Shell Trading Risk Management, LLC

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

Shell Trading Risk Management, LLC (**"STRM"**) appreciates the opportunity to provide comment on the U.S. Commodity Futures Trading Commission's (**"CFTC"** or **"Commission"**) proposed rule regarding, among other things, the codification of the relief provided in CFTC No-Action Letter 19-29[1] (the **"Proposal"**),[2] as well as the CFTC's willingness to listen to market participants' concerns regarding the challenges surrounding the implementation of the Commission's margin requirements.

STRM is supportive of the Proposal, in particular the codification of the ability of certain swap dealers to, in certain circumstances, rely upon the model-based initial margin calculations of their swap dealer counterparties. Further, as set out below, STRM has a few minor suggested improvements to the Proposal.

II. PERMITING CERTAIN SWAP DEALERS TO RELY UPON THE MODEL-BASED INITIAL MARGIN CALCULATIONS OF THEIR SWAP DEALER COUNTERPARTIES IS NECESSARY AND APPROPRIATE

It is imperative that smaller swap dealers that would otherwise utilize the grid-based method to calculate the amount of initial

[1] CFTC No-Action Letter 19-29, Request for No-Action Relief Concerning Calculation of Initial Margin (Dec. 19, 2019) (**"No-Action Letter"**), https://www.cftc.gov/csl/19-29/download.

[2] *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.

margin that they must collect from another swap dealer be permitted to rely upon initial amounts calculated using their counterparty's initial margin model. Allowing smaller swap dealers to do so will allow them to continue to play an important role in energy swap markets.

Specifically, as the Commission notes, the core business of many smaller swap dealers, like STRM, is to service the unique needs of non-financial costumers, with STRM doing so in energy swap markets. Therefore, given that the vast majority of STRM's counterparties fall outside the definition of financial end-user and are not registered swap dealers, the benefits of building and operating an initial margin model are minimal, especially when compared to the cost of doing so, which the Commission correctly points out are significant.[3]

However, while not using an initial margin model and using the grid-based model would not generally raise issues for STRM when facing its customers, doing so could raise material issues, or at least introduce unnecessary complexity, when STRM transacts with other swap dealers who serve as the primary counterparties with which STRM is able to lay-off risk. Specifically, at a minimum, when facing a swap dealer using an initial margin model, the misalignment between the margin calculation methodologies will result in materially worse pricing for STRM as the grid-based method typically would require the swap dealer counterparty to post more initial margin than they would under the model-based approach. That increased cost could make it more difficult for STRM to hedge and, consequently, to offer the level of market access its customers need.

In some circumstances, the difference in the initial margin requirements between the grid-based method and an initial margin model could cause certain transactions to be uneconomic. For example, in the absence of proposed CFTC Regulation 23.154(a)(5), the Municipal Prepayment Transactions cited in the CFTC Global Markets Advisory Committee's Margin Subcommittee's report on initial margin requirements[4] could be uneconomic for STRM to hedge with a swap dealer that uses an initial margin model.

In short, the grid-based approach to initial margin requirements is a blunt tool that is sufficient for small swap dealers, like STRM, to use with their limited number of financial end-user counterparties. However, if it is required to be used when calculating initial margin requirements that must be collected from a swap dealer utilizing an

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[3] Proposal at 59,709.

[4] 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 36 (May 19, 2020) ("**CFTC GMAC Subcommittee Report**"), https://www.cftc.gov/media/3886/GMAC_051920MarginSubcommitteeReport/download.

initial margin model, the grid-based method could limit STRM's ability to hedge efficiently and economically. Therefore, the Commission should adopt proposed CFTC Regulation 23.154(a)(5), as doing so will ultimately benefit STRM, its customers, and energy swap markets, without, as discussed below, materially increasing risk.

III. THE COMMISSION'S EXISTING SWAP DEALER RISK MANAGEMENT REQUIREMENTS ADDRESS POTENTIAL RISKS POSED BY PROPOSED CFTC REGULATION 23.154(a)(5)

In discussing the potential merits of proposed CFTC Regulation 23.154(a)(5), the CFTC notes that the No-Action Letter placed a number of conditions and limitations on Cargill's use of the relief provided by the No-Action Letter due to a few risk-related concerns. However, the Commission then rightly acknowledges that the limitations are unnecessary as the CFTC believes that the current regulatory obligations placed on swap dealers are capable of addressing such concerns.[5] As a result, there are only two conditions placed on the use of proposed CFTC Regulation 23.154 (a)(5): (i) a requirement that the relevant swap be a hedge; and (ii) the requirement that the counterparty's initial margin model satisfy the requirements of CFTC Regulation 23.154(b).

STRM agrees that the entirety of the regulatory requirements imposed on swap dealers under Part 23 of the CFTC Regulations are more than sufficient to mitigate any potential risks raised by proposed CFTC Regulation 23.154(a)(5). Further, there are Part 23 requirements that specifically address the potential concerns noted in the Proposal.

First, the CFTC states that proposed CFTC Regulation 23.154(a)(5) could give rise to a conflict of interest as the counterparty using the model-based approach to calculate initial margin is calculating the amount of initial margin it must post. However, CFTC Regulation 23.605 already requires that swap dealers adopt and implement policies and procedures to address conflicts of interest. In addition, the risk management program required under CFTC Regulation 23.600 requires compliance with the Commission's margin requirements, and CFTC Regulation 23.154(b)(5) requires a swap dealer that utilizes an initial margin model to have an independent audit function annually assess, among other things, compliance with margin related policies and procedures and the efficacy of the calculation of initial margin requirements. In short, there are multiple existing components of a swap dealer's required compliance program that are more than adequate to address any potential concerns raised by proposed CFTC Regulation 23.154(a)(5).

Second, proposed CFTC Regulation 23.154(a)(5) would not provide an exception from the CFTC's initial margin requirements or otherwise

[5] Proposal at 59,709.

diminish the efficacy of those requirements. It would simply allow a small swap dealer, like STRM, to utilize the approved initial margin calculation methodology that is appropriate for the circumstances surrounding a particular trading relationship.

IV. THE CFTC SHOULD REMOVE THE HEDGING CONDITION IN PROPOSED CFTC REGULATION 23.154(a)(5)

STRM understands that the CFTC does not want proposed CFTC Regulation 23.154(a)(5) to be universally available. However, limiting access to the proposed provision by requiring a swap dealer to be hedging is problematic and would minimize the value of the relief.

Specifically, obligating a swap dealer to be hedging in order to utilize proposed CFTC Regulation 23.154(a)(5), would, as discussed below, require a swap dealer: (i) to hedge its client-facing transactions on a one-to-one basis rather than a portfolio basis, as each swap would need to be tied to a specific customer-facing transaction; or (ii) to not, on occasion, accommodate the demand of another swap dealer for whom the swap dealer might be best situated to assist. This is not an optimal outcome.

Under proposed CFTC Regulation 23.154(a)(5), a swap dealer must only use the proffered relief with respect to "uncleared swaps entered into...for the purpose of hedging the covered swap entity's swaps with non-swap entity counterparties." In practice, this condition would require a swap dealer to hedge its transactions on a transaction-by-transaction basis rather than a portfolio basis, which is a common, prudent risk management practice, in order to utilize proposed CFTC Regulation 23.154(a)(5).

In addition to likely foreclosing the opportunity to engage in portfolio hedging, the hedging condition could cause a swap dealer additional compliance burdens. In order to provide the representations necessary to utilize proposed CFTC Regulation 23.154(a)(5), a swap dealer would be required to implement processes and procedures to classify individual transactions with other swap dealers as hedges[6] and tie those hedges to particular client-facing transactions. Putting in place the infrastructure needed to do this would impose a material compliance burden that could nullify any benefit offered by the relief in proposed CFTC Regulation 23.154(a)(5).

[6] STRM notes that the Commission does not define "hedging" as the term is used in proposed CFTC Regulation 23.154(a)(5). STRM would suggest the Commission use the phrase "hedge or mitigate commercial risk" in its place if the CFTC decides to adopt proposed CFTC Regulation 23.154(a)(5) as drafted.

Further, as the Commission notes in the Proposal,[7] small swap dealers play an important role in the markets they serve by accommodating the demand of non-financial counterparties. This is especially true in energy swap markets. In addition, swap dealers, like STRM, are especially well situated, on occasion, to serve as a counterparty to other swap dealers that need to lay off risk unique to the markets that STRM understands best and where other parts of Shell have existing physical commodity exposure. As such, if proposed CFTC Regulation 23.154(a)(5) requires a choice between access to the relief and offering a needed service, then each choice presents a downside.

If the CFTC would like to limit the scope of proposed CFTC Regulation 23.154(a)(5), it should not do so through the proposed hedging condition. In the alternative, the Commission could predicate the availability of proposed CFTC Regulation 23.154(a)(5) on the size of the swap dealer. According to 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.[8] Using the Phase 5 threshold of $750 billion notional as the threshold below which a swap dealer could use 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.

V. CONCLUSION

STRM appreciates the CFTC issuing the Proposal and, in particular proposing CFTC Regulation 23.154(a)(5). STRM believes that with the minor changes suggested above, the Proposal would offer meaningful relief to certain swap dealers without introducing additional risk into swap markets.

We appreciate the opportunity to submit comments regarding the Proposal and look forward to working with the Commission as it moves to finalize the proposed requirements.

Respectfully submitted,

/s/

Scott Earnest
Chief Compliance Officer
Shell Trading Risk Management, LLC

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7 Proposal at 59,708

8 CFTC GMAC Subcommittee Report at 17.