

May 15, 2017

**VIA ELECTRONIC SUBMISSION**

Mr. Christopher Kirkpatrick  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

**Re: Proposed Rule; *Capital Requirements of Swap Dealers and Major Swap Participants* (RIN 3038-AD54)**

Dear Mr. Kirkpatrick:

**I. INTRODUCTION**

On behalf of The Commercial Energy Working Group (the “**Working Group**”), Eversheds Sutherland (US) LLP submits this letter in response to the request for public comment set forth in the Commodity Futures Trading Commission’s (the “**CFTC**” or “**Commission**”) Proposed Rule; *Capital Requirements of Swap Dealers and Major Swap Participants* (the “**Proposed Capital Rule**”).<sup>1</sup> The Working Group is concerned that the CFTC’s proposed approach for capital requirements for non-financial swap dealers (“**Non-financial SDs**”), while well-intentioned, may create a significant barrier to entry that prevents non-financial companies acting as swap dealers in commodity markets at or above a level that requires registration. Many of those commodity derivatives markets, as discussed further below, have experienced a decline in liquidity since 2010 and would benefit from an increase, and be further harmed by a decrease, in the number of active market makers.

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 producers, processors, merchandisers, and owners of energy commodities. Among the

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<sup>1</sup> See Proposed Rule; *Capital Requirements of Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 91,252 (Dec. 16, 2016), available at <http://www.cftc.gov/idc/groups/public/@Irfederalregister/documents/file/2016-29368a.pdf>.

members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group advocates regarding regulatory, legislative, and market developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

## II. COMMENTS OF THE WORKING GROUP

The Proposed Capital Rule provides three capital approaches for registered swap dealers: (i) a bank-based approach; (ii) a net-liquid-asset-based approach; and (iii) a tangible net worth approach.<sup>2</sup> The tangible net worth approach is only available to entities that are predominantly engaged in non-financial activities. If a Non-financial SD cannot meet the requirements of the tangible net worth approach, not only might it be forced to operate like a bank in terms of its assets, but the firm will also be further constricted by a liquidity coverage ratio or liquidity stress test in order to comply with the requirements of the bank-based approach or net-liquid-asset-based approach, as applicable. For non-financial firms that do not have cash or highly liquid assets as their predominant type of assets, the changes necessary to come into compliance with the capital rules, on top of all of the other compliance costs associated with being a swap dealer, would likely be prohibitive.

The Working Group appreciates that in providing the tangible net worth approach the CFTC recognized that a small number of swap dealers are substantially engaged in commercial rather than financial operations, which might make using the bank-based and net-liquid-asset-based capital paradigms difficult.<sup>3</sup> The Commission states that the less stringent tangible net worth capital approach is intended to offer a potential benefit to swap market participants, by encouraging more firms, and not just those that are traditional financial firms, to act as swap dealers and make markets in swaps.<sup>4</sup> Nowhere is the role of non-financial entities as swap dealers more important for the market than the commodity swaps markets, and it is no coincidence that the only Non-financial SDs registered with the Commission are dealers in such markets.

The Working Group agrees with the Commission's goal of creating a capital requirement for Non-financial SDs that will allow those entities to continue to be active in commodity swap markets, which of recent, have experienced a decline in liquidity. These liquidity issues have

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<sup>2</sup> See Proposed CFTC Regulation 23.101.

<sup>3</sup> Proposed Capital Rule at 91,255-56.

<sup>4</sup> *Id.*

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been noted in both the press<sup>5</sup> and by members of the Commission's Energy and Environmental Markets Advisory Committee ("EEMAC"). Specifically, Paul Hughes of Southern Company stated before EEMAC that

...when I'm looking to go offset risks[,] in the past[,] I would have been able to do it, [but] there's no more players out there. Those ponds [of liquidity] have dried up. And I think you can't necessarily attribute that to one specific rule...but I do think Dodd-Frank has had an impact on the markets and we can't ignore that.<sup>6</sup>

Hughes' testimony goes on to attribute that drop in liquidity to the absence of market participants willing to engage in swap dealing activity.<sup>7</sup>

The Commission's proposed capital paradigm might actually serve as a meaningful barrier to entry for non-financial entities considering engaging in more than a *de minimis* amount of swap dealing activity, and thus might have negative implications for liquidity, particularly if commercial firms cannot use the tangible net worth approach to meet its capital requirements. This potential detrimental impact to liquidity would be more significant if the CFTC does not address the pending drop in the swap dealer *de minimis* threshold scheduled for December of 2018.

### **1. The Definition of "predominantly engaged in non-financial activities" is Too Restrictive.**

If the goal of the proposed tangible net worth capital approach is to provide flexibility so as to allow non-financial entities to act as swap dealers in markets where their presence and expertise is needed, then amendments need to be made to the tangible net worth approach to account for the unique nature of Non-financial SDs and the commodity swap markets in which they participate.

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<sup>5</sup> See *Few Commodity Traders Saw Improved Liquidity in 2015 – Poll*, Alexander Osipovich, Energy Risk (Jan. 8, 2016), available at <http://www.risk.net/energy-risk/news/2440802/few-commodity-traders-saw-improved-liquidity-in-2015-poll>; *U.S. Energy Firms Lament Liquidity "Void" After Bank Exits*, Alexander Osipovich, Energy Risk (May 15, 2015), available at <http://www.risk.net/energy-risk/news/2408668/us-energy-firms-lament-liquidity-void-after-bank-exits>; *Bank Exits from Commodity Trading Hurt U.S. Power Firms*, Peter Maloney, Energy Risk (Nov. 20, 2015), available at <http://www.risk.net/energy-risk/feature/2435373/bank-exits-from-commodity-trading-hurt-us-power-firms>.

<sup>6</sup> Transcript of the CFTC EEMAC Meeting of Feb. 26, 2015 at 221, available at <http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/emaactranscript022615.pdf> (quoting Paul Hughes of Southern Company, an Associate Member of EEMAC).

<sup>7</sup> See *id.* at 226. Specifically, Hughes stated "I used to maybe have eight or ten counterparties that...I could call on and reliably expect to be there. Some of those counterparties have just left. Some of them have kind of left the marketplace, some of them got completely out of the business. Some of them have moved overseas." *Id.*

The Proposed Capital Rule limits the availability of the tangible net worth approach to entities that derive less than 15% of their revenue over the previous two years from financial activity and whose financial assets represent less than 15% of their consolidated assets over the past two years. This limitation presupposes that there is one proper way to structure a swap dealer inside of a larger non-financial enterprise. By focusing on the assets and revenue of just the registered swap dealer to determine whether an entity is “non-financial” for the purposes of the Proposed Capital Rule and, thus, able to utilize the tangible net worth approach, the CFTC is effectively dictating the corporate structure and business model that a Non-financial SD must adopt if they would like to utilize the capital approach intended for them. This structure effectively requires that the registered swap dealer have significant amounts of other assets and business activity. However, as a practical matter, many commercial energy firms conduct their swaps activity out of a single, market facing entity that aggregates the risks and needs of its affiliates and provides the company one face to the market. Under the Proposed Capital Rule, that common structure could not be used by a Non-financial SD seeking to use the tangible net worth approach, which was intended to accommodate the needs of such firms.

To allow for flexibility on how Non-financial SDs structure their business, the Working Group suggests that the Commission look to the nature of the business of the swap dealer’s ultimate parent to determine whether a swap dealer is “predominantly engaged in non-financial activities.” If the ultimate parent is “predominantly engaged in non-financial activities” under the terms of the Proposed Capital Rule, then the tangible net worth approach should be available to any subsidiary swap dealer. To prevent the Proposed Capital Rule from creating an incentive to conduct swap dealing activity that is not tied to a larger physical commodities business within a non-financial enterprise, the Commission could limit the applicability of this approach to swap dealers who only engage in swap dealing activity in swap markets for exempt and agricultural commodities.

For some companies, it might make sense to conduct swap dealing activity through an entity that engages in other lines of commodities business and also holds significant amounts of hard assets. In other circumstances, it might be more efficient for a non-financial company to create a new standalone entity to act as a swap dealer. This definitional limitation is material and would undoubtedly factor into the calculus conducted by non-financial enterprises when determining whether to become a swap dealer. Capital and liquidity requirements designed for financial entities, could be a significant enough barrier to entry to cause certain energy swap market participants to limit the amount of swap dealing activity to avoid registration primarily because of the inflexibility of the capital rules.

In addition, the Commission should exclude financial hedges of physical commodity, interest rate, or other corporate risks from the analysis of whether an entity is “predominantly engaged in non-financial activities.” Financial hedges are an integral part of managing a commercial energy firm and are not indicative of an entity being engaged in financial activity.

Finally, to the extent the Commission does not modify the tangible net worth approach as recommended above, it should consider revising the other two capital approaches to allow Non-financial SDs that cannot satisfy the conditions necessary to use the tangible net worth approach to use physical assets to meet such capital requirements. This could be done by setting a separate, but higher capital requirement for swap dealers that elect to use physical assets as part of their capital base.

## **2. The Capital Rules for Non-financial SDs Should Account for the Use of Sweep Accounts.**

If a commercial firm must employ either the bank-based approach or the net-liquid-asset-based approach, the Commission should make accommodations for common operations of commercial firms that may differ from banking institutions. One specific area of concern is cash management. In large non-financial enterprises it is common practice for available cash sitting within various entities' accounts to be swept up into a corporate omnibus account to be held overnight at a financial institution to optimize the returns on that cash. The cash is still the property of the individual companies, for example a swap dealer subsidiary, and is returned into the accounts of the individual entities within the company for use the next morning. Assuming that the cash remains unencumbered property of the swap dealer, the Working Group would like to confirm that cash held in this manner would be considered part of a swap dealer's capital base in the context of the Proposed Capital Rule.

## **3. The National Futures Association's Capital Rules Adoption Process Should Provide for Formal Public Comment.**

The Proposed Capital Rule does not provide a complete picture of the potential capital requirements for swap dealers as it would defer to the rules of the National Futures Association (the "NFA") if the NFA's capital requirements are higher than those imposed by the Commission.<sup>8</sup> The NFA has yet to propose capital rules for swap dealers. If the NFA simply proposes higher or lower capital requirements using substantially the same structure proposed by the Commission, it would either nullify its own rule or the CFTC's. Therefore, we suggest that the NFA explore alternative approaches to those proposed by the CFTC to provide necessary flexibility to the universe of capital requirements.

Market participant input is crucial to the development of a well-constructed NFA capital rule. Under Section 17(j) of the Commodity Exchange Act, the Commission has the right to review any new NFA rule. However, that right of review does not include a guaranteed opportunity for market participants to provide comments with respect to new NFA rules. The Working Group respectfully requests that the Commission provide time and opportunity for the public to comment on the NFA's capital requirement rules for swap dealers. In addition, the

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<sup>8</sup> See Proposed CFTC Regulation 23.101.

Commission might consider formally or informally encouraging the NFA to consult all types of swap dealers, including Non-financial SDs, when developing such rules.

#### **4. The Proposed Rule's Reporting Timelines Should be Extended.**

Non-financial SDs likely will have significant difficulty in complying with the timeframe for a number of the Proposed Capital Rule's reporting obligations. More importantly, even if Non-financial SDs were able to comply with the required reporting timeframes, doing so would likely be costly. In particular, the proposed timeframes for (i) filing the monthly and annual reports with the CFTC and (ii) the required public disclosure of financial reports would likely be quite difficult for a Non-Financial SD to satisfy as they do not have the same financial reporting systems as banks or other financial institutions.

To address this concern, the Working Group respectfully requests that the Commission extend the timeframes for filing certain reports as follows.

The Proposed Rule would require a swap dealer to provide the CFTC with their audited financial statements within 60 days of the end of the year. This is not practical for many large non-financial companies. These companies typically are able to provide audited financial statements within 90 days of the end of the year. Reducing that time frame by a third, would likely be quite costly. Therefore, the Working Group requests that the Commission extend the deadline for the filing of annual financial reports with the CFTC to 90 days.

Requiring swap dealers to publicly disclose quarterly financial information within ten business days of providing that data to the CFTC is too short. Typically, a Non-financial SD that is part of a public company would not publicly disclose its entity-level financial information and a Non-financial SD that was part of a private company would not do so either. As such, additional review will likely be needed by external or internal auditors before that information is made public. To allow for this additional review, the Working Group requests that the CFTC extend the public disclosure deadline to 20 business days.

Finally, including a materiality threshold for a Non-financial SD's monthly financial report to the Commission would make meeting the deadline for filing such report more feasible.

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### **III. CONCLUSION**

The Working Group appreciates this opportunity to comment on the Capital NOPR and respectfully requests that the Commission amend the proposed approach for capital requirements for Non-financial SDs as suggested.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe

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