

iii. Portfolio Concentration Charge is Unnecessary.

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[75] Proposed CFTC Rule 23.104(d)(6).

[76] The Working will discuss potential risk-sensitive approaches to the determination of credit risk in the additional comments noted above in Section IV.A.

The aim of the Proposed Capital Rules is to provide an equity buffer against potential shocks to a Covered Swap Entity's operations resulting from market and credit risks. If the credit exposure charge component of the capital requirement acts according to design, a Covered Swap Entity should already be subject to a capital requirement sufficient to cover the potential credit risk in its portfolio. In that light, the proposed portfolio concentration charge is unnecessary. The credit exposure in a Covered Swap Entity's portfolio should already be addressed by the general credit risk requirement and the Commission does not offer an explanation as to the basis for the portfolio concentration charge. The Working Group requests that the portfolio concentration charge be removed from the Proposed Capital Rules.

iv. Counterparty Credit Charge Determination Should be Made by Counterparties.

Under the Proposed Capital Rules, a Covered Swap Entity must assign a credit risk factor to a counterparty. By default that credit risk factor is 50% or, upon approval by the Commission a Covered Swap Entity may assign counterparties credit risk factors of 20%, 50% or 150%.[77] The proposed credit risk factors severely limit the ability of Covered Swap Entities to make their own credit determination and will likely force them to treat counterparties with substantively different creditworthiness in the same manner for capital purposes. Consistent with current industry practice, the Working Group suggests that the Commission permit the use of proprietary credit models or fundamental credit review by market participants when assigning credit risk factors, and allow such factors to be assigned at a level determined by the Covered Swap Entity, not just 20%, 50% or 150%.

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[77] Proposed CFTC Rule 23.104(e)(1).

V. CONCLUSION.

The Working Group supports tailored regulation that brings transparency and stability to the swap markets in the United States. We appreciate the balance the Commission 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 Commission 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

§ 23.154
Margin treatment for uncleared swaps between covered swap entities and non-financial entities.
~~(a) Initial margin.~~

(a~~1~~) ~~On or before the date of execution of an~~With respect to uncleared swaps entered into between a covered swap entity and a non-financial entity, the covered swap entity shall require such non-financial entity to post, and the covered swap entity shall post, any initial margin and/or variation margin that may be required pursuant to the terms of the applicable credit support arrangement entered into between them. The requirements of each party to post, or to require the other party to post, initial and/or variation margin shall be exclusively governed by the applicable credit support arrangement entered into between them and failure of either party to post initial and/or variation margin pursuant to the terms of such credit support arrangement shall not constitute a termination event, illegality, or similar event that would invalidate a swap or permit a party to terminate a swap except as provided in the applicable credit support arrangement or other swap trading relationship documentation entered into between the parties.

~~(2) Until such an uncleared swap is liquidated, the covered swap entity shall require the counterparty to maintain any initial margin that may be required pursuant to the credit support arrangement between them.~~

(~~3~~b) The credit support arrangements entered into between a covered swap entity and a non-financial entity may provide for a threshold below which the nonfinancial entity is not required to post any initial margin and/or variation margin and may also provide for a threshold below which the covered swap entity is not required to post any initial margin and/or variation margin.

~~(4) On or before the date of execution of an uncleared swap between a covered swap entity and a non-financial entity, the covered swap entity shall post any initial margin that may be required pursuant to the credit support arrangement between them.~~

~~(5) Until such an uncleared swap is liquidated, the covered swap entity shall maintain any initial margin that may be required pursuant to the credit support arrangement between them.~~

~~(6) The credit support arrangements between a covered swap entity and a non-financial entity may provide for a threshold below which the covered swap entity is not required to post initial margin.~~

~~(7) For risk management and capital purposes, each covered swap entity shall calculate each day a hypothetical initial margin requirement for each such uncleared swap as if the counterparty~~

~~were a swap dealer and compare that amount to any initial margin required pursuant to the credit support arrangements.~~

~~(b) Variation margin.~~

~~(1) For each uncleared swap between a covered swap entity and a non-financial entity, each covered swap entity shall require the non-financial entity to pay any variation margin that may be required pursuant to the credit support arrangements between them.~~

~~(2) The credit support arrangements between a covered swap entity and a non-financial entity may provide for a threshold below which the nonfinancial entity is not required to pay variation margin.~~

~~(3) For each uncleared swap between a covered swap entity and a nonfinancial entity, each covered swap entity shall pay any variation margin that may be required pursuant to the credit support arrangements between them.~~

~~(4) The credit support arrangements between a covered swap entity and a non-financial entity may provide for a threshold below which the covered swap entity is not required to pay variation margin.~~

(c~~5~~) To the extent that ~~more than one uncleared swap is executed pursuant to~~ swap trading relationship documentation entered into between a covered swap entity and ~~its counterparty~~counterparty non-financial entity ~~that permits netting~~contains provisions that allow exposure to be calculated on a net basis for a portfolio of transactions, including transactions that are not swaps, a covered swap entity may calculate and comply with the initial and/or variation margin requirements of this paragraph on an aggregate basis with respect to all uncleared swaps and any other transactions governed by such ~~agreement~~provisions.~~, provided that the covered swap entity complies with these variation margin requirements for all uncleared swaps governed by such agreement regardless of whether the uncleared swaps were entered into on or after the effective date.~~

~~(6) For risk management purposes, each covered swap entity shall calculate each day a hypothetical variation margin requirement for each such uncleared swap as if the counterparty were a swap dealer and compare that amount to any variation margin required pursuant to the credit support arrangements.~~

§ 23.155 Calculation of initial margin.

(a) Means of calculation.

(1) Each covered swap entity shall calculate initial margin using the methodology specified in the credit support arrangements with the counterparty provided that, with respect to a counterparty that is a swap dealer, major swap participant, or financial entity, the methodology shall be consistent with the requirements of this section.

§ 23.157 Forms of margin.

(a) Initial margin.

(1) With respect to swaps entered into with a counterparty that is a swap dealer, major swap participant, or financial entity, Eeach covered swap entity shall post and accept as initial margin only assets specified in the credit support arrangements with the counterparty.

(3) Each covered swap entity shall accept as initial margin from nonfinancial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.

(4) A covered swap entity may not collect, as initial margin or variation margin required by the part, any asset that is an obligation of the counterparty providing such asset.

(b) Variation margin.

(1) With respect to swaps entered into with a counterparty that is a swap dealer, major swap participant, or financial entity, Eeach covered swap entity shall pay and collect as variation margin only assets specified in the credit support arrangements with the counterparty.

(3) Each covered swap entity shall accept as variation margin from nonfinancial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.

(c) Haircuts.

(1) With respect to swaps entered into with a counterparty that is a swap dealer, major swap participant, or financial entity, Eeach covered swap entity shall apply haircuts to any asset posted or received as margin as specified in the credit support arrangements with the counterparty.

(2) With respect to swaps entered into with a counterparty that is a swap dealer, major swap participant, or financial entity, Eeach covered swap entity shall apply haircuts to any asset received as margin that reflect the credit and liquidity characteristics of the asset.

(d) Non-financial entities. With respect to uncleared swaps entered into between a covered swap entity and a non-financial entity, the types of assets that each party may post and accept as initial

margin and/or variation margin and the value assigned to any such asset shall be exclusively governed by the applicable credit support arrangement entered into between such parties.