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Submitted Electronically

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Re: Margin and Capital Requirements for Covered Swap Entities, Docket No. OCC-2011-0008; RIN 1557-AD43; Docket No. R-1415; RIN 7100 AD74; RIN 3064-AD79; RIN 3052-AC69; RIN 2590-AA45

Ladies and Gentlemen:

The American Petroleum Institute ("API") appreciates the opportunity to submit these comments in response to the notice of proposed rulemaking ("Notice") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the "Prudential Regulators") concerning margin and

capital requirements for covered swap entities under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

API is a national trade association representing more than 450 oil and natural gas companies. API's members transact in physical and financial, exchange-traded, and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers. Associated with the hedging of physical exposures, API members enter into swap transactions to offset credit risks and to facilitate physical transactions. API members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry. Because API members rely on non-cleared swaps to hedge risk, we appreciate the opportunity to comment.

I. Introduction

API appreciates that Dodd-Frank requires the Prudential Regulators to set margin requirements, with respect to non-cleared swaps, on swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants (collectively, "swap entities") subject to their jurisdiction ("covered swap entities"). Congress did not, however, intend these requirements to apply to, or impose new costs and regulatory burdens on, end users that enter into bilateral, non-cleared swaps to hedge their commercial risk. API therefore opposes the Prudential Regulators' proposal to require covered swap entities to collect margin from commercial end users. API further opposes the significant limitations that the Prudential Regulators' proposed margin rules would impose on the use of non-cash collateral. Because end users must be able to invest cash in their businesses, rather than divert funds to comply with new margin requirements, Congress specifically directed regulators to permit end users to negotiate individualized agreements with respect to non-cash collateral. Finally, API is concerned that new requirements mandating credit support arrangements would increase costs and administrative burdens for end users.

API believes that end users hedge risk most efficiently and effectively when they are able to negotiate customized terms with their counterparties free of undue regulatory

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010). The proposed rules are set forth in Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (proposed May 11, 2011) (to be codified at 12 C.F.R. pts. 45, 237, 324, 624, 1221). The Prudential Regulators extended the comment period for this Notice until July 11, 2011, in Margin and Capital Requirements For Covered Swap Entities, 76 Fed. Reg. 37,029 (June 24, 2011).

intervention. Recognizing that Dodd-Frank preserves end users' ability to enter into non-cleared swaps with customized contract terms, API offers the following comments:

- The language, structure, and legislative history of Dodd-Frank clearly indicate that regulators are not authorized to adopt margin requirements that apply to commercial end users. Accordingly, API opposes the Prudential Regulators' proposal to impose margin requirements on commercial end users. API further respectfully requests that the Prudential Regulators adopt comparable margin requirements to those proposed by the Commodity Futures Trading Commission (the "CFTC"), which would not impose minimum margin requirements on end users.

- The final margin rules should preserve the ability of commercial end users to negotiate appropriate forms of collateral and valuation timeframes with counterparties. The Prudential Regulators should therefore permit end users to post forms of non-cash collateral other than the highly liquid debt securities included in the proposed rules. The proposed rules are inconsistent with Dodd-Frank's requirements and current commercial practice.

- Any new documentation requirements should not impose substantive regulatory compliance obligations on non-cleared, bilateral swaps involving end users. End users must be able to negotiate customized terms without unnecessary regulatory restrictions.

II. Dodd-Frank Does Not Authorize Regulators to Adopt Margin Requirements that Apply to Commercial End Users

Dodd-Frank does not give regulators any authority to impose margin requirements on end users. The statutory text, structure, and legislative history of Dodd-Frank all clearly indicate that these requirements were intended to apply to swap entities, not to impose significant new margin-related costs on nonfinancial entities that enter into swaps to hedge or mitigate commercial risk. Recognizing this congressional intent, the CFTC's proposed rules would not impose margin on end users.[2] Although the Prudential Regulators referred to legislative history indicating that "Congress did not intend . . . to impose margin requirements on nonfinancial end users engaged in hedging activities, even in cases where they entered into swaps or security-based swaps with swap entities," the proposed rules would require margin to be collected from

[2] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732, 23,736 & n.13 (proposed Apr. 28, 2011) (to be codified at 17 C.F.R. pt. 23) (hereinafter "CFTC Proposed Margin Rules").

end users.[3] API strongly opposes this proposal, which is contrary to Dodd-Frank's language, Dodd-Frank's structure, and Congress's intent, as well as not comparable to rules proposed by the CFTC.

Dodd-Frank adds Section 4s(e) to the Commodity Exchange Act ("CEA"). New Section 4s(e)(1) states that "*[e]ach registered swap dealer and major swap participant* for which there is a prudential regulator shall meet such minimum capital requirements and minimum initial and variation margin requirements as the prudential regulator shall by rule or regulation prescribe under paragraph (2)(A)."[4] New Section 4s(e)(2)(A), in turn, requires the Prudential Regulators, jointly and in consultation with the CFTC and the Securities and Exchange Commission (the "SEC"), to:

> *adopt rules for swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant*, for which there is a prudential regulator imposing --
>
> (i) capital requirements; and
>
> (ii) both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization.[5]

New Section 15F of the Securities Exchange Act of 1934 includes substantially identical language with respect to security-based swap dealers and major security-based swap participants for which there is a prudential regulator. Thus, by their plain language, these sections, which do not even discuss end users, impose minimum margin requirements on only swap entities. API disagrees that the reference to "all swaps that are not cleared" requires margin on both sides of each non-cleared swap transaction. To the contrary, as discussed below, members of Congress explained that this language did not permit regulators to set margin requirements on the end-user side of a transaction.

Further, imposing margin requirements on end users would be inconsistent with the end-user clearing exception. Dodd-Frank makes it unlawful to engage in a swap that is required to be cleared unless that swap is submitted for clearing.[6] This clearing requirement does not, however, extend to nonfinancial entities that enter into swaps to hedge or mitigate

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[3] Notice, 76 Fed. Reg. at 27,569.

[4] Dodd-Frank § 731 (CEA § 4s(e)(1)(A)) (emphasis added).

[5] *Id.* § 731 (CEA § 4s(e)(2)(A)) (emphasis added).

[6] *Id.* § 723(a)(3) (CEA § 2(h)(1)(A)).

commercial risk.[7] In fact, this clearing exception was designed to preserve end users' ability to hedge risk without being subject to costly margin requirements. Imposing margin requirements on end users' non-cleared swaps in a manner that resembles margin requirements imposed by central clearing parties with respect to cleared swaps would therefore, as the Prudential Regulators have already observed, "lessen[] the effectiveness of the clearing requirement exemption for these nonfinancial end users as concerns margin."[8]

The legislative history confirms that Congress intended margin requirements to apply only to swap dealers and major swap participants -- not to end users. As the following statements in the *Congressional Record* show, Congress did not intend or understand Dodd-Frank to authorize regulators to require end users to post margin:

- Senators Dodd and Lincoln: "The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs 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.

  "Again, Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but *rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction*. In cases where a Swap Dealer enters into an uncleared swap with an end user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the Congressional intent to protect end users from burdensome costs."[9]

- Senator Lincoln: "[I]t is clear in this legislation that the regulators only have the authority to set capital and margin requirements on swap dealers and

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[7] *Id.* (CEA § 2(h)(7)).

[8] Notice, 76 Fed. Reg. at 27.570.

[9] Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson (June 30, 2010), *in* 156 Cong. Reg. S6192 (daily ed. July 22, 2010) (emphasis added).

major swap participants for uncleared swaps, not on end users who qualify for the exemption from mandatory clearing."[10]

- Senator Dodd: "There is no authority to set margin on end users, only major swap participants and swap dealers."[11]
- Representative Peterson: "[W]e have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant."[12]
- Representative Frank: "We do differentiate between end users and others. The marginal requirements are not on end users. They are only on the financial and major swap participants. And they are permissive. They are not mandatory, and they are going to be done, I think, with an appropriate touch."[13]

The statutory text and legislative history therefore show that Congress carefully drafted Dodd-Frank to avoid imposing costly new margin requirements on end users. These requirements would, as Senators Dodd and Lincoln stated, actually increase risk by raising the cost of hedging transactions. Consistent with congressional intent and Dodd-Frank's design, it is critical that neither the Prudential Regulators nor the CFTC require swap dealers and major swap participants to collect margin from end users. Congress intended to preserve the ability of end users to negotiate bilaterally for credit terms that are more appropriate and economical than the minimum margin requirements. API therefore opposes the Prudential Regulators' proposal to collect margin from end users.

Not only is the Prudential Regulators' proposal inconsistent with Dodd-Frank and congressional intent, it is not comparable with the CFTC's margin proposal. Dodd-Frank provides that the Prudential Regulators, the CFTC, and the SEC "shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements and minimum initial and variation margin requirements, including the use of non cash collateral."[14] Accordingly, API urges the Prudential Regulators to adopt final rules that more closely match congressional intent and the CFTC's margin requirements. As discussed above, API believes

[10] 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

[11] *Id.* (statement of Sen. Dodd).

[12] 156 Cong. Rec. H5248 (daily ed. June 30, 2010) (statement of Rep. Peterson).

[13] *Id.* (statement of Rep. Frank).

[14] Dodd-Frank § 731 (CEA § 4s(e)(3)(D)(ii)).

these rules should not require collection of margin from commercial end users. Rather, the Prudential Regulators should adopt final rules that reflect a risk-based approach that recognizes that commercial end users should not be subject to restrictive new regulation that would raise costs and impair their ability to hedge risk.

III. The Prudential Regulators Should Not Impose Specific Documentation Standards and Collateral Restrictions on Contracts with Commercial End Users

The proposed rules would also govern the relationship between commercial end users and swap entity counterparties beyond the required collection of margin. Specifically, the proposed rules limit forms of non-cash collateral that end users may post as margin to cash and government securities, impose extensive new documentation requirements that will potentially impair end users' ability to tailor bilateral swap contracts to meet their hedging needs, and ultimately involve regulators in all aspects of the bilateral relationship between counterparties. API is concerned that these requirements are not warranted for commercial end users, which Congress did not intend to be subject to new margin requirements and which Congress and the Prudential Regulators have recognized pose less risk to the safety and soundness of their counterparties or the United States financial system.

A. The Prudential Regulators Should Not Limit Forms of Non-Cash Collateral that Commercial End Users May Post as Margin

Unlike the CFTC's proposed margin rules, which would permit commercial end users to post any non-cash asset if its value is reasonably ascertainable on a periodic basis,[15] the Prudential Regulators' proposed rule "does *not* allow for the use of non-cash collateral, other than the limited types of highly-liquid, high-quality debt securities" listed in the rule.[16] API opposes this limitation on eligible forms of collateral, which is inconsistent with current market practice and Congress's intent. Because commercial end users pose less risk to their counterparties and the financial system, and because many might not enter into swaps to hedge risk if they were forced to comply with rigid, cash margin requirements, API believes that permitting non-cash collateral would preserve both the financial integrity of swap markets and the stability of the United States financial system. Based on the experience of API members, API believes that current market practice with respect to non-cash collateral has worked well to mitigate risk. API therefore requests that the Prudential Regulators provide commercial end users with the flexibility to post various forms of collateral acceptable to counterparties.

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[15] CFTC Proposed Margin Rules, 76 Fed. Reg. at 23,739.

[16] Notice, 76 Fed. Reg. at 27,578 (emphasis in original).

Dodd-Frank states that regulators "shall permit the use of noncash collateral."[17] Senators Dodd and Lincoln explained that this provision "recognized that the individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management."[18] Contrary to Dodd-Frank's language and Congress's intent, the Prudential Regulators have proposed to prohibit commercial end users from posting non-cash collateral as margin, except for government securities or, in the case of initial margin only, certain securities issued by government-sponsored enterprises.[19] In proposing this rule, the Prudential Regulators expressed three concerns that, API believes, do not justify the proposal to limit forms of non-cash collateral that commercial end users may post as margin. First, the Prudential Regulators suggested that end users would not need the flexibility to post non-cash collateral because the proposed rules already permit swap entities to adopt credit exposure thresholds for nonfinancial end users.[20] API strongly disagrees. An end user must have the flexibility to negotiate the type of collateral it can post to secure a bilateral swap. This flexibility will ultimately preserve end users' access to swaps to hedge risk and ensure the safety of swap entities. Second, the Prudential Regulators suggested that non-cash collateral would be "complicated by procyclical considerations," that is, the value of assets posted as collateral might be under stress in a period of financial stress. API believes that this concern is unwarranted with respect to commercial end users, which, unlike financial entities, are unlikely to have interconnected financial positions that cause systemic risk. Finally, the Prudential Regulators expressed concern about the difficulty of establishing appropriate haircuts for non-cash collateral. API understands that haircuts in this context may necessarily be less precise than haircuts for the securities that the Prudential Regulators have proposed as eligible collateral. But API believes that Congress rejected concerns about the administrability of such standards when it required regulators to permit non-cash collateral.

Currently, many commercial end users, including API members, post non-cash collateral to counterparties. For example, instead of posting cash or highly liquid securities, an end user might post a lien on property equal to the value of the agreed margin amount. This approach allows end users to use cash in their business -- in the case of API members, to explore

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[17] Dodd-Frank § 731 (CEA § 4s(e)(3)(C)).

[18] Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson (June 30, 2010), *in* 156 Cong. Reg. S6192 (daily ed. July 22, 2010) ("Congress recognized that the individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management. That is why Congress specifically mandates that regulators permit the use of non-cash collateral for counterparty arrangements with Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation.").

[19] Notice, 76 Fed. Reg. at 27,578.

[20] *See id.*

for oil and gas, to drill new wells, and to provide energy to consumers at lower prices. Cash margin requirements would tie up money that could be used more productively for investment and exploration, to lower energy prices, and to create jobs. As the legislative history described above reveals, Congress did not impose margin requirements on commercial end users precisely to avoid taking funds out of productive use in the economy. And the provision for non-cash collateral expressly preserves commercial end users' ability to post non-cash assets pursuant to individually negotiated credit arrangements.

Accordingly, API respectfully requests that the Prudential Regulators adopt final rules that would not limit the forms of non-cash collateral that commercial end users could post as margin. Further, as noted above, the Prudential Regulators' requirements for non-cash collateral must be "comparable" to those proposed by the CFTC. API therefore requests that Prudential Regulators adopt final rules that are more in line with the CFTC's proposal. API believes that both sets of final margin rules should preserve the ability of commercial end users to negotiate appropriate forms of collateral and valuation timeframes with counterparties.

B. The Prudential Regulators Should Not Use Margin Rules or Documentation Standards to Prescribe Extensive New Substantive Requirements that Apply to Commercial End Users

API is concerned that the proposed rules would impose extensive new substantive requirements on bilateral swaps involving end users. For example, the proposed rules require commercial end users transacting with swap entities to enter into credit support arrangements that specify the methodology used to calculate margin and the applicable thresholds below which initial and variation margin will not be collected.[21] The proposed rules further specify how margin must be calculated and how frequently it must be collected.[22] API is concerned that these requirements will unnecessarily raise transaction costs and limit the ability of commercial end users to customize swaps to meet their hedging needs, without materially reducing systemic risk.

API believes that end users and the market are best served by allowing counterparties to negotiate contracts, often with customized terms, that are tailored to meet the specific needs and circumstances of the parties. API further believes that reciprocal evaluation of each counterparty's credit and proposed collateral is more efficient than specific regulatory prescriptions. End users should therefore be free, as they are now, to negotiate the type of collateral and relevant valuation method, the applicable credit thresholds, and other credit management requirements. New documentation standards that would require credit support annexes with all counterparties would be contrary to current market practice and inconsistent

[21] *See id.* at 27,589 (proposed § ___.5).

[22] *See id.* at 27,589-91 (proposed §§ ___.4, ___.8).

with Congress's recognition that new margin-related requirements could increase risk by raising the cost or regulatory burdens of hedging transactions.

Beyond the transaction costs associated with these new requirements, API is concerned about potential regulatory involvement in bilateral contract relationships. By mandating that commercial end users enter into credit support arrangements satisfying certain criteria and specifying certain terms, the proposed rules potentially convert ordinary breaches of contract into regulatory violations subject to enforcement. The Prudential Regulators should therefore clarify that the proposed rules only create compliance obligations for swap entities and will not trigger enforcement action against commercial end users.

IV. Conclusion

For the reasons described in these comments, API believes that Dodd-Frank does not permit the Prudential Regulators to impose margin requirements on commercial end users. API therefore opposes the Prudential Regulators' proposal to require swap entities to collect margin from commercial end users. API is further concerned that the proposed rules would impose a new set of substantive obligations on end-user transactions -- including significant restrictions on collateral, documentation, and valuation -- that would raise transaction costs and impair end users' ability to negotiate swaps with their counterparties. These requirements are inconsistent with Congress's intent to preserve end users' ability to hedge risk, as they do now, with non-cash collateral and customized, negotiated contracts. Accordingly, API respectfully requests that the Commission clarify that these new substantive requirements will not apply to commercial end users.

API appreciates the opportunity to provide these comments. We would be pleased to provide additional information regarding our views on the proposed rule, and would welcome the opportunity to work with the Prudential Regulators to clarify these issues. Please contact me or Brian Knapp at (202) 682-8172 if you have any questions.

Sincerely yours,

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