EVERSHEDS SUTHERLAND

Eversheds Sutherland (US) LLP
700 Sixth Street, NW, Suite 700
Washington, DC 20001-3980

T: +1 202.383.0100
F: +1 202.637.3593

October 23, 2020

VIA ELECTRONIC SUBMISSION

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

Re: Notice of Proposed Rulemaking, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants* (RIN 3038- AF05)

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 on the Commodity Futures Trading Commission's (the "**CFTC**" or "**Commission**") Notice of Proposed Rulemaking, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants* (the "**Proposed Rule**").[1] The Working Group appreciates the opportunity to provide comments on the Proposed Rule and looks forward to working with the Commission while it continues the process of improving and simplifying its uncleared swap margin rules.

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 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.

[1] *See* Notice of Proposed Rulemaking, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 85 Fed. Reg. 59,702 (Sep. 23, 2020), https://www.cftc.gov/sites/default/files/2020/09/2020-18303a.pdf.

Eversheds Sutherland (US) LLP is part of a global legal practice, operating through various separate and distinct legal entities, under Eversheds Sutherland. For a full description of the structure and a list of offices, please visit www.eversheds-sutherland.com.
45321279.6

II. COMMENTS OF THE WORKING GROUP

1. The Proposed Rule's Amendments to the Current AANA Calculation Approach Would Align the CFTC's Rules with International Standards and Eliminate Unnecessary Complexity

The Commission's current methodology for calculating average aggregate notional amounts ("**AANA**") when determining whether a financial end-user has material swaps exposure, and thus, must post initial margin, are unnecessarily complex and do not align with international standards. As described in the Proposed Rule, the CFTC's margin rules require a financial end-user to determine whether it has material swaps exposure by calculating its average daily AANA over June, July, and August of the prior year, to determine whether it must post initial margin on January 1 of the current year.[2] Contrast that with the international approach to the AANA calculation set out in the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions' Framework for margin requirements for non-centrally cleared derivatives ("**BCBS/IOSCO Framework**"),[3] the form of which has been adopted by other major jurisdictions.[4] Under the BCBS/IOSCO Framework, an entity would calculate its AANA by averaging its month-end AANA for March, April, and May of the current year to determine if it must post initial margin on September 1 of the current year.

As the Commissions states, its current approach to the AANA calculation introduces unnecessary complexity in two primary ways.[5] *First*, the use of an average daily AANA rather than an average month-end AANA requires a more resource-intensive method of monitoring and capturing data that generally has no other use to financial end-users. *Second*, the timing misalignment between the Commission's AANA calculation approach and that in the BCBS/IOSCO Framework requires a financial end-user to potentially have to calculate its AANA twice, using two different methods. In short, as the Commission discusses in the preamble to the Proposed Rule, aligning its AANA calculation methodology with the BCBS/IOSCO Framework would reduce complexity for financial end-users and would do so in a manner that would not compromise the goals of its margin requirements.[6]

In addition, the CFTC asks whether it should amend its approach to the AANA calculation even if the Prudential Regulators do not do so. The Working Group believes it should. Specifically, if the Commission chooses to finalize its amendments to its AANA

---

[2] Proposed Rule at 59,704.

[3] Proposed Rule at 59,704.

[4] For example:

- EU: Commission Delegated Regulation (EU) 2016/2251 Supplementing Regulation (EU) No. 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC Derivatives, Central Counterparties and Trade Repositories with Regard to Regulatory Technical Standards for Risk Mitigation Techniques for OTC Derivative Contracts Not Cleared by a Central Counterparty at Article 28(1) (Oct. 4, 2016), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN;
- Canada: Office of the Superintendent of Financial Institutions Canada (OSFI) Guideline No. E–22, Margin Requirements for Non-Centrally Cleared Derivatives at Section 5 ¶ 71 (April 2020), https://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf.

[5] Proposed Rule at 59,704.

[6] Proposed Rule at 59,704.

calculation methodology as proposed, it will put pressure on the Prudential Regulators to follow suit and make corresponding improvements to their margin rules.

In addition, as the universe of financial end-users potentially subject to initial margin requirements is almost, by definition, larger and more sophisticated market participants, it is probable that most of these entities belong to a corporate group that has to calculate AANA for multiple different jurisdictions. As this is likely the case, then a deviation between the CFTC and the Prudential Regulators with respect to their approach to the calculation of AANA would not increase the regulatory burden for most financial end-users as they would already be calculating AANA under both the current CFTC/Prudential Regulator approach and the BCBS/IOSCO Framework.

Given the discussion above, the Working Group fully supports the Commission finalizing the amendments to its AANA calculation approach as proposed.

2. The Commission Should Codify the Proposed IM Calculation Relief with an Amendment

a. The Proposed IM Calculation Relief Is Crucial to Smaller Swap Dealers and the Markets They Serve

For smaller swap dealers that would otherwise utilize the table or grid based method to calculate the amount of initial margin they must collect, the Working Group strongly supports allowing them to rely upon amounts calculated using their swap dealer counterparty's approved initial margin model. In short, allowing smaller swap dealers to do so will allow them to continue to play their crucial role in certain discreet swap markets, like energy swap markets, in an economic and cost effective manner.

There are a number of reasons why a swap dealer might opt not to utilize a margin model, but the primary reason is likely cost. The adoption and use of an approved initial margin model, such as ISDA's SIMM model is, as the Commission notes, expensive and "would impose a disproportionate burden on [swap dealers otherwise relying on the table-based method] relative to the discrete and limited nature of their uncleared swap activities."[7] Said another way, for many smaller swap dealers whose primary business is generally providing financial hedging transactions to non-financial market participants in discreet parts of swap markets, such as energy swap markets, an approved margin model would potentially be used only in limited circumstances and, given the cost of such models, their use would be economically untenable for smaller swap dealers.

As the Commission correctly notes,[8] the absence of a model is generally a non-issue for such smaller swap dealers with the majority of their counterparties as they are typically non-financial end-users or financial end-users. However, if a smaller dealer that relies upon the table method enters into swaps with a swap dealer that uses an approved model to calculate initial margin requirements, issues can arise.

In the best case scenario, the mismatch between the margin calculation methodologies will result in worse pricing for the smaller swap dealer as the table method will likely cause their counterparty to post more initial margin than they would under a model-based approach,

---

[7] Proposed Rule at 59,709.

[8] Proposed Rule at 59,709.

and the cost of that margin would be reflected in a higher price provided to the smaller swap dealer. In the worst case, the difference in initial margin levels might cause pricing on a transaction between the smaller swap dealer and a swap dealer using an initial margin model to be uneconomic. In the long run, this issue may serve to limit activity between smaller and larger swap dealers in certain swap markets, like energy swap markets, which would bifurcate liquidity in such markets, potentially resulting in smaller swap dealers dropping out of the market. This outcome is not a remote possibility – the Commission has seen this before in futures markets where the precipitous decline in the number of futures commission merchants over the past decade can be attributed, in part, to the increase in regulatory costs,[9] such as the costs noted above that would be imposed on smaller swap dealers.

b. The CFTC Should Remove the Hedging Condition Imposed on Proposed IM Calculation Relief

The Working Group understands the Commission's desire to place reasonable limits on the availability of the proposed initial margin calculation relief. However, limiting the relief to circumstances where the swap dealer relying upon the relief is hedging raises a number of practical implementation challenges that will either limit the value of the relief or the scope of smaller swap dealers' businesses.

First, proposed CFTC Regulation 23.154(a)(5) states that, in order to rely on the provision, a swap dealer must only use it with respect to "uncleared swaps entered into…for the purpose of hedging the covered swap entity's swaps with non-swap entity counterparties." That language would, in practice, require a swap dealer to hedge its transactions on a one-to-one basis rather than a portfolio basis in order to utilize proposed CFTC Regulation 23.154(a)(5). Specifically, if a swap dealer must be able to demonstrate that each swap for which it relies upon proposed CFTC Regulation 23.154(a)(5) is a hedge of a transaction with a non-swap dealer, then it cannot engage in portfolio hedging if the portfolio would include risk related to a swap with another swap dealer. Consequently, the hedging limitation on the use of proposed CFTC Regulation 23.154(a)(5) would have the consequence of limiting the flexibility and efficacy of a swap dealer's risk management program if it chooses to utilize that provision as proposed.

Second, even if a swap dealer is able to hedge its risk in a manner that allows it to rely upon proposed CFTC Regulation 23.154(a)(5), using that provision in practice may be difficult or impractical if it enters into non-hedge transactions with a particular swap dealer counterparty as doing so would require the use of the table method for determining initial margin to be collected in some circumstances and its counterparty's initial margin model in other circumstances. This would be operationally complex, potentially to the point of being unworkable, and may result in a swap dealer being forced to choose between entering into transactions in the inter-dealer market or using proposed CFTC Regulation 23.154(a)(5). This limitation could have negative implications for liquidity in certain markets.

For example, in energy swap markets, smaller non-financial swap dealers do generally enter into the significant majority of their swap dealing transactions with non-swap dealers. However, in certain circumstances, because of the unique insights and risk profiles provided by their physical business, they may be one of the best situated market participants with

[9] *See* Remarks of Acting CFTC Chairman J. Christopher Giancarlo Before the ISDA 32nd Annual Meeting (May 10, 2017), https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22 (noting that "[t]he FCM marketplace has declined from 100 CFTC-registered entities in 2002 to 55 at the beginning of 2017," and that "[o]f these 55, just 19 were holding customer funds for swaps clearing").

whom other swap dealers can lay off their customer risk. Therefore, forcing these smaller non-financial swap dealers to choose between using proposed CFTC Regulation 23.154(a)(5) and providing needed liquidity to the market is a suboptimal outcome.

As noted above, the Working Group understands the Commission's desire to limit the scope of proposed CFTC Regulation 23.154(a)(5). However, as demonstrated above, conditioning its use to transactions where a swap dealer is hedging is problematic. In the alternative, the Commission could predicate the availability of proposed CFTC Regulation 23.154(a)(5) on the size of the swap dealer. As described in the CFTC's own study on its margin rules, only 20 swap dealers will begin posting and collecting initial margin in Phase 5 and Phase 6 of the initial margin rollout, and many of these swap dealers may rely on the table method for calculating their initial margin requirements.[10] Using the Phase 5 threshold of $750 billion notional as the threshold below which a swap dealer could use the relief provided by proposed CFTC Regulation 23.154(a)(5) would accomplish the goal of limiting the scope of such relief without imposing conditions on the business of swap dealers that could have adverse market impacts.

c. The Commission's Existing Internal Business Conduct Standards Address Any Potential Risks with Proposed CFTC Regulation 23.154(a)(5)

In the preamble to the Proposed Rule, the Commission explains that in the no-action letter upon which proposed CFTC Regulation 23.154(a)(5) is based, it placed a number of conditions on the ability of Cargill to rely upon its counterparty's model-based initial margin calculations due to a few risk-related concerns.[11] However, the Commission then goes on to state that those conditions were largely unnecessary as the CFTC believes "that [CFTC Regulation] 23.600 addresses these concerns." As a result, the Commission chose to only propose codifying two conditions: (i) the hedging condition discussed above; and (ii) the requirement that the initial margin model satisfy the requirements of CFTC Regulation 23.154(b).[12]

The Working Group agrees with the Commission's decision to limit the conditions placed on proposed CFTC Regulation 23.154(a)(5), and as set above, believes the proposed hedging requirement is also not needed, as a number of other regulatory requirements imposed on swap dealers significantly mitigate any potential risks or issues raised by permitting a swap dealer to rely on their swap dealer counterparty's initial margin model calculations.

For two primary reasons, the only condition or limitation placed on the use of proposed CFTC Regulation 23.154(a)(5) should be that the relevant initial margin model meets the requirements of CFTC Regulation 23.154(b).

---

[10] Report to the CFTC's Global Markets Advisory Committee by the Subcommittee on Margin Requirements for Non-Cleared Swaps, Recommendations to Improve Scoping and Implementation of Initial Margin Requirements for Non-Cleared Swaps at 17 (May 19, 2020) ("**CFTC GMAC Subcommittee Margin Report**"), https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&ved=2ahUKEwi75sLow7XsAhVTXM0KHYFTAFYQFjAAegQIBhAC&url=https%3A%2F%2Fwww.cftc.gov%2Fmedia%2F3886%2FGMAC_051920MarginSubcommitteeReport%2Fdownload&usg=AOvVaw292hS-yh0h-svijVpLeUYg.

[11] Proposed Rule at 59,708.

[12] Proposed CFTC Regulation 23.154(a)(5).

First, as the CFTC discusses at some length in the Proposed Rule,[13] the existing internal business conduct requirement regulatory paradigm directly addresses the potential issues raised by the Commission. Specifically, swap dealers must have a general risk management program in place, and that program must include policies and procedures that address, among other things, conflicts of interest, the diligent supervision of personnel, and compliance with applicable capital and margin requirements.[14] In combination, a swap dealer's policies and procedures designed to address those requirements should more than adequately guard against any potential issues raised by proposed CFTC Regulation 23.154(a)(5) for either counterparty.

Second, as noted in the CFTC GMAC Subcommittee Margin Report, all registered swap dealers currently subject to initial margin requirements use the ISDA SIMM initial margin model.[15] Given that there is a standard initial margin model in use, it should be difficult for a swap dealer to deviate significantly from the market standard initial margin requirement, and it would be plausible for a swap dealer relying upon proposed CFTC Regulation 23.154(a)(5) to see that another dealer is doing so. In short, given the number of safeguards already in place, if the ISDA SIMM model is in near universal use and is deemed compliant by the CFTC, its application in the context of proposed CFTC Regulation 23.154(a)(5) should be viewed essentially the same as its application in determining initial margin requirements more generally.

III. CONCLUSION

The Working Group appreciates this opportunity to comment on the Proposed Rule and respectfully requests that the Commission consider the Working Group's comments when finalizing the Proposed Rule.

If you have any questions, please contact the undersigned.

Respectfully submitted,
/s/ Alexander S. Holtan
Alexander S. Holtan

Counsel to The Commercial Energy Working Group

---

[13] Proposed Rule at 59,709.

[14] *See* CFTC Regulations 23.600 and 23.605.

[15] CFTC GMAC Subcommittee Margin Report at 17.