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VIA ELECTRONIC SUBMISSION

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Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
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Mr. Alfred M. Pollard
General Counsel
Attention: Comments
Federal Housing Finance Agency
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Fourth Floor
Washington, DC 20552

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
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Re: *Margin and Capital Requirements for Covered Swap Entities*
RIN 1557-AD43; RIN 7100-AD74; RIN 3064-AD79; RIN 3052-AC69; and RIN 2590-
AA45

Ladies and Gentlemen:

On behalf of the Working Group of Commercial Energy Firms (the “Working Group”), Hunton & Williams LLP respectfully submits this letter in response to the prudential regulators’ (the “Prudential Regulators”)¹ request for comment concerning the Prudential Regulators’ Notice of Proposed Rulemaking on “Margin and Capital Requirements for Covered Swap Entities” (the “Proposed Rules”).² The Working Group is a diverse group of commercial firms in the energy

¹ Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration and the Federal Housing Finance Agency.

² Notice of Proposed Rulemaking on “*Margin and Capital Requirements for Covered Swap Entities*”, 76 Fed. Reg. 27,564 (May 11, 2011).

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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 energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

The Working Group is offering the comments below on the Proposed Rules as its members often transact with swap dealers that will be subject to the regulatory oversight of the Prudential Regulators. As such, the Prudential Regulators' capital and margin requirements will have direct consequences for the Working Group's members' ability to manage the risks associated with their core business of providing energy products to customers.

I. GENERAL COMMENTS REGARDING CAPITAL AND MARGIN.

A. Proposed Rules Have Substantial Cost Implications.³

i. Cost to the U.S. Economy Will be Significant.

The Working Group acknowledges that the basic parameters of the Proposed Rules are mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). However, the Proposed Rules, as currently drafted, will impose new margin requirements on Covered Swap Entities in a manner not well attuned to the specific risks inherent in swaps. The result of the Proposed Rules will be significant costs for not only Covered Swap Entities, but also the U.S. economy and financial system, especially when coupled with the Commodity Futures Trading Commission's (the "CFTC") proposed rules on margin and capital requirements for Covered Swap Entities (the "CFTC's Proposed Rules").⁴

First, the Proposed Rules and the CFTC's Proposed Rules will impose significant direct costs on Covered Swap Entities and their counterparties. The Office of the Comptroller of the Currency (the "OCC") estimates that the new margin requirements under the Act will result in swap market participants posting over \$2 trillion in the form of initial margin, with an associated annual cost of \$20 billion per 1% of forgone potential return⁵ on such margin.⁶ In fact, one bank

³ The Working Group is conducting its own study of the total cost of compliance of with the proposed rules set forth under the Act. The Working Group anticipates submitting the study to the CFTC by the end of this fiscal quarter.

⁴ Notice of Proposed Rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" 76 Fed. Reg. 23732 (Apr. 28, 2011) and Notice of Proposed Rulemaking on "Capital Requirements of Swap Dealers and Major Swap Participants" 76 Fed. Reg. 27802 (May 12, 2011).

⁵ This cost is most easily expressed as the difference between a Covered Swap Entity's cost of capital and its potential return on collateral posted as initial margin. The cost is likely substantial. Given the forms of collateral

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holding company estimates that it will have to post as well as receive at least \$1.4 trillion in initial margin, most of which will be segregated.⁷ If the Proposed Rules and the CFTC's Proposed Rules require swap market participants to post over \$2 trillion in initial margin, then it will be the equivalent of reallocating over 7% of U.S. GDP.⁸ That could have a significant impact on the U.S. economy.

Second, the Proposed Rules and CFTC's Proposed Rules will likely lead to higher per transaction costs for swap market participants. Higher costs will likely reduce the number of transactions, lowering liquidity and, consequently, increasing volatility in swap markets. Covered Swap Entities and their counterparties will likely pass on the associated higher costs and price volatility to consumers.

Third, the Proposed Rules and the CFTC's Proposed Rules may adversely affect cash management practices at commercial firms. The imposition of capital and margin requirements may reduce counterparty credit risk, but it will not eliminate risk altogether. The reduction in counterparty credit risk achieved through capital and margin requirements results from transformation of such risk into increased liquidity risk. As observed during the recent financial crisis, requirements of firms to deliver substantial amounts of margin can cause liquidity issues or even crises at such firms. In the case of non-financial Covered Swap Entities, liquidity risk might actually pose a greater risk than credit risk, given the nature of their balance sheets.

Fourth, the Proposed Rules set capital and margin requirements that could drive smaller swap dealers out of swap markets and serve as substantial barriers to entry for new swap dealers. Under such an outcome, the swap markets will lose depth and liquidity would likely decrease, increasing price volatility. Also, the swap dealing function in swap markets would likely be concentrated in the entities who, in part because of their derivatives exposures, were deemed "too-big-to-fail."

Fifth, the Proposed Rules will impose substantial indirect as well as opportunity costs. If margin requirements are improperly constructed many non-financial entities, such as commercial energy firms that are members of the Working Group, will be left with the unenviable choice of leaving certain risks unhedged or paying inordinately high prices for appropriate and necessary

permitted under the Prudential Regulators' Proposed Rules, the lost return is essentially a Covered Swap Entity's cost of capital as returns on cash and cash equivalents are minimal.

⁶ See Office of the Comptroller of the Currency, "Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule", at 5 (Apr. 15, 2011).

⁷ See comments of J.P. Morgan Chase & Co. filed in response to the Prudential Regulators' Proposed Rules on June 24, 2011.

⁸ U.S. GDP for FY 2010 was \$14.66 trillion. Central Intelligence Agency World Fact Book, updated June 14, 2011. Available at: <https://www.cia.gov/library/publications/the-world-factbook/geos/us.html>.

risk management. It is likely that some or all of the associated increased costs and volatility will be passed on to consumers.

ii. General Suggestions to Lower Potential Cost of the Proposed Rules.

The Working Group believes the Proposed Rules, as currently constructed, are unnecessarily expensive. However, there are steps that the Prudential Regulators can take to reduce the burden imposed by the Proposed Rules while properly accounting for the risks associated with uncleared swaps.

The Prudential Regulators should ensure that the Proposed Rules permit the netting and offset of margin requirements to the fullest extent possible. The use of reasonable netting and offset arrangements across a variety of exposures reduces counterparty credit risk and lowers the cost of trading by allowing the efficient use of capital. According to the OCC, legally enforceable netting agreements allowed banks to reduce gross positive fair value derivatives exposures by 90.4% in the first quarter of 2011.⁹ As discussed herein, the Proposed Rules must be amended to allow Covered Swap Entities and their counterparties to net and offset their counterparty exposure to the largest degree appropriate.

Additionally, the Prudential Regulators should permit commercial firms that are not Covered Swap Entities to deliver non-cash collateral to meet their margin obligations. Limiting eligible collateral to mostly cash and cash equivalents eliminates forms of collateral widely accepted in today's swap markets. There are several forms of non-cash collateral that are accepted in today's markets, such as liens on physical and financial assets and letters of credit. These other instruments and legal rights provide the credit support that trading relationships require and help firms lower costs by reducing a counterparty's funding obligations. So long as the collateral delivered can cover the swap exposure in the event of a termination of the swaps and the liquidation of the collateral, then the Prudential Regulators should permit delivery of such assets.

Finally, the Prudential Regulators should remove the segregation requirement for all initial margin posted with regards to swaps between Covered Swap Entities. Congress recognized that certain swap market participants value the ability to segregate initial margin posted with regards to uncleared swaps. Accordingly, Section 724 of the Act provides counterparties of Covered Swap Entities with the option to elect to segregate initial margin posted to an uncleared swap. Imposing mandatory segregation of initial margin on swaps between Covered Swap Entities will prove extremely costly and will serve as a massive liquidity drain. Removing the segregation requirement from the Proposed Rules will substantially lower the costs imposed by such rules, and because swap market participants have the option to elect

⁹ See OCC at 5.

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segregation, those entities that deem it desirable will still have the ability to segregate initial margin.

B. Capital and Margin Requirements for Uncleared Swaps Should Not Be Constructed to Force Centralized Clearing.

The Prudential Regulators' capital and margin requirements should not be set with the intent of moving all over-the-counter swaps to centralized clearing, as many uncleared swaps cannot be cleared. The capital and margin requirements should reflect Congress' intent that such requirements "be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."¹⁰ Intentionally driving swap markets to centralized clearing could increase risk for commercial energy firms and the financial system as a whole. Less risk is posed when entities are able to diversify and manage overall risk by optimizing and balancing the counterparty credit risk associated with uncleared transactions and the liquidity risk associated with cleared transactions.

Congress clearly contemplated and accounted for the continued existence of an uncleared swap market.¹¹ There are certain swaps that are either too customized or are not liquid enough to be centrally cleared. The former are often hedging tools designed to address the specific hedging needs of end users. The latter are common in energy swap markets where, for example, certain delivery points for natural gas have only episodic liquidity. These swaps are necessary risk management tools and are not designed to avoid centralized clearing.

As these swaps by their nature cannot be cleared, imposing margin requirements on such swaps with the intent of driving them to centralized clearing will only increase risk and costs to entities that rely on these swaps to manage risk. These entities, many of whom are end users, will be left with the unenviable choice of leaving certain risks unhedged or paying inordinately high prices for the necessary swaps. As noted above, it is likely that these end users will be forced to pass on the associated higher costs and price volatility to consumers.

Congress clearly intended "to protect end users from burdensome costs associated with margin requirements and mandatory clearing."¹² Imposing non-risk based margin and capital requirements on uncleared swaps would run counter to that directive. If margin requirements are set with the intent of driving uncleared swaps to centralized clearing, those requirements will

¹⁰ *Id.*

¹¹ S. Rep. No. 111-176 at 34.

¹² See Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

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undermine the Congressional intent underlying the end user exception from centralized clearing (the “End User Exception”).¹³

C. The Prudential Regulators Should Implement the Proposed Rules After Mandatory Centralized Clearing is Available.

The Act’s centralized clearing requirement and margin and capital requirements were intended to work in conjunction with one another to reduce systemic risk.¹⁴ The centralized clearing requirement is intended to address the risk of those swaps that are liquid and standardized enough to be centrally cleared. The margin and capital requirements for uncleared swaps are intended to address the risk posed by swaps that are not capable of being cleared.¹⁵ Accordingly, the clearing, margin and capital requirements should be implemented in a logical order.

If the Prudential Regulators impose final margin rules under the Act prior to the implementation of the Act’s mandatory clearing requirement, then it will subject that portion of the market that is liquid enough to be readily clearable, but is not currently cleared to higher margin requirements than if they were subject to mandatory centralized clearing.¹⁶ This higher margin requirement could potentially remove the liquidity from certain classes of swaps that makes them capable of being cleared.

II. COMMENTS ON THE PROPOSED RULES.

A. Application of Proposed Rules to Transactions With Non-Financial Entities.

The Working Group agrees with the stated intent of Congress and the CFTC’s decision to not impose margin requirements on non-financial entities.¹⁷ However, the Working Group

¹³ Section 2(h)(7) of the CEA.

¹⁴ S. Rep. No. 111-176 at 33 (2010), available at <http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf>.

¹⁵ As Congress did not provide the Commission, the Securities Exchange Commission and the Prudential Regulators with the authority to impose margin requirements on non-financial end users, the only swaps subject to the margin requirements for uncleared swaps should be those that are too customized or illiquid to be deemed not subject to mandatory clearing.

¹⁶ Under the Commission’s proposed rules, Initial margin requirements will have to account for 99% of price changes within a five day period for cleared swaps and 99% of price changes within a ten day period for uncleared swaps.

¹⁷ See Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010). Senators Dodd and Lincoln stated:

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believes that the Prudential Regulators' approach to the exchange of margin between Covered Swap Entities and non-financial counterparties places the issue in the incorrect context. The determination of the parameters of such a credit relationship should be undertaken as a bilateral negotiation, without a presumption favoring one party. The Working Group respectfully requests the Prudential Regulators amend the Proposed Rules to reflect, for swaps between Covered Swap Entities and non-financial entities, that the requirements of each party to post collateral, or to require the other party to post collateral shall be exclusively governed by the applicable credit support arrangement entered into between the relevant counterparties.

B. The Proposed Rules Should Align With the CFTC's Proposed Rules.¹⁸

Without consistent valuation and margin methodology and with inconsistent approaches to netting and permissible forms of collateral there will likely be a number of discrepancies in swap markets that will be the product of the divergent regulatory regimes. At best those differences will impose additional burdens on swap market participants. At worst, such differences may lead to substantive market distortions. To avoid potential market abnormalities that could result from different regulatory regimes, the Working Group respectfully requests that the Prudential Regulators work with the CFTC to better align their proposed rules with the contours set forth in the Proposed Rules.

C. Netting Under the Proposed Rules.

The Working Group appreciates that the Proposed Rules clearly permit the netting of variation margin.¹⁹ However, the netting provisions of the Proposed Rules must be amended to permit Covered Swap Entities and their counterparties to net counterparty exposures in the most

"The legislation does not authorize the regulators to impose margin on end users...If regulators raise the cost 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...Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end user counterparties-especially if those requirements will discourage the use of swaps by end users or harm economic growth."

See also, Floor colloquy between Congressman Frank, Chairman, Committee on Financial Services and Congressman Peterson, Chairman, Committee on Agriculture in response to the letter from Sen. Dodd and Sen. Lincoln. 156 Cong. Rec. H 5248 (daily ed. June 30, 2010) (colloquy between Cong. Frank and Cong. Peterson). Congressman Frank and Congressman Peterson state that the Act does not give regulators the authority to impose margin requirements on end users and that margin requirements imposed on Swap Dealers and Major Swap Participants should be structured in a way to minimize the impact on end users.

¹⁸ The Working Group notes that the Securities and Exchange Commission "SEC" has yet to propose capital and margin requirements. However, such requirements will likely not have a substantive impact on commodity swap markets.

¹⁹ Proposed CFTC Rule 23.154(b)(5).

efficient manner possible. Permitting Covered Swap Entities and their counterparties to net and offset collateral requirements across a wide variety of exposures, including swap and non-swap positions, would (i) reduce the overall amount of counterparty credit risk each party bears with respect to the other party across several trading relationships and (ii) allow entities to make efficient use of their capital.

Currently, master netting agreements and certain master trading agreements allow counterparties to net both swap and non-swap exposures with the same counterparty or affiliated counterparties. For example, a commercial energy firm may have physical natural gas trades in place with a certain counterparty. At the same time, the commercial energy firm may have financial trades with the same counterparty, such as a basis trade effectively converting the price of natural gas determined at one commonly-referenced location (*e.g.*, Henry Hub) into the price at the location where the gas is actually delivered.²⁰ A master netting agreement allows the commercial energy firm to evaluate credit risk on a consolidated basis and make efficient use of capital.²¹

The Proposed Rule must be amended to allow efficient netting. Under the alternative grid-based method for initial margin set forth in Proposed Rule 8(a),²² Covered Swap Entities cannot net initial margin requirements. The Prudential Regulators request comment as to whether they should amend the grid-based method to allow Covered Swap Entities to offset initial margin requirements.²³ The Working Group respectfully suggests that the Prudential Regulators allow Covered Swap Entities and their counterparties to offset initial margin requirements to the fullest extent possible when there is a sound theoretical basis and significant empirical support for such offset.

The Proposed Rules allow the netting of variation margin for swaps executed under the same compliant swap trading relationship documentation. However, netting is permissible upon a “retroactive toll charge,” meaning netting is only available if the parties net variation margin for all swaps under the same master agreement regardless of when any such swap was executed. Thus, to net swaps entered into after the effective date of the Prudential Regulators’ final rules on margin a party must apply the new margin rules to swaps entered into before the effective

²⁰ Another common example in energy-swap markets is the use of an ISDA Master Agreement with a gas annex and a power annex. With such documentation in place, the counterparties can trade both physical and financial gas and power positions under the same master agreement.

²¹ It is possible that the commercial energy firm trades physical natural gas through one affiliate, but financial positions through another affiliate, each facing the same customer. Master netting agreements are also utilized under this circumstance.

²² The alternative grid-based method for initial margin requires Covered Swap Entities to determine initial margin amounts based on the characteristics of a swap such as duration and the underlying asset.

²³ Proposed Rules at 27,573.

date. However, a Covered Swap Entity may elect to net initial margin only for swaps entered into after the effective date of the Prudential Regulator's final rules.²⁴ It is uncertain why the Prudential Regulators believes this retro-active toll charge is warranted, particularly as netting reduces counterparty credit risk. If the Prudential Regulators retain the "retroactive toll charge," the Working Group respectfully requests that the Prudential Regulators make clear that the decision to structure netting between two counterparties in a manner that will incur the "retroactive toll charge" must be agreed to by both counterparties and not just required by the Covered Swap Entity.

D. Further Refinement of Appendix A.

The Working Group believes the grid set forth in Appendix A to the Proposed Rules, as proposed by the Prudential Regulators, warrants further refinement in addition to allowing offsets. The alternative grid-based method applies initial margin requirements without sufficient granularity. For example, all commodity contracts are assessed the same initial margin requirement, without regard to duration. As a result, the margin requirements for uncleared commodity-based swaps are not risk-based. The Prudential Regulators should provide separate initial margin requirements for different commodities (*e.g.*, wheat, gasoline, electricity, etc.) and add further delineation for the duration of any uncleared swap.

E. Single Measure of Exposure.

The Act does require the Prudential Regulators to distinguish between initial and variation margin.²⁵ However, the Act does not obligate the Prudential Regulators to require counterparties to treat their net credit exposure as two distinct components; initial and variation margin. Swap market participants generally view credit exposure to counterparties in the aggregate. Exposure is treated as a single number. Swap market participants do not distinguish between initial and variation margin. Initial margin and variation margin should be thought of as measures of exposure to be compared against a single threshold. Parties should be permitted (though not required) to treat the sum of current exposure (*i.e.*, variation margin) and potential future exposure (*i.e.*, initial margin) as one exposure and to have one threshold, where permitted, against which to apply the exposure.

Under the default provisions in Paragraph 3 of the Credit Support Annex to the ISDA Master Agreement, exposure is treated in the aggregate. In the event that a counterparty is required to post an independent amount (similar to initial margin) that is factored into the exposure calculation as a buffer. For example, if one counterparty to a swap has an independent amount of \$250,000 and the net mark-to-market exposure between the counterparties is zero,

²⁴ Proposed Rule 8(b).

²⁵ Section 4s(e)(1) of the Commodity Exchange Act requires the Commission to set both initial and variation margin requirements for Covered Swap Entities.

then that counterparty would be obligated to post \$250,000 in collateral. In the event that the net mark-to-market exposure placed the counterparty obligated to post an independent amount in-the-money by \$100,000, then it would be obligated to post \$150,000 in collateral. Finally, in the event that a counterparty was out-of-the-money by \$100,000, then it would be obligated to post \$350,000 in collateral.

One benefit of a single threshold is that it is more efficient with regards to liquidity and capital management. In the example above, only the aggregate net exposure (including the independent amount) between the counterparties is exchanged. When initial margin and variation margin are treated as separate exposures, then both counterparties are required to post initial margin (if applicable) and exchange variation margin. The latter paradigm requires a higher amount of gross capital to operate, making it less efficient and more costly.

The single exposure paradigm allows a counterparty to account for potential movements in credit exposure to another counterparty by building in an exposure buffer beyond actual current exposure in the form of an independent amount. However, it does not result in the unwarranted result of a party that is extremely in-the-money having to post collateral to a party to which it has a large credit exposure. If the out-of-the-money were to default under the initial and variation margin paradigm, it would owe the in-the-money party the close out amount (*e.g.* the difference between the mark-to-market value of the swap and the aggregate amount of variation margin posted) **and** any initial margin posted by the in-the-money counterparty. Though the initial margin is the property of the in-the-money counterparty, the recovery of such margin can prove difficult. The use of a single exposure approach reduces the settlement risk to an in-the-money counterparty in the event of a default.

The treatment of variation and initial margin as one exposure and the use of a single threshold, where appropriate, would allow for the efficient use of capital without permitting the build up of excessive uncollateralized counterparty credit exposure. The Working Group respectfully requests that the Prudential Regulators amend the Proposed Rules to allow counterparties to treat exposure in the aggregate and to use a single margin threshold.

F. Thresholds Should be the Product of Bilateral Negotiation.

The Working Group supports the Prudential Regulators allowing for unsecured credit thresholds with regards to swaps between Covered Swap Entities and non-financial entities. The Proposed Rules define “initial margin threshold amount” for nonfinancial entities as the “credit exposure limit that has been established by a covered swap entity ... that appropriately takes into account and addresses the credit risk posed by the counterparty ... and that has been reviewed, monitored and approved in accordance with the covered swap entity’s credit processes.”²⁶

²⁶

Proposed Rule 2.

“Variation margin threshold amount” is defined in similar manner.²⁷ In both cases, the Working Group requests that the Prudential Regulators clarify that margin thresholds are negotiable terms left to both counterparties to determine, but are bounded by the Proposed Rules.

The Working Group believes that the use of unsecured thresholds is a beneficial tool for trading with commercial energy firms. Many energy companies are quite creditworthy. They have valuable assets and stable revenue. Often, federal and state regulators closely regulate the financial activities of these firms. However, such firms may have limited available cash to deliver as collateral or, as is often the case, they have other business needs to which such cash can (or must) be allocated, such as capital expenditures to update transmission lines or to install environmental technology. Use of an unsecured threshold permits these firms to enter into swaps to manage risks associated with their commercial business, but also allows such firms financial flexibility to manage their available cash.

G. Use of Non-Cash Collateral.

The Working Group recommends that the Prudential Regulators permit commercial firms that are not Covered Swap Entities to satisfy margin requirements with non-cash collateral. Permitting such entities to do so is consistent with the Act and important to the operation of many commercial firms.

The Act requires the Prudential Regulators to “permit the use of non-cash collateral, as...the prudential regulator[s] determines to be consistent with preserving the financial integrity of markets trading swaps and preserving the stability of the United States financial system.”²⁸ Senators Dodd and Lincoln, in a letter to Congressmen Frank and Peterson, recognized that “individual credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management. That is why Congress specifically

²⁷ *Id.*

²⁸ New CEA Section 4s(e)(3)(C).

mandates that regulators permit the use of non-cash collateral.”²⁹ However, in spite of Congress’ instructions, the Prudential Regulators have not elected to do so.³⁰

In justification of the decision to not allow for the use of non-cash collateral, the Prudential Regulators cite to pro-cyclicality concerns,³¹ the difficulty of assigning regulatory haircuts to the myriad of potential forms of non-cash collateral and the availability of unsecured credit thresholds.³² In the alternative, the Prudential Regulators suggest that (i) non-financial entities can elect to use non-cash assets as collateral by using such assets to raise cash through secured lending facilities or (ii) use non-cash collateral to “secure” an unsecured credit threshold.³³

The Working Group acknowledges that under a certain set of circumstances the Prudential Regulator’s concerns might be valid and, as discussed below, the Working Group appreciates the availability of unsecured thresholds. However, the use of secured lending facilities or using non-cash assets to effectively “secure” an unsecured threshold are poor alternatives to allowing non-cash collateral to be considered as eligible collateral with respect to margin requirements. Use of a secured lending facility will impose additional costs on non-financial entities without a corresponding benefit of reducing risk to the financial system. Because a non-financial entity would be required to borrow from “financial institution A” in order to provide eligible collateral to “financial institution B”, all the Prudential Regulators have

²⁹ See Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

See also, Floor colloquy between Congressman Frank, Chairman, Committee on Financial Services and Congressman Peterson, Chairman, Committee on Agriculture in response to the letter from Sen. Dodd and Sen. Lincoln. 156 Cong. Rec. H 5248 (daily ed. June 30, 2010) (colloquy between Cong. Frank and Cong. Peterson). Congressman Frank and Congressman Peterson state that the Act does not give regulators the authority to impose margin requirements on end users and that margin requirements imposed on Swap Dealers and Major Swap Participants should be structured in a way to minimize the impact on end users.

³⁰ The Working Group acknowledges that the Prudential Regulators do allow a limited set of debt instruments to serve as collateral as well. Proposed Rules at 27,578.

³¹ We understand this concern to be that the value of collateral will lessen as market forces cause the value of a swap to run against the party that delivered the collateral. The Working Group would note that under certain circumstances non-cash collateral can actually be counter-cyclical. For example, an oil company might secure a short financial position on oil by the delivery of an interest in some of its oil reserves. If the value of oil rises, the short position moves against the oil company. At the same time, the value of the collateral increases. This is an example of “right-way risk.”

³² Proposed Rules at 27,578.

³³ *Id.*

accomplished in requiring use of a secured lending facility is converting a potential liability (possible losses on a swap position) into a current one (borrowed money debt), thus increasing the cost of doing business, while not actually removing any risk from the institutions they regulate. If anything, the multiple transactions only heighten interconnectivity and transparency issues.

Using available non-cash assets to effectively “secure” unsecured credit thresholds may also be more costly than simply allowing such non-cash assets to be used as eligible collateral. The Working Group is concerned that if a Covered Swap Entity and a non-financial entity counterparty negotiate a credit threshold that is effectively secured by non-cash assets, then the Covered Swap Entity may be assessed a capital charge on exposure up to the amount of this threshold as if such exposure were unsecured and would likely pass the cost of such capital on to the non-financial end user. If non-cash assets were permitted to serve as eligible collateral, the value of such non-cash assets would appropriately reduce the capital charge associated with the related exposure.

The Working Group believes that financial institutions can generally assess the value of non-cash collateral and do not require the Prudential Regulators to assign specific regulatory haircuts. *First*, currently in swap markets, banks often accept non-cash collateral, such as letters of credit and liens on assets. *Second*, at a more basic level, banks frequently engage in secured lending with non-cash assets such as property or equipment serving as collateral. As stated above, the use of non-cash collateral with regards to swaps relies on the same basic premise as secured lending. As such, the Prudential Regulators should not limit the ability of bank Covered Swap Entities to accept any form of collateral that they can accept for a loan as collateral for a swap. Though, there maybe liquidity concerns with regards to the use of non-cash collateral with regards to swaps, those concerns can be accounted for in various ways, such as the use of higher haircuts determined by the relevant counterparties.

The Working Group strongly believes that any margin requirements set by the Prudential Regulators should be consistent with the Act and should permit margin requirements applicable to non-financial end users to be satisfied with non-cash collateral, such as letters of credit, liens on assets, and other arrangements such as offset rights for other trading relationships.³⁴ The use of non-cash collateral would allow non-financial entities to engage in necessary business practices like hedging and price discovery, while making allowances for any corporate structure and unique liquidity constraints. These types of arrangements have historically proven to be a successful means of managing credit risk and should not be unnecessarily disrupted.

³⁴ Offset rights allow counterparties to effectively represent counterparty credit risk as a net exposure. Consequently, the use of offsets allows counterparties to make more efficient use of collateral, limiting potential liquidity concerns.

H. Use of Initial Margin Models.

The Proposed Rules allow Covered Swap Entities to use proprietary initial margin models to determine initial margin amounts.³⁵ The use of proprietary models will likely make it difficult for Covered Swap Entities' counterparties to anticipate potential changes in initial margin amounts and, consequently, difficult to manage working capital and liquidity.

The Working Group respectfully requests that the Prudential Regulators require that Covered Swap Entities provide their counterparties, upon request, with access to the model that will be used to assign initial margin requirements.³⁶ It is necessary for counterparties of Covered Swap Entities to have such access to adequately anticipate their working capital needs. Such transparency will also allow counterparties to make more informed choices as to their preferred trading counterparties and allow them to monitor and dispute initial margin calculations if they prove to be contrary to agreed upon terms.

I. Implications of the Proposed Rules for Covered Swap Entities.

i. Ten-Day Liquidation Time Horizon for Initial Margin Determinations.

Under the Proposed Rules, an initial margin model is required to set initial margin at a level that covers at least 99% of price changes over at least a ten-day liquidation time horizon.³⁷ We understand that such requirements arguably must be equal to or greater than margin requirements for comparable cleared swaps,³⁸ and that proposed DCO margin requirements would require a five-day time horizon.³⁹ However, the Prudential Regulators provides little explanation as to why a ten-day time horizon (*i.e.*, double the time horizon for cleared swaps) is appropriate for all uncleared swaps.

³⁵ Proposed Rule 8.

³⁶ The Working Group notes that access to the model would not include access into the Covered Swap Entity's credit determination regarding the relevant counterparty. The credit determination should be made separate and apart from the analysis of the amount of initial margin necessary to account for the risk associated with a particular swap. In other words, a Covered Swap Entity should make a transparent determination as to the initial margin required to cover the risk inherent in the swap and would then increase that amount by an agreed upon percentage to account for the credit risk posed by the counterparty.

³⁷ Proposed Rule (8)(d)(1).

³⁸ Section 4s(e)(3)(A) of the Commodity Exchange Act states: "to offset the greater risk ... arising from swaps that are not cleared, the [capital] requirements imposed under paragraph (2) shall..."

³⁹ See CFTC Notice of Proposed Rulemaking on "Risk Management Requirements for Derivatives Clearing Organizations", 76 Fed. Reg. 3698, 3704-05 (Jan. 20, 2011). The Working Group would note that a five-day time horizon is already high when compared to current time horizon for cleared swaps which can range from three to five days.

The Prudential Regulators state the longer time horizon for uncleared swaps is necessary because of such swap's lower liquidity. The function of initial margin, according to the Prudential Regulators, is to serve as a buffer against market movements in between variation margin calls. Initial margin serves to compensate a counterparty for the risk posed by price movements if a swap has to be replaced in the event of a counterparty default.

It is highly unlikely that it will take ten days to replace a swap. Under the ISDA Master Agreement, failure to provide variation margin, if required, is an event of default after one business day. The non-defaulting counterparty then must wait one more business day before it is permitted to terminate all swaps between the counterparties. After such termination, the non-defaulting counterparty is the owner of any initial margin, assuming it is the in-the-money counterparty. Under this paradigm it is highly unlikely that a counterparty will need ten days to replace its swaps. Therefore, the Working Group respectfully requests that the Prudential Regulators clarify why a ten-day time horizon is appropriate as the basis for the initial margin requirements for uncleared swaps.

ii. Timing of Valuation and Collateral Exchange.

The Working Group respectfully requests that the Prudential Regulators clarify the collateral transfer timing requirements of the Proposed Rules with regards to swaps between Covered Swap Entities and between Covered Swap Entities and financial entities. The Proposed Rules require a Covered Swap Entity to comply with the initial margin requirements for the duration of the swap, starting on or before the execution date.⁴⁰

The Working Group is worried that, as drafted, it will not be operationally possible to comply with the Proposed Rules under certain circumstances. Requiring initial margin be in place at execution of a swap does not comport with general market practice. For example, once counterparties enter into a swap there are multiple back office steps that must be completed before the transfer of initial margin can take place. Depending on the timing of a trade, it can take up to two business days before initial margin is received by a counterparty. If counterparties were required to have initial margin in place at execution, counterparties would essentially be required to agree upon the terms of a swap and then wait for up to two business days before executing such swap. After a two business day period that swap may no longer make sense for the counterparties at the previously agreed upon terms.

Further, common market practice is to exchange variation margin on a staggered or time-delayed basis. A counterparty will typically measure exposure based on the previous day's price and then request collateral to be delivered the following business day. This creates a natural lag between execution and the first delivery of variation margin.

⁴⁰ Proposed Rules 3(b) and 4(a).

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The Proposed Rules also do not appear to contemplate a scenario such as a force majeure. The Proposed Rules provide a safe harbor to a Covered Swap Entity whose counterparties do not deliver the required variation margin as long as the Covered Swap Entity makes “necessary efforts to attempt to collect the required variation margin.”⁴¹ However, the safe harbor does not appear to apply if the Covered Swap Entity is unable to make necessary efforts to collect variation margin and does not apply to the collection of initial margin.

In the examples above, the counterparties to a swap fully intend to comply with the Proposed Rules, but are unable to because of operational constraints. The Working Group respectfully requests that the Prudential Regulators provide a limited safe harbor for counterparties that are temporarily unable to comply with the requirements of the Proposed Rule for operational reasons.

III. CONCLUSION.

The Working Group supports tailored regulation that brings transparency and stability to the swap markets in the United States. We appreciate the balance the Prudential Regulators must strike between effective regulation and not hindering the uncleared energy-based swap markets. The Working Group offers its advice and experience to assist the Prudential Regulators in implementing the Act. Please let us know if you have any questions or would like additional information.

Respectfully submitted,

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⁴¹ Proposed Rule 4(e).