October 23, 2020

VIA ELECTRONIC SUBMISSION

Christopher Kirkpatrick
Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: RIN 3038-AF05; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

Dear Mr. Kirkpatrick,

bp has over a 150-year history in the U.S. and remains committed to being a significant contributor to America's economy and energy security. In the U.S. , bp has a larger economic footprint than it does in any other country. Between 2005 and 2019 bp invested more than $125 billion in the U.S. and our operations contributed $90 billion to the national economy in 2019 alone. We employ about 12,000 people across the country and support more than 115,000 additional American jobs through our operations and activities.

bp's purpose is reimagining energy for people and our planet. We have an ambition of becoming a net-zero company by 2050. We also want to help the world reach net zero and improve people's lives.

bp's Interest in this Matter

Please accept these comments from BP Energy Company ("*BPEC*") in furtherance of the notice of proposed rulemaking approved by the U.S. Commodity Futures Trading Commission ("*CFTC*" or "*Commission*") on August 14, 2020 on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants ("*Proposed Rule*").[1] BPEC, based in Houston, Texas, is a marketer of natural gas, electric power and natural gas liquids with operations throughout the continental United States, and is a swap dealer ("*SD*") provisionally registered with the CFTC. Therefore, BPEC would be subject to the outcome of this Proposed Rule.

BPEC was a member of the Subcommittee on Margin Requirements for Non-Cleared Swaps ("*Margin Subcommittee*"), which was established by the Global Markets Advisory Committee ("*GMAC*") to identify challenges associated with application of the Commission's Initial Margin ("*IM*") requirements to market participants in

[1] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, Notice of Proposed Rulemaking, 85 Fed. Reg. 59,702 (Sept. 23, 2020).

Implementation Phases 5 and 6 (as defined in the Proposed Rule) as well as other related matters. BPEC also helped author portions of the report to the CFTC's GMAC entitled "Recommendations to Improve Scoping and Implementation of Initial Margin Requirements for Non-Cleared Swaps," (the "*GMAC IM Report*") which was adopted by the GMAC on May 19, 2020.

The Proposed Rule adopts an important recommendation of the Margin Subcommittee, which would permit certain smaller covered swap entities ("*Small CSEs*")[2] that enter into uncleared swaps with larger CSE ("*Large CSE*" or "*swap entity counterparty*")[3] to use Large CSE's risk-based model calculation of IM in lieu of its own IM calculation (*i.e.*, the "*alternative method of calculation of IM*").[4]

BPEC's Comments on the Proposed Rule

As a Small CSE that is working towards compliance with the IM requirements by the Phase 5 deadline, BPEC appreciates this proposed modification as a common-sense measure that will greatly reduce the complexity and burden associated with Phase 5 implementation and, for reasons provided below, will not add to the systemic risk of transacting uncleared swaps but will foster greater liquidity and contribute to lowering the hedging costs of the end-users.

In these comments, BPEC requests two important modifications to the Commission's Proposed Rule:

1. The Commission should remove the hedging restriction on allowing Small CSEs to use the regulator-approved risk-based model calculation of IM of a Large CSE or a swap entity[5] subject to a Prudential Regulator ("*Bank SD*"); and, separately,

[2] CFTC Regulation § 23.150 defines "covered swap entity" ("***CSE***") as "a swap dealer or major swap participant for which there is no prudential regulator". The GMAC IM Report defines Small CSEs as "a dealer entity that is a CSE and that did not exceed the AANA thresholds in the prior phases (Phase 1 through 4) and may be subject to IM requirements in the remaining phases…", at p. 17. The Proposed Rule refers to these entities as "smaller CSEs that offer swaps services to smaller entities that are neither SDs nor MSPs, with some of those risk-taking transactions requiring the exchange or regulatory margin and some, at the option of the parties, requiring the exchange of contractually-agreed margin." Proposed Rule at p. 59705.

[3] The GMAC IM Report refers to these larger entities as those who have started posting and collecting IM during Phase 1 through 4 and that "Large CSEs are a concentrated segment of the market…" and that these entities "have adopted the ISDA SIMMtm risk-based model (SIMM) to calculate IM and received the required regulatory approval to do so.". The GMAC IM Report at p. 18 and p.17.

[4] Proposed Rule at p. 59708 "Commission Regulation 23.154 – Alternative Method of Calculation of IM". Also, the GMAC IM Report explains that "many Small CSEs intend to choose GRID based on the type of activity they primarily engage in (e.g., physical commodities) and customer classification (e.g., end users)." "…Under the Margin Rules, CSEs have the option to calculate the amount of mandatory IM using either a risk-based model or the standardized IM table set forth in the Margin Rules (such method based on the standardized IM table, GRID)." The GMAC IM Report at p. 17.

[5] CFTC Regulation § 23.150 defined "swap entity" as "a person that is registered with the Commission as a swap dealer or major swap participant pursuant to the Act." Swap Entities may or may not have a Prudential Regulator (as defined in the CEA § 1a(39)), while the term CSE refers only to "swap entities "without the Prudential Regulator that must comply with CFTC's established margin rules. Further, the Proposed Rule states (in Note 5) that SDs for

2. The Commission should extend this flexibility to allow a Small CSE transacting swaps with certain special purpose / financing vehicles ("*SPVs*") affiliated with Bank SDs or Large CSEs, to use either the regulator-approved risk-based model of a Bank SD or of Large CSE's affiliated with SPV, or the Bank SD / Large CSE's affiliated-entity tasked by the Large CSE or Bank SD with administering on a day-to-day basis their IM calculation under the regulator-approved risk-based model.

<u>Background on Suggested Modifications:</u>

1. BPEC's Comments on the Proposed Rule: The Commission should remove the hedging restriction on allowing Small CSEs to use the risk-based model calculation of IM of a Large CSE counterparty or a Bank SD

The Commission has proposed in the Proposed Rule that "the CSE would be able to use the risk-based model calculation of IM of a swap entity counterparty only if the uncleared swaps for which IM is calculated are entered into for the purpose of hedging the CSE's own risk."[6] The Commission states its intent in limiting this provision to hedging transaction is to "ensure its narrow application."[7] The Commission states its assumption that, "a CSE participating in the inter-dealer market in a dealing capacity should have the capacity to develop, implement, and use an approved risk-based model."[8] The Commission also assumes that Small CSEs that are not obtaining the regulatory approval to use a risk-based model for the calculation of IM will enter into uncleared swaps mostly with end-user counterparties and then will hedge the risk of those swaps with a few larger swap entity counterparties(*i.e.*, Large CSEs or Bank SDs).

The Commission in the Proposed Rule explained that the hedging limitation is necessitated by Commissions concerns that: (a) being able to rely on the Large CSE (or Bank SD) IM calculation model, the Small CSE may "forgo altogether the adoption of a risk-based model and may be less incentivized to monitor IM exposures on a regular basis"… and "[a]s a result, the CSE may collect insufficient amounts of IM to offset counterparty risk…"; and (b) "the swap entity [counterparty] calculating the IM for the

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which there is a Prudential Regulator must meet the margin requirements established by the applicable Prudential Regulator (i.e., Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015) ("***Prudential Margin Rule***")). In Note 59 of the Proposed Rule, the CFTC notes that if this Proposed Rule is adopted, it will diverge from Prudential Margin Rule. Also, see questions for comments in the Proposed Rule at 59710 in reference to divergence of proposed CFTC Regulation § 23.154(a) from Prudential Margin Rule.

[6] Proposed Rule at p. 59708

[7] *Id*.

[8] *Id*.

CSE may be conflicted, as it may have a bias in favor of calculating and posting lower amounts of IM to its CSE counterparty".[9] Below we address each of these concerns.

a. Small Overall Scope of Small CSE vs. Larger Swap Entity Counterparty Transactions

Phase 5 and 6 CSEs (*i.e.*, Small CSEs) sought the ability to use the approved risk-based model of their Large CSE or Bank SD counterparties because the expense of having to develop and maintain a risk-based model is not justified by the limited nature and small overall volume of uncleared transactions they will enter that require exchange of IM. Furthermore, Small CSEs estimate that within a limited number of swaps that will require the exchange, posting and custody of IM, the number of swaps between Small CSEs and Large CSEs/Bank SDs will be insignificant as compared to the overall volume of IM expected to be exchanged, posted and held in custody under the Margin Rules.

Further, the limited nature of the relief proposed in the Proposed Rule is explained in the GMAC IM Report by comparing the 40 Large CSE that already exchange, post and custody the IM to the 20 Small CSEs that will be required to do so under Phases 5 and 6.[10] Beyond the fact the Small CSEs are a much smaller segment of the swaps market, the scope of IM exchanged and posted by Small CSEs will also include swap relationships with financial end users ("*FEUs*"), and swap transactions with FEUs are outside the scope of the relief proposed in the Proposed Rule.

b. Characterization of Transactions as Hedges

The IM calculation for certain types of transactions is vastly different based on whether the standard notional value model is used (*i.e.*, the GRID) versus a risk-based model using potential future exposure, which makes it difficult for Small CSEs to transact certain types of transactions absent this relief.[11] It will be difficult if not impossible, however, to ensure all transactions subject to this relief constitute hedging of the Small CSE's own risks.

For example, what standard will be used to determine whether a given swap transaction is a "hedge"? Must each swap with a Large CSE or Bank SD be matched one-by one with the "non-swap entity counterparty"? How can portfolio hedging or dynamic hedging be administered? What happens if the underlying hedging transactions with a "non-swap counterparty" have been terminated, must a swap with the Large CSE/Bank SD be terminated as well? Can anticipatory hedges count for the exemption?

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[9] *Id*.

[10] GMAC IM Report at p. 17.

[11] For example, the Margin Subcommittee Report on page 36 discussed the hurdles around Municipal Prepayment Transactions (see note 12 below for further discussion of Municipal Prepayment Transactions).

As these questions demonstrate, and as Commission's other rulemakings addressing hedging issues have demonstrated in the past,[12] the concept of hedging is very difficult to administer and given its complexity, many CSEs that otherwise would have been able to rely on the relief in the Proposed Rule will be reluctant to do so fearing that they may mischaracterize these transactions as "hedges" given the uncertainty of the application of the "hedging" standard.

c. Operational Challenges

Operationally, many CSEs do not separate hedging from dealing on a transaction-by-transaction basis since CSEs often manage hedging on a portfolio basis. As a result, there may be no clear determination whether swaps that are part of a complex commercial transaction can always be considered hedging. For example, the "Municipal Prepayment Transaction"[13] that was described in the Margin Subcommittee's report to GMAC involves a CSE taking on long-term (possibly 20-30 year) price exposure on behalf of a municipality. Once that exposure enters the CSE's general portfolio, it is difficult to discern which swaps are tied to reducing that exposure and which are tied to speculative trading on price moves. To the extent this relief is limited to hedging transactions, CSEs could have to undertake a significant amount of analysis and legal review to make hedging determinations, which may render this relief impracticable.

Further, operational challenge of administering the "hedging" limitation will not only be the matter for Small CSEs, but also for their swap entity counterparties – Large CSEs. These swap counterparties will need to obtain representations from Small CSEs that the swap transactions are indeed hedges and form a reasonable belief that their counterparties relying on the IM relief (*i.e.*, the alternative method) are acting in good faith and are indeed laying of these risks with their non-swap entity counterparties.

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[12] For decades, commodity exchanges have implemented and administered the position limits regime with respect to exchange-traded positions and all futures traders must abide by speculative position limits that ensure that speculative position levels do not reach levels representative of systemic risk. After years of deliberation, and as required by the Dodd Frank Act, the CFTC has expanded its federal position limits in the proposed rulemaking in February 2020 *Position Limits for Derivatives*, Notice of Proposed Rulemaking, 85 Fed. Reg. 11596 (February 27, 2020). When implemented, under the new position limits rule, CSEs will have to abide by federal-mandated speculative position limits as well. Given that it took the CFTC almost a decade to complete its rulemaking on position limits (where the concept of hedging is central to the administration of position limits), it is likely that the implementation of the hedging limitation of the proposed IM regime will be equally laborious.

[13] Municipal Prepayment Transactions involve matched commodity swaps used to hedge a municipality's prepayment for the supply of long-term (e.g., 20-30 year) natural gas or electricity requirements. The matched swaps allow the parties to hedge their respective exposures to the changing price of the natural gas or electricity underlying the transaction with a single CSE. They expressly contain no mark-to-market credit exposure to participants upon either early termination or replacement events. The matched swaps thus economically offset each other in every way. Under the structure of the Municipal Prepayment Transactions, neither swap will survive the termination of the prepayment transaction, and the prepayment transaction will not survive if both commodity swaps do not remain in place. Accordingly, there is no counterparty, safety and soundness, or systemic risk associated with the matched commodity swaps in Municipal Prepayment Transactions.

This additional level of scrutiny will likely deter many of the Large CSEs from transacting with Small CSE.

d. Documentation Challenges

Also, CSEs typically transact both hedging and dealing swaps under a single ISDA Master Agreement and calculate IM at the relationship or master contract level versus at the transaction level.[14] Therefore, it would be extremely complex and result in potential added operational risk if CSEs were required to manage the IM requirement differently for hedging vs. non-hedging transactions. This could create a likely scenario that a Large CSE that uses a risk-based SIMM model would not want to transact with a Small CSE that intends to rely on the IM relief if it were required to separate transactions from an IM perspective. Also, treating IM separately based on transaction type would not take into account the true exposure between the parties and could result in greater cost and increased portfolio risk.

Finally, commodity markets are dynamic and the character of an individual trade may change away from hedging when it is placed in the context of a larger portfolio. Requiring market participants to tag each transaction as dealing or hedging and maintain that designation would limit current flexibility to change the character of a swap and manage risks at the portfolio level. Therefore, limiting this relief to hedge transactions may diminish its utility for CSEs and decrease liquidity in structured financing markets.

e. Existing Risk Management Programs

BPEC supports the Commission's goal of ensuring CSEs are not provided flexibility that will result in increased systemic risk in the uncleared swap market, but providing flexibility to use a counterparty's risk-based model calculation of IM would not result in increased systemic risk, even if the proposed relief of using the alternative IM calculation method extended to non-hedging swaps. As the GMAC IM Report indicates, transactions subject to this relief will still be subject to numerous controls to ensure they do not result in any added systemic risk.

For example, CSE's (regardless of their size) must operate within the parameters of a risk management program consistent with 17 CFR § 23.600. Among the controls the Commission has prescribed in § 23.600(b), all CSEs must have in place robust risk management programs that are reviewed regularly by the National Futures Association ("*NFA*"). Pursuant to § 23.600(c), CSEs must operate under approved risk controls or tolerance limits associated with market risk, credit risk, liquidity risk, foreign currency risk, legal risk, operational risk and settlement risk. CSE risk management programs measure daily market exposure, volatility of prices, basis and correlation risks, leverage, and position concentration to comply with market risk tolerance limits. Pursuant to the

[14] This calculation level allows for netting of transaction exposures where allowable within a portfolio.

Dodd Frank market risk obligations, CSE risk management programs all include Value-at-Risk ("*VaR*") limits applicable to all transactions to control systemic risk.

Further, pursuant to 17 CFR § 23.153, all CSEs are required to collect and post variation margin for uncleared swaps transactions between CSEs/FEUs. The exposure for the underlying uncleared swaps for variation margining is based on counterparty exposure calculated daily based on current notional settlement values, intra-month mark-to-market ("*MTM*") and forward MTM.

Commission's concern that the "CSEs may forgo altogether the adoption of a risk-based model" is misplaced for the reasons discussed above (*i.e.*, CSEs independent obligation under Part § 23 to maintain a risk management program) and the fact that in the absence of the risk-based model that CSEs will be required to use the GRID. This means that if the Small CSEs rely on the Large CSE's risk-based model, they rely on a regulator-approved model of a swap entity counterparty, and in the event that the Small CSE does not rely on the Large CSE's risk-based model, it will be relying on the IM calculation under the GRID. In either event, the Small CSE will be using an approved IM calculation method (*i.e.*, either approved by the regulator for Large CSEs or a method provided in the Margin Rule).

Accordingly, even if the requested relief is applied to non-hedge transactions, the transactions will be subject to an appropriate level of IM that is calculated using a regulator-approved risk-based model assessment, so systemic risk should not increase.[15] Indeed, all transactions, both hedging and non-hedging, between bank SDs that use the SIMM risk-based model will be subject to the same IM calculation. It is unclear why CSEs should be treated any differently simply because they seek this limited relief.

f. Non-Swap Entity Counterparty Challenges

The Proposed Rule correctly assumes that Small CSEs primarily act as swap intermediaries in less liquid markets and provide the ability to hedge for smaller FEUs and other entities that otherwise would not be able to hedge and therefore will absorb greater market risks. Greater unhedged market risks inevitably translate into higher everyday prices for average consumers. As noted above, it is not always possible to match swap by swap on the swap entity's counterparty side with the swaps on the FEU and end user side. Accordingly, if the hedging limitation will reduce the amount of transactions that Small CSEs will be able to enter, this will adversely impact their non-swap entity counterparty base.

[15] Furthermore, as noted above in note 11, CSEs will be subject to speculative position limits with respect to most commodity swaps and, given that a large number of swaps that otherwise would be subject to the IM relief in the Proposed Rule are commodity swaps, any potential systemic risks of under-collateralization will be further mitigated.

The Municipal Gas Prepay example discussed above and addressed in the GMAC IM Report is just one of these situations. There are many other instances when end-users, such as municipalities, schools, hospitals, manufacturing facilities that require guaranteed and economically-priced supplies of energy commodities, would not be able to hedge their market exposure in the futures markets on the exchanges, and Small CSEs will not be able to accommodate their transactions because the IM calculated under the GRID would make these transactions uneconomical when hedged with the Large CSE or a Bank SD (*e.g.*, a 30-year swap margined under a GRID would require an astronomical amount of IM that would make the transaction unfeasible). Again, as noted above, it would be very difficult for a Small CSE, if not impossible, to match one-by-one the swaps on the end-user side with the swaps on the Large CSE or Bank SD swap counterparty side. Therefore, a certain segment of the end-user market will become underserved.

g. Swap Entity Counterparty Conflicts Bias

With respect to CFTC's concern that potential conflicts of Large CSEs and Bank SDs exhibiting "a bias in favor of calculating and posting lower amounts of IM to its CSE counterparty…",[16] the CFTC itself in note 57 of the Proposed Rule notes that all swap entities are required to comply with risk management program requirements is § 23.600. Therefore, in the event that under the alternative IM calculation method a Large CSE or Bank SD instructs a Small CSE to collect from itself (*i.e.,* a Large CSE under its regulator-approved IM risk-based calculation method) a smaller amount of IM that otherwise would have been required, the hedging nature of Small CSE's swap transaction would have no effect on this risk and would in no measurable way mitigate this conflict. In other words, the Large CSE or Bank SD would remain "conflicted" regardless of whether the swap with the Small CSE is hedging or speculative.

h. Codification of the No-Action Letter Relief Should Not be a Restatement of the No-Action Letter

Finally, we also note that one of the bases for the GMAC IM Report was CFTC Letter No. 19-29,[17] where for the first time the concept of using the alternative IM calculation method was proposed and articulated. Also, the CFTC in the Proposed Rule specifically states that it is proposing to codify this letter.[18] As any CFTC no-action letter provides, it is limited to the specific facts and circumstances of the entity that had requested the relief and, as a CFTC staff no-action letter, it is not binding on other market participants and is only a pronouncement of opinions of CFTC staff, not the Commission. Accordingly, given that proposed IM relief in the Proposed Rule will have the industry-wide application, we encourage the CFTC to take a fresh look at the proposed relief and

[16] Proposed Rule at p. 59708.
[17] CFTC Letter 19-29, Request for No-Action Relief Concerning Calculation of Initial Margin, (Dec. 19, 2019).
[18] Proposed Rule at note 28 p. 59704.

not be constrained by the limitations that the Commission had believed were appropriate for the purposes of the entity-specific no action relief.

For the foregoing reasons, the Commission should extend the ability for Small CSEs to use the regulator-approved risk-based model of a swap entity counterparty to both hedging and non-hedging transactions. The Commission's focus should be on controlling systemic risk, which, for the foregoing reasons, would not increase under this proposal, and not just on ensuring a narrow application of this relief as was originally extended to a specific market participant in the past.

2. The Commission should extend this flexibility to allow a Small CSE transacting swaps with certain SPVs affiliated with Bank SDs or Large CSEs, to use either the regulator-approved risk-based model of a Bank SD or of Large CSE's affiliated with the SPV, or the Bank SD / Large CSE's affiliated-entity tasked by the Large CSE or Bank SD with administering on a day-to-day basis their IM calculation under the regulator-approved risk-based model.

Some Bank SDs or Large CSEs use SPVs to transact uncleared swaps designed to hedge or otherwise mitigate the risks associated with bespoke structuring deals and specific asset commercial transactions. A Bank SD or a Large CSE may use a separate SPV for individual transactions or perhaps use an SPV to conduct several transactions in a specific category, such as Municipal Gas Pre-Pay transactions (discussed above and in the GMAC IM Report). SPVs would typically be consolidated with Bank SD or Large CSE and will likely be categorized as FEUs and "margin affiliates"[19] for purposes of the CFTC and Prudential Margin Rules. These SPVs often have not individually built out risk-based IM models but, under this relief, will be able to use the regulator-approved risk-based model of their affiliated Bank SD or Large CSE counterparty.

BPEC seeks to ensure Small CSEs will not be competitively disadvantaged versus Bank SDs or Large SDs when transacting swaps with these SPVs because Bank SDs and Large CSEs will be able to use the risk-based model, while without this relief Small SDs will not be able to and instead will have to revert to the GRID which for long-term dated swaps will produce completely uneconomical results.

To allow for an equivalent playing field, the Commission should extend this flexibility either to use the risk-based model of the swap entity counterparty or, when transacting with a FEU affiliate of a Bank SD or a Large CSE, to use the regulator-approved risk based model of the affiliated Bank SD or a Large CSE. This would allow a Small CSE to

[19] *See* 17 CFR § 23.151 "Margin affiliate. A company is a margin affiliate of another company if: (1) Either company consolidates the other on a financial statement prepared in accordance with U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards, (2) Both companies are consolidated with a third company on a financial statement prepared in accordance with such principles or standards, or (3) For a company that is not subject to such principles or standards, if consolidation as described in paragraph (1) or (2) of this definition would have occurred if such principles or standards had applied."

use the Bank SD's / Lage CSE's affiliate's regulator-approved risk-based model IM calculation when transacting with an SPV (even if the Small CSE is not *directly* transacting with the Bank SD / Large CSE and only with its margin affiliate – SVP). For the reasons stated above, this extended relief should result in no added systemic risk. Moreover, absent this relief, certain types of businesses may be fully consolidated within the banks and liquidity will suffer.

Conclusion

BPEC appreciates the opportunity to comment in this proceeding, and respectfully requests Commission support for the requested modifications. Please contact the undersigned, Jennifer Minnis, at Jennifer.Minnis@bp.com or 281.546.1232 if you have any questions regarding BPEC's submission.

Respectfully submitted,

/s/Jennifer Minnis
Jennifer Minnis
Managing Counsel – IST Houston

BP America Inc.

cc: Honorable Heath P. Tarbert (Chairman)
Honorable Brian D. Quintenz (Commissioner)
Honorable Rostin Behnam (Commissioner)
Honorable Dawn DeBerry Stump (Commissioner)
Honorable Dan M. Berkovitz (Commissioner)