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Sent: Wednesday, November 24, 2010 8:09 PM
To: CapMargin <CapMargin@CFTC.gov>; secretary <secretary@CFTC.gov>
Cc: McIndoe, David <dmcindoe@hunton.com>; Sweeney, R. Michael <rsweeney@hunton.com>; Menezes, Mark W. <mmenezes@hunton.com>
Subject: Working Group of Commercial Energy Firms Pre-Comments on Capital and Margin Requirements
Attach: Working Group of Commercial Energy Firms Pre-Comments on Capital and Margin Requirements_(32691608)_(14).pdf; Appendix A_(33508222)_(2).XLSX

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms, Hunton & Williams LLP submits for your consideration this letter concerning the capital and margin requirements for entities deemed Swap Dealers or Major Swap Participants under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. If you have any questions, please contact David McIndoe at (202) 955-1947, Michael Sweeney at (202) 955-1944, or Mark Menezes at (202) 419-2122. Thank you for your consideration.

Respectfully,

Alexander Holtan

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November 24, 2010

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC MAIL

Re: *Rulemakings for Capital and Margin Requirements under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter concerning the required rulemakings regarding capital and margin requirements for Swap Dealers and Major Swap Participants under Section 731 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). While the Working Group believes that its members, as end users and traders in the energy derivatives markets, are not Swap Dealers or Major Swap Participants, rules that provide further definition of these terms have yet to be proposed. Therefore, the Working Group is submitting this letter in the event that members of the Working Group are deemed to be "Swap Dealers" or "Major Swap Participants" based on further definition of these terms.[1]

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 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.

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1 For a complete discussion of the Working Group's views on the definitions of "Swap Dealer" and "Major Swap Participant" please see the Working Group's comment letters on such definitions, filed with the Commission on September 20, 2010.

I. EXECUTIVE SUMMARY.

The Commodity Futures Trading Commission (the "Commission") should adopt a capital regime for energy companies and other industrial firms that will be subject to regulation by the Commission as Swap Dealers or Major Swap Participants that is properly tailored to the existing business structures and balance sheets of these firms. These regulations should mandate that each Swap Dealer or Major Swap Participant retain regulatory capital (as defined herein) in an amount that can cover a significant percentage of the net unsecured counterparty credit exposure related to its uncleared Swaps with non-affiliates. The unsecured counterparty credit exposure related to uncleared Swaps, for regulatory capital purposes, should reflect the benefits of netting arrangements inherent in underlying master agreements and any other legally enforceable netting agreements. These regulations should also be flexible enough to accommodate typical balance sheet structures of market participants in energy trading markets, particularly those with a greater concentration of fixed assets, and should consider credit support arrangements such as parental guarantees from affiliated entities. Failure to acknowledge and account for these practices could disrupt commercial arrangements that provide commercial end users of Swaps and ultimate energy consumers with significant benefits.

The Commission should adopt a margin regime for Swap Dealers and Major Swap Participants that (a) allows for prudent extension of unsecured credit among Swap Dealers, Major Swap Participants and their counterparties; (b) preserves the ability of Swap Dealers, Major Swap Participants and their counterparties to enter into contractual arrangements that net exposures across all outstanding transactions in a trading relationship, including transactions that are not Swaps, when calculating margin requirements; and (c) requires delivery of margin only for net exposure that exceeds reasonable unsecured credit thresholds specified in agreements between Swap Dealers, Major Swap Participants and their counterparties.

To ensure that margin thresholds set by Swap Dealers and Major Swap Participants reflect prudent extension of unsecured credit, the Commission should adopt a threshold that puts a limit on the amount of unsecured credit permitted in one trading relationship.[2] This threshold should represent a significant percentage of a Swap Dealer or Major Swap Participant's regulatory capital, which would effectively prevent concentrated exposure to any single counterparty.

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[2] A trading relationship is typically between two distinct counterparties. However, in certain instances, a trading relationship may exist between one counterparty and a group of affiliated entities for credit purposes.

Swap transactions between affiliated entities should not be subject to capital or margin requirements. Swap transactions entered into between affiliates do not create credit exposure for the ultimate controlling entity. Therefore, the application of capital and margin requirements on such transactions will only serve to drain liquidity and productive capital from Swap Dealers and Major Swap Participants.

Consistent with Section 731 of the Act, the Commission's margin requirements also should allow for the use of a wide range of high quality non-cash collateral in order to alleviate any potential liquidity risk concerns for nonfinancial entities, such as commercial energy firms.

Given Congress's intent to not unduly burden end users of Swaps, the Commission, consistent with the rules recommended above, should not require either a Swap Dealer or Major Swap Participant or its counterparty to deliver margin when the counterparty is relying upon the "end-user exemption" from the clearing requirements. Margining practices in such circumstances should be left to negotiations between the parties to the transaction.

Finally, the credit terms of uncleared Swaps negotiated before the effective date of the rules implementing any margin requirements should be honored. The Commission should not retroactively impose mandatory margin requirements on such Swaps.

II. Comments of the Working Group.

A. General.

Section 731 of the Act adds a new Section 4s to the Commodity Exchange Act (the "CEA"). This new section of the CEA, among other things, mandates that the Commission promulgate regulations for the imposition of capital and margin requirements for registered non-bank Swap Dealers and registered non-bank Major Swap Participants. New CEA Section 4s(e)(3)(A) states that the capital and margin requirements are for the purpose of offsetting "the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared."[3] The capital and margin requirements must meet two standards under this new section. Each requirement must "help ensure the safety and

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[3] Congress did not identify exactly which Swaps present less risk than uncleared Swaps, but it is permissible to infer Congress was referring to cleared Swaps. The Working Group of Commercial Energy Firms maintains that central clearing does not necessarily result in less risk existing in the United States financial system, just a centralization of such risk.

soundness of the swap dealer or major swap participant" and "be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."[4]

In the aggregate, capital requirements and margin requirements for Swap Dealers and Major Swap Participants are closely-related mechanisms for managing systemic risk. Application under the CEA of both prudential requirements can ensure greater consistency of credit practices and help prevent a default of a Swap Dealer or Major Swap Participant from resulting in financial loss large enough to cause a material adverse event for the financial system of the United States.[5]

The Working Group makes the following initial observations regarding both capital and margin requirements.

- Effective design of capital and margin requirements begins with properly crafting capital standards. Capital requirements provide a buffer to absorb unexpected losses and effectively place limitations on the amount of leverage used by a firm. In this way, effective capital requirements limit the transfer of risk from one party to the next and to the entire financial system.[6] Thus, the Commission, when regulating Swap Dealers and Major Swap Participants, should first establish appropriate capital standards.

- Delivery of margin by one party to an uncleared Swap should reduce the requirements of one or both parties to maintain capital. Both capital and margin requirements provide a buffer to absorb of the default of a Swap Dealer or Major Swap Participant, regardless of whether the default is Swaps related. Requiring Swap Dealers and Major Swap Participants to hold two forms of credit support for the same transaction, without taking into account the interaction between the two, would impose unnecessary and potentially serious capital and liquidity constraints on Swap Dealers and Major Swap Participants.

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4 New CEA Section 4s(e)(3)(A).

5 The Working Group is not aware of any default in the energy trading markets that led to a material adverse event for the financial system of the United States. The imposition of the reasonable and sound capital and margin requirements that much of the energy industry already follows should not be burdensome for Swap Dealers, Major Swap Participants or commercial end users.

6 As seen in the recent financial crisis, U.S. taxpayers often ultimately absorb financial risk, and sometimes taxpayers incur large losses as a consequence.

- Margin requirements for uncleared Swaps are specific to the terms of each Swap and the counterparties to such transaction. The Commission (or any self regulatory organization) will not be capable of performing the nuanced, individual analysis required for every uncleared Swap and every counterparty. The counterparties to each Swap transaction are better able to effectively evaluate the credit risks associated with all of their transactions.

- 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 concerns or even crises at such firms. In the case of nonfinancial firms, such as commercial energy firms, liquidity risk might actually pose a greater risk to the larger United States financial system than credit risk. The permitted use of prudently extended unsecured credit and a wide range of high quality noncash collateral for margin requirements would mitigate potentially significant liquidity constraints imposed by mandatory capital and margin requirements.[7]

- In the uncleared Swap markets, while counterparties may specify collateral requirements for individual trades, counterparty credit risk is not generally measured or addressed on a trade-by-trade basis. Rather, firms evaluate counterparty credit risk based on financial information far beyond the terms of individual Swaps and in the context of an entire trading relationship between two counterparties.

Swap transactions are not cleared centrally for, at a minimum, two reasons under Section 723 of the Act. *First*, certain Swaps will not be cleared because they are not offered for clearing and the Commission has not determined that such Swaps must be cleared. *Second*, Swaps may not be cleared because a counterparty has availed itself of the exemption for central clearing for non-financial end-users. The Commission should recognize that each group of uncleared Swaps has a different risk profile.

B. CAPITAL.

1. CAPITAL REQUIREMENTS SHOULD BE TAILORED FOR COMMERCIAL ENERGY FIRMS THAT ARE DEEMED SWAP DEALERS OR MAJOR SWAP PARTICIPANTS.

[7] For a discussion of noncash collateral, please see Section II.C.6.

Establishing a tailored capital regime is the cornerstone for the Commission setting appropriate prudential regulations for non-bank Swap Dealers or non-bank Major Swap Participants. As mentioned above, capital requirements serve to limit the transfer of risk from one party to another party or to the financial system of the United States. A tailored or efficient capital regime achieves this purpose but also addresses the unique characteristics of the traders to which capital requirements are applied, the customs of the markets in which they operate and the nature of the derivatives that they trade.

Capital requirements need not be uniform for all Swap Dealers and Major Swap Participants. The Commission might promulgate several capital requirements, each one appropriate to a class of firms or persons. This would allow the Commission to comply with Congress' instruction that capital requirements be "appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."[8] A person primarily engaged in the production, refining, transportation, marketing, storage or delivery of physical energy commodities (each, a "Commercial Energy Firm") that is deemed a Swap Dealer or Major Swap Participant, for example, will have a balance sheet that is quite different from that of an investment bank. Instead of mostly financial assets, Commercial Energy Firms' balance sheets are often dominated by fixed assets and have a lower degree of leverage. Valuable fixed assets and low leverage often make the Commercial Energy Firm particularly creditworthy. Moreover, such a Commercial Energy Firm will have fewer highly liquid financial assets on its balance sheet relative to a financial institution, while still being highly creditworthy due to its ability to generate cash flow over time through its non-financial assets.

Commercial Energy Firms that are regulated as Swap Dealers or Major Swap Participants should be permitted to include their direct or indirect ownership or control of fixed assets and their physical commodity assets (*e.g.,* natural gas in storage or proven reserves) in the calculation of net capital when satisfying any capital requirements established by the Commission. They also should be permitted to satisfy capital requirements with parental guarantees or other forms of credit support provided by affiliates. If the Commission were to require such persons to meet the capital requirements only with highly liquid assets, the capital requirements would be overly restrictive and burdensome. As possible consequences, such Commercial Energy Firms may be forced to (a) accept more commercial risk as they are effectively prohibited from hedging commercial risks or (b) allocate liquid assets away from other objectives, like improving energy infrastructure or hiring additional personnel.

For the purposes of capital regulation, the Commission should adopt a comprehensive view of a person's business as intended by Congress. New CEA Section 4s(e)(2)(C) instructs

[8] New CEA Section 4s(e)(3)(A)(ii).

the Commission, in setting capital requirements for a Swap Dealer or Major Swap Participant to "take into account the risks associated with other types of swaps … and the other activities conducted by that person that are not otherwise subject to regulation . . . by virtue of the status of the person as a swap dealer or major swap participant."[9]

Consistent with the Commission's traditional principles-based approach, capital requirements should be applied to the capital base associated with the trading entity. Such an approach will allow the Commission to regulate the appropriate entity, whether it be a holding company, legal entity or discrete business unit. A principles-based approach will empower each regulated person to most efficiently structure their entity given its unique corporate structure and its other commercial and regulatory needs.

2. PROPOSED CAPITAL REQUIREMENTS FOR COMMERCIAL ENERGY FIRMS DEEMED SWAP DEALERS OR MAJOR SWAP PARTICIPANTS.

Capital requirements for Swap Dealers and Major Swap Participants,[10] similar to the capital requirement for futures commission merchants ("FCMs"), broker-dealers, and banks, should assure that losses arising from a firm's Risk Exposure would be covered by capital and not impede the firm's ability to pay its liabilities as they come due.[11] For the purposes of this section, the Working Group proposes to define "Risk Exposure" as the aggregate counterparty credit exposure borne by the Swap Dealer (or Major Swap Participant) arising from non-affiliated counterparties on non-cleared Swaps after reflecting the effects of netting as provided for in any master agreement for each such counterparty and the value of any collateral held by the Swap Dealer (or Major Swap Participant).

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9 New CEA Section 4s(e) clearly states that margin requirements apply to uncleared Swaps. However, it is not certain that the capital requirements are similarly limited only to uncleared Swaps. New CEA Section 4s(e)(3), however, suggests that the purpose of such capital standards is to offset the risk of uncleared Swaps. On this basis, the Working Group concludes that the capital requirements do not apply to cleared Swaps. This interpretation recognizes that, with respect to cleared Swaps, systemic risk concerns with respect to a firm's default are likely mitigated by the margin requirement of the designated clearing organization ("DCO"), the capital requirements established by the DCO for its members, the DCO's guarantee funds, the DCO's assessment authority and other sources of funds available to the DCO.

10 As discussed in other comments submitted to the Commission by the Working Group, Major Swap Participants are, in essence, large, active traders. Thus, they do not play the same intermediary role as Swap Dealers. Capital requirements for Major Swap Participants may be less about mandating a buffer to absorb losses, but rather a limitation on unsecured leverage.

11 Capital requirements create a buffer to limit the impact of a default of a counterparty on a Swap Dealer or Major Swap Participant. With such a buffer in place, should a counterparty to a Swap Dealer or Major Swap Participant default on a Swap, that default should not cause the Swap Dealer or Major Swap Participant to be unable to perform on Swaps with its other counterparties.

The Working Group recommends that the Commission establish a capital standard for Commercial Energy Firms that are deemed Swap Dealers or Major Swap Participants that requires each Commercial Energy Firm regulated as a Swap Dealer or Major Swap Participant to maintain regulatory capital in an amount equal to a significant percentage of its Risk Exposure.[12] A capital charge should not be assessed to the extent that the counterparty credit exposure of an uncleared Swap is secured by the delivery of collateral or if a Swap is centrally cleared.[13] To the extent that the market value of an uncleared Swap is secured by the delivery of collateral, or if a Swap is centrally cleared, there should be little risk that a counterparty would be financially affected by the default of a Swap Dealer or Major Swap Participant (regardless of whether or not such default was triggered by the default of another counterparty).

Commercial Energy Firms, as discussed above, often have fixed assets that make them extremely credit worthy counterparties despite having smaller amounts of liquid financial assets as compared to financial institutions. Thus, the Working Group suggests that "regulatory capital" include such fixed assets when applying capital standards on a Commercial Energy Firm that is a Swap Dealer or a Major Swap Participant.

The Working Group suggests that the Commission define "regulatory capital" in a manner that gives credit for guarantees and other credit support arrangements provided to a Swap Dealer or Major Swap Participant by its corporate parent or other of its affiliates. Such an approach to the consideration of affiliate credit support would be consistent with the Commission's treatment of other classes of entities under the CEA. For example, the definition of "Eligible Contract Participant" in new CEA Section 1a(18) includes any entity "the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement" by an entity that is an Eligible Contract Participant.

Uncleared Swaps between affiliated entities[14] should not be subject to a capital charge. There is no systemic risk presented by an affiliate transaction. In such a transaction, the net

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[12] For example, FCMs are required to maintain regulatory capital in an amount equal to or greater than 8% of the net aggregate unsecured market value of the noncustomer positions they carry.

[13] As discussed below in Section III.C.2, when making a determination of whether an uncleared Swap (including any master agreement) is secured, the Commission should look to the terms of the uncleared Swap and any related transaction in physical energy commodities.

[14] Section 2 of the Act sets forth the following definition of "affiliate:" "The term 'affiliate' has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)." Section 3 of the Federal Deposit Insurance Act defines affiliate as "having the meaning given to such term in section 1841(k) of this

risk posed to the larger corporate family by the uncleared Swap is zero, so a Swap Dealer or Major Swap Participant should not be required to retain capital with respect to such an uncleared Swap.

The proposed capital standard meets Congress's express requirements that any capital requirements imposed under new CEA Section 4s both "help ensure the safety and soundness of the swap dealer or major swap participant" and "be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."

The Working Group has attached as Schedule A an approach for the calculation of Risk Exposure and "regulatory capital" for a commercial firm that happens to be a Swap Dealer or Major Swap Participant. The model accounts for the distinct differences between commercial firms and financial firms. The model's calculation of "regulatory capital" and Risk Exposure considers fundamental value of fixed assets and parental guarantees and incorporates the benefits of netting.[15] The suggested model is also consistent with the prudent credit practices and master agreements used in energy-based Swap markets, which will allow for a smoother transition to this capital regime if adopted by the Commission for market participants that become regulated as Swap Dealers or Major Swap Participants. For example, the model's treatment of Independent Amounts[16] is consistent with the treatment of Independent Amounts under the Credit Support Annex to the ISDA Master Agreement. The model accounts for Independent Amounts to the extent that they are not collateralized and does not "net" out Independent Amounts that are liabilities. This is a conservative approach that is consistent with prudent credit practices.

The Working Group's suggested model is not inherently tied to a specific set of generally accepted accounting principles or accounting standard. Any capital regime adopted by the Commission should accommodate market participants whose financial statements are reported under United States Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). Stated another way, a firm's regulatory balance sheet should not be entirely dependent on its financial balance sheet.

Finally, the Working Group recommends that the Commission adopt a threshold level for Risk Exposure below which a Swap Dealer is not subject to a "regulatory capital"

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title." Section 1841(k) defines affiliate as "any company that controls, is controlled by, or is under common control with another company."

15 For a discussion of netting see Section II.C.3.

16 Independent Amount is analogous, though not equivalent to, the concept of initial margin in cleared markets.

requirement. If the Commission adopts a broad definition of "Swap Dealer," then commercial firms that engage in activities that the Commission might deem to be Swap dealing, but do so as an ancillary though necessary part of their business might be Swap Dealers. Such commercial firms are typically engaging in transactions essential to their commercial operations and are not taking large derivatives positions and are not financial intermediaries. As such, they are minor Swap Dealers and do not pose a risk to the U.S. financial system and, therefore, should not be subject to mandatory capital requirements.[17]

C. Margin.

New CEA Section 4s(e)(2)(B) requires the Commission to adopt rules for non-bank Swap Dealers and non-bank Major Swap Participants that impose both initial and variation margin requirements on all uncleared Swaps. These margin requirements must "help ensure the safety and soundness of the Swap Dealer or Major Swap Participant."[18] The Working Group recommends that the Commission impose margin requirements that are complimentary to and integrate seamlessly with the capital requirements for uncleared Swaps. This integration will assure that the capital and margin requirements are properly tailored and not overly burdensome with redundant risk mitigation measures.

1. Credit Practices in Uncleared Energy-Based Swap Markets.

In uncleared energy-based Swap markets, credit practices differ from those used in the futures markets or by central clearing organizations. Credit practices used in futures markets and by central clearing organizations generally treat the credit risk of market participants the same and seek to eliminate such risk. In uncleared energy-based Swap markets, principles-based credit practices are used to address the risks inherent in the Swap transaction and the credit and other risks associated with a particular counterparty are minimized and allocated to a specific counterparty rather than eliminated altogether. Counterparty credit risk is a unique feature in every uncleared Swap transaction. How such risk is addressed may be the sole unique feature in an otherwise "standard" uncleared Swap transaction.

The current credit practices in uncleared energy-based Swap markets have functioned well. While there have been a number of high profile bankruptcies of energy firms that engaged in substantial levels of trading in energy commodities and energy-based derivatives, the defaults related to the trading of energy commodities did not translate into a substantial threat to the United States financial system or even the energy sector.

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17 Such treatment is consistent with the treatment of banks regulated by [-] with less than [-] in assets.

18 New CEA Section 4s(e)(3)(C).

In uncleared energy-based Swap markets, there are three principal methods through which parties address counterparty credit risk. The first method of addressing counterparty credit risk is the use of an unsecured credit threshold. For reasons that include the reduction of administrative costs and burdens, counterparties often agree that some degree of unsecured credit for one or both parties is appropriate. After mutual performance of thorough due diligence on the credit worthiness of the each party, counterparties often agree that some degree of unsecured credit for one or both parties is appropriate. The principles-based approach used with such due diligence includes, among other things, the review and analysis of numerous types of credit-related financial information, including, but not limited to current debt levels and maturation schedules, available liquidity, expected level of transaction activity (including term), as well as potential market value volatility and regulatory stability. Other factors that may be considered in determining a credit threshold are the credit support, if any, supplied by a counterparty's corporate family and netting arrangements.

The second method is the widely used practice of using master agreements, which have evolved and matured over the past 15 years and include multiple risk reducing mechanisms. Such agreements allow for multi-transaction netting across a trading relationship, including both financial and physical transactions, and were designed to work in tandem with bankruptcy law. Such netting eliminates the possibility of a solvent counterparty owing full value on "out of the money" transactions while receiving fractional or no value on "in the money" transactions with an insolvent counterparty.

The third method of addressing counterparty credit risk in uncleared energy-based Swap markets is the delivery of collateral representing only the net exposure of one party to the other in excess of that party's unsecured credit threshold. Counterparties exchange payments based on changes in credit exposure to each other that result from fluctuations in the market value of outstanding transactions, including Swaps. Under master trading agreements, uncleared energy-based Swaps are marked-to-market and these payments are exchanged as frequently as daily. This is not called "variation margin" in uncleared energy-based Swap markets, but is similar in concept.

2. THE COMMISSION IS NOT WELL EQUIPPED TO SET MARGIN WITH RESPECT TO UNCLEARED SWAPS.

Under new CEA Section 4s(e)(3)(A)(ii), the Commission was given the unenviable task of trying to set margin requirements that are "appropriate for the risk associated" with individual uncleared Swaps in markets where transactions range from "plain-vanilla" and general to extremely customized and complex. To set truly appropriate margin levels for such a wide variety of uncleared Swaps, the Commission would either need to delve into the details of each uncleared Swap, or small group of uncleared Swaps, and face an unmanageable administrative burden or provide market participants with well reasoned parameters and allow them to determine the appropriate amount of margin given the unique credit relationship between counterparties and the structure of the related uncleared Swap.

In practice, the application of margin requirements on individual uncleared Swaps by the Commission would raise a multitude of implementation issues that would make such requirements unworkable. *First*, to set appropriate margin requirements for every individual uncleared Swap, the Commission would be required to make counterparty credit determinations on innumerable individual transactions, as well as determinations as to the price and volatility of unique and complex instruments. *Second*, parties would likely need to seek Commission input or approval before consummating an uncleared Swap to ensure that the margin provisions complied with what the Commission deemed appropriate. *Third*, parties to uncleared Swaps subject to the Commission margin requirements, potentially including, Commercial Energy Firms and other derivatives end users, likely would have to make significant changes to their information technology systems to accommodate the Commissions margin protocols. *Fourth*, the Commission would have to have the analytical capacity to supply periodic "risk arrays," as frequently as daily, on customized uncleared Swaps to allow counterparties to mark their uncleared Swaps to market.

If the margin paradigm imposed on Swap Dealers and Major Swap Participants is too rigid, there will likely be serious consequences for the health and stability of the United States financial system. The imposition of credit terms that are too rigid and conservative will require market participants to either (a) use unnecessarily large amounts of productive capital that could be used to invest in their underlying business to secure their credit relationships when entering into uncleared Swaps, or (b) limit their use of uncleared Swaps to a degree that essential commercial functions, such as hedging and price discovery, will be unnecessarily limited and valuable liquidity will be drained from uncleared Swap markets.

If the Commission promulgates margin rules requiring specific margin terms for individual uncleared Swaps, parties will be obligated to adhere to the mandated margin requirements for each individual transaction, regardless of the net position between counterparties across their credit relationship. The end result will be to effectively undermine the ability to engage in multi-transaction netting, the benefits of which to energy markets and ultimately energy consumers are discussed below in Section III.C.3.

3. MARGIN PARADIGM MUST ALLOW MARKET PARTICIPANTS A DEGREE OF FLEXIBILITY.

If uncleared Swap markets are to continue to function efficiently under the new regulatory paradigm set forth under Title VII of the Act, market participants must be given a reasonable and necessary degree of flexibility in structuring their credit relationships. The Working Group's recommended approach below would allow the Commission and other regulators to mitigate risk to the financial system of the United States in an efficient manner that does not needlessly remove capital from productive uses and is not costly to United States taxpayers.

The Working Group respectfully proposes that the Commission, in promulgating margin rules under Section 731 of the Act with respect to uncleared Swap transactions (a) allows for prudent extension of unsecured credit among Swap Dealers, Major Swap Participants and their counterparties; (b) preserves the ability of Swap Dealers, Major Swap Participants and their counterparties to enter into contractual arrangements that net exposures across all outstanding transactions in a trading relationship, including transactions that are not Swaps, when calculating margin requirements; and (c) only requires delivery of margin for net exposure that exceeds reasonable thresholds specified in agreements between Swap Dealers, Major Swap Participants, and their counterparties. This approach is consistent with Congressional intent because it allows the Commission to establish margin requirements for Swap Dealers and Major Swap Participants without imposing costly and burdensome restrictions on the use of credit.

Margin rules adopted by the Commission should allow counterparties to consider their entire trading relationship when determining appropriate margin levels and allow them to net obligations across all outstanding transactions, including transactions in physical energy commodities and other transactions in commodities, between the two counterparties. Consideration of the entire trading relationship between two counterparties by the Commission is essential if margin rules are to "be appropriate for the risk associated with non-cleared swaps."[19]

Specifically, margin regulations should recognize and account for the benefits of multi-transaction netting agreements entered into by Commercial Energy Firms that cover entire trading relationships, not just uncleared energy-based Swaps. It is common practice for Commercial Energy Firms to enter into a transaction for a physical energy commodity and then enter into a related uncleared energy-based Swap transaction with the same counterparty as a risk mitigation tool. Any multi-transaction netting agreement between the two counterparties will typically net obligations under both the physical energy transaction and the uncleared energy-based Swap. Multi-transaction netting agreements allow counterparties to transfer only the net amount due between the two parties. Without such a netting agreement, a counterparty who is net "in the money" across an entire credit relationship would be required to make payments or transfer collateral on the individual transactions in which it was "out of the money" regardless of the fact that it is owed money or collateral by the other counterparty. Trades in physical energy commodities and uncleared energy-based Swaps are often

[19] New CEA Section 4s(e)(3)(A).

inextricably linked, and counterparties should be able to consider their entire trading relationship when agreeing upon appropriate margin levels and when netting obligations. These arrangements provide a platform for counterparties to enter into or expand trading relationships in a commercially prudent manner.

As noted above, multi-transaction netting agreements reduce counterparty credit risk because they allow parties to avoid one of the perverse consequences of bankruptcy. If the bankrupt counterparty is net "out of the money" across a trading relationship, they still have the right to collect any amount due on individual transactions while having no obligation to make payments owed. These netting agreements allow counterparties to adapt the structure of their trading relationship to reduce liquidity constraints in the event either counterparty becomes liquidity constrained. If counterparties were required to exchange margin on a transaction by transaction basis the flexibility of multi-transaction netting would be lost and the likelihood of an entity becoming liquidity constrained would be greatly increased.

The importance of multi-transactional netting agreements is recognized under the federal bankruptcy code. Section 561 of the bankruptcy code provides that a party to a multi-transactional netting agreement, upon the filing of a bankruptcy petition for the counterparty, can terminate all trading transactions, net the resulting close-out amounts and set-off against collateral held by such party. Importantly, Section 561 allows the terminating party to take these actions without violating the automatic stay or being subject to avoidance powers or other limitations under the bankruptcy code and is a critical component of modern credit practice. It permits a party to evaluate counterparty risks apart from concerns that (a) the bankruptcy trustee might cherry-pick only the trades favorable to the debtor and (b) that enforcement will be delayed or even thwarted in a bankruptcy proceeding.

Importantly, multi-transactional netting agreements, as supported by Section 561 of the bankruptcy code, also provide useful risk mitigation tools *prior* to bankruptcy. In fact, these tools often help keep firms from becoming insolvent. Counterparties can do many things to address a large swing in mark-to-market exposure, not all of which have the same liquidity implications of posting or terminating transactions. For example, they can structure other Swap transactions that will reduce the overall net exposure between the parties. Often, such mitigation trades are done with other commodities or products. It is the knowledge that the multi-transactional netting agreement is enforceable that provides a party with necessary legal and credit comfort to take affirmative action to help its financially troubled counterparty. Otherwise, the party's only incentive is to quickly terminate the trade and foreclose on collateral, thus hastening the demise of the counterparty. From a systemic risk perspective, the flexibility provided by netting lowers the probability of a contagious spread of losses.

4. RECOMMENDED UNSECURED CREDIT THRESHOLD.

The Commission should set a maximum unsecured credit threshold that a Swap Dealer or Major Swap Participant could extend to any single trading relationship. That level should be set at a substantial percentage[20] of a Swap Dealer or Major Swap Participant's regulatory capital. Setting an unsecured credit threshold as a percentage of an entity's regulatory capital will prevent a Swap Dealer or Major Swap Participant from being overly exposed to one counterparty. The combination of a limit on a Swap Dealer's or Major Swap Participant's exposure to any particular counterparty and a requirement to reserve capital for the use of unsecured credit should result in a sound use of unsecured credit by Swap Dealers and Major Swap Participants, while providing adequate flexibility for structuring their counterparty credit relationships.

The Act does not preclude the use of a credit threshold. It requires Swap Dealers and Major Swap Participants to meet "minimum initial and variation margin requirements"[21] with such margin requirements set, as mentioned above, "[to] help ensure the safety and soundness of the swap dealer or major swap participant" and "[to] be appropriate for the risk associated with non-cleared swaps held as a swap dealer or major swap participant."[22] These requirements do not prevent the Commission from adopting a credit threshold. As discussed throughout this letter, adopting a credit threshold might, in many cases, help ensure the "safety and soundness" of a Swap Dealer or Major Swap Participant and might be "appropriate for the risk associated" with a given uncleared Swap.

A maximum unsecured credit threshold that is a substantial percentage of a Swap Dealer or Major Swap Participant's regulatory capital for each trading relationship is consistent with predominant credit best practices in the uncleared energy-based Swap markets. The combination of this suggested concentration limit with the capital regime proposed in Section III.B.2 is conceptually equivalent to the regulatory system for national banks.[23] Counterparty credit risk concentration concerns are addressed by concentration

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[20] For example, a national bank is subject to lending limits that generally limit a national bank's unsecured loan exposure to one entity to 15% of the bank's capital and surplus. Capital and surplus is defined to include the bank's Tier 1 and Tier 2 capital plus the balance of the bank's allowance for loan and lease losses not included in the bank's Tier 2 capital. *See* 12 C.F.R. 32.2 and 32.3.

Also, Section 165(e) of Dodd-Frank imposes a 25% credit exposure concentration limit on systemically important nonbank financial companies regulated by the Federal Reserve.

[21] New CEA Section 4s(e).

[22] New CEA Section 4s(e)(3)(A).

[23] *See* note 20 *supra*.

limits and overall leverage concerns are addressed by the requirement that regulatory capital be retained for any use of unsecured credit.

A maximum unsecured credit threshold that is a substantial percentage of a Swap Dealer or Major Swap Participant's regulatory capital for each trading relationship would allow the Commission to impose both initial and variation margin requirements on Swap Dealers and Major Swap Participants without imposing an undue burden on both market participants and the Commission. The Working Group suggests the Commission adopt a principles-based approach to both margin requirements and require Swap Dealers, Major Swap Participants, and their counterparties to agree on reasonable initial margin requirements, which could be zero or greater, based on potential future exposure between the counterparties and reasonable variation margin requirements based on current exposure between the counterparties.[24] Swap Dealers, Major Swap Participants, and their counterparties should be permitted to apply both any initial margin requirement and any variation margin requirement against an unsecured credit threshold. In other words, a counterparty should be permitted to apply their combined margin requirement to an unsecured credit threshold to determine if a transfer of collateral between counterparties is necessary. Such an approach is consistent with the standard master agreement used for most derivatives transactions and would provide needed continuity to market participants. The Credit Support Annex to the ISDA Master Agreement's formula for the determination of whether a collateral transfer is required between counterparties requires each counterparty to account for both any required Independent Amount (initial margin) and any mark-to-market exposure between counterparties. When the mark-to-market exposure added to the unpaid Independent Amount, if any, exceeds the unsecured credit threshold agreed upon by the parties (with such threshold being less than the maximum unsecured credit threshold set by the Commission), the parties must provide sufficient security to get back beneath the threshold.

Even if the Commission establishes a maximum unsecured credit threshold, market participants likely will offer credit terms that are more restrictive than the maximum threshold for almost all of their trading relationships. The terms of any credit threshold are carefully negotiated between counterparties and are a function of the credit worthiness of the party to which it is applied. The maximum threshold should be seen by the Commission as the maximum permissible amount of Swaps-related credit exposure between two large and very credit worthy institutions.

Finally, if the Commission elects to adopt a margin regime different from the one suggested by the Working Group, it should not impose a cap on the aggregate amount of unsecured credit a Swap Dealer or Major Swap Participant may have across all of its trading

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[24] For example, the Commission could require margin requirements be set based on [-].

relationships. To do so would be arbitrary and unnecessarily restrictive. The proper method to address concerns with a Swap Dealer or Major Swap Participant's level of unsecured credit in its trading relationships is through capital requirements. The Working Group's suggested capital requirement paradigm, discussed above in Section III.B.2, would require a Swap Dealer or Major Swap Participant to retain capital if they choose to enter into trading relationships that allow for the use of unsecured credit.

5. NO MARGIN REQUIREMENTS FOR UNCLEARED SWAPS WHERE A PARTY IS RELYING UPON THE "END-USER EXEMPTION" FROM CLEARING.

The rules adopted by the Commission imposing margin requirements on Swap Dealers and Major Swap Participants should be structured in a way that do not impose a *de facto* mandatory margin requirement on commercial end users of derivatives, such as Commercial Energy Firms, that enter into uncleared Swaps to hedge their unique commercial risk. Such an approach would be consistent with the intent of Congress. Senators Dodd and Lincoln clearly stated:

> "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."[25]

Inflexible margin requirements imposed on Swap Dealers and Major Swap Participants will likely force such entities to pass on the costs of such margin requirements to commercial end users of derivatives, such as Commercial Energy Firms, as part of the cost of entering into a Swap. Such costs would likely force commercial end users of derivatives to choose between using inordinate amounts of productive capital to hedge their commercial risk and unnecessarily limit their hedging and risk management or investments in their businesses.

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[25] *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.

The Working Group respectfully requests that the Commission not impose margin requirements on a Swap Dealer or a Major Swap Participant when facing an "end user" that is relying on the exemption from the central clearing requirement for hedging transactions. Arguably, Congress created the "end-user exception" from the clearing requirements in recognition of the lack of systemic risk inherent in hedging transactions. When a hedge is "out-of-the-money," the underlying commodity is "in-the-money" and vice-versa. As no material systemic risk exists for such uncleared Swaps, there is no need for the risk mitigation tools of capital and margin requirements.

6. THE PERMITTED USE OF NONCASH COLLATERAL SHOULD REFLECT CURRENT PRUDENT MARKET PRACTICES.

The Act requires the Commission to "permit the use of noncash collateral, as…the Commission determines to be consistent with preserving the financial integrity of markets trading Swaps and preserving the stability of the United States financial system."[26] 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 mandates that regulators permit the use of noncash collateral."[27]

Any margin requirements set by the Commission should be consistent with the Act and allow such requirements to be satisfied by the delivery of many forms of high quality, liquid collateral, such as letters of credit and liens and offset rights for other trading relationships. The use of high quality noncash collateral would allow commercial end users, such as Commercial Energy Firms, as well as Swap Dealers and Major Swap Participants to use Swaps 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 already proven to be a successful means of managing credit risk and should not be unnecessarily disrupted.

7. TRANSACTIONS BETWEEN AFFILIATES SHOULD NOT BE SUBJECT TO MARGIN REQUIREMENTS.

Any margin requirements promulgated by the Commission under Section 731 of the Act should not apply to Swaps entered into between a Swap Dealer or Major Swap Participant and its affiliates. Transactions between two affiliated entities result in the same corporate family taking both sides of the Swap. The corporate family's net credit exposure from the

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[26] New CEA Section 4s(e)(3)(C).

[27] *See* Dodd Lincoln letter, *supra* note 25.

trade is zero. Given that the net credit exposure is zero, the imposition of margin requirements would not serve a credit mitigation function and would only divert capital from other productive uses. Therefore, any transaction between affiliated entities should not be subject to the Working Group's recommended unsecured credit concentration limitation.

8. Margin Requirements Should Not be Applied Retroactively.

Any new margin requirements imposed by the Commission under Section 731 of the Act should only be applied to Swaps entered into after the associated final rule becomes effective. This approach abates several legal issues regarding the application of new laws to existing privately negotiated contracts. Furthermore, this approach avoids the considerable cost to the Commission of having to determine the appropriate level of margin for contracts negotiated in the absence of mandatory margin requirements and the considerable cost to market participants who would be forced to renegotiate the terms of existing credit relationships and existing Swaps.[28] Finally, such an approach would be consistent with recent Congressional testimony given by both Chairman Gensler and Chairman Shapiro stating that the new margin requirements should only apply prospectively[29] and with statements made by Commissioner O'Malia remarking that "any rule or regulation designed to [apply margin requirements to existing contracts] would be of questionable legality and an extremely unwise policy decision."[30]

D. Economic Costs and Risks of Excessively Rigid Margin and Capital Requirements.

The Commission could substantially disrupt well-functioning energy markets if it imposes rigid capital and margin requirements on non-bank Swap Dealers and non-bank Major Swap Participants in such markets. These markets are intimately connected with the lives of every person in the United States, all of whom are energy consumers. Thus, the

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[28] To efficiently manage their Swaps portfolios, which will include existing and new Swaps, Swap Dealers and Major Swap Participants likely will conform the margin paradigms of some of their existing Swaps to the margin requirements adopted by the Commission. However, such a decision should be left to market participants.

[29] *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act Before the Senate Committee on Banking, Housing, and Urban Affairs,* 111th Cong. (2010) (response by Chairman Gensler and Chairman Shapiro to question posed by Senator Johanns).

[30] *CFTC Public Meeting on Governance, Financial Resources, Interim Final Rule: Pre-Enactment Swaps,* October 1, 2010 (opening statement of Commissioner Scott D. O'Malia).

Commission should evaluate the costs and benefits associated with its regime for capital and margin requirements.

The evaluation of costs and benefits should be robust and contain objective quantitative analysis. It should address both micro- and macro-economic effects. For example, the Commission should look at both the liquidity impact and capital restraint that result from capital and margin requirements. It also should address the impact of such requirements on such concepts as monetary supply. In particular, the Commission's analysis should determine the impact of capital and margin requirements on the U.S. jobs market.

The Commission should make an affirmative finding that the benefits of the capital and margin requirements for non-bank Swap Dealers and non-bank Major Swap Participants exceed the costs of such requirements on each Swap market and the broader U.S. economy. The Commission should not interpret the Act as a finding of Congress that the benefits outweigh the costs. While Congress authorized the Commission to impose such capital and margin requirements, it relied on the Commission to supply the details of such requirements. As the economic impact of the capital and margin requirements flow directly from such details, Congress's instruction cannot be characterized as a finding as to relative costs and benefits.

The Commission should not interpret Section 15(a) of the Commodity Exchange Act to relieve the Commission of having to find that benefits outweigh the costs associated with its capital and margin requirements for non-bank Swap Dealers and non-bank Major Swap Participants. The Working Group agrees that CEA Section 15(a) does not affirmatively require such a finding, rather that the Commission simply "consider the costs and benefits of the action of the Commission."[31] However, given the potentially enormous impact to financial system of the United States, the Commission should provide all stakeholders, including U.S. taxpayers, the benefit of confidence that it is crafting efficient regulation.

The Commission, in conducting its analysis of costs and benefits under CEA Section 15(a) with respect to capital and margin requirements for non-bank Swap Dealers and non-bank Major Swap Participants, should provide extensive analysis to each of the criteria of CEA Section 15(b).[32] In conducting any cost benefit analysis, the Commission should evaluate the costs against other productive uses for the capital and the Commission's policy obligations. For example, when analyzing the potential impact to the energy industry of any

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[31] 17 USC 19(a)

[32] These criteria are: (A) protection of market participants and the public; (B) the efficiency, competitiveness and financial integrity of futures markets; (C) price discovery; (D) sound risk management practices; and (D) other public interest considerations. 15 U.S.C. 19(b).

proposed capital and margin requirements, the Commission could, using data sources like the ISDA Margin Survey or information from the Bank for International Settlements, estimate the additional amount of margin and capital that energy market participants will be required to post and retain with regards to outstanding energy Swaps. Assuming that market participants could fund any margin and capital requirements by drawing on lines of credit, the Commission could then estimate the total cost of such margin and capital requirements by estimating the carrying cost of such debt. The Commission may then compare the cost estimate to the cost of potential job creating investments, such as new wind farms. The Commission could then also analyze the potential multiplier effects of removing from the U.S. economy the estimated amount of productive capital required to fund new margin and capital requirements.

The Working Group believes that its suggestions with respect to capital and margin requirements for non-bank Swap Dealers and non-bank Major Swap Participants, achieves a proper balance between costs and benefits for U.S. energy markets and the traders in those markets. If the Commission were to adopt these proposals, the analysis under CEA Section 15(a) should be much easier as the proposals draw on existing concepts in today's energy markets and the broader financial system. As a consequence, the Commission would not be required to make large extrapolations about the foreseeable consequences of changes to the market stemming from the capital and margin requirements for non-bank Swap Dealers and non-bank Major Swap Participants.

E. OPEN COMMENT PERIOD.

Given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commission to better understand how their proposed rules will impact Swap markets.

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 Commission 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 Commission in implementing the Act. Please let us know if you have any questions or would like additional information.

Respectfully submitted,

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APPENDIX A

Appendix A

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4	a.
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6	b.
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8	c.
9	d.
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21	h.
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23	i.
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25	j.
26	
27	k.
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29	l.
30	m.
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35	**Consistent with SEC Rule 15c3-1 for broker-dealers, Net Counterparty Risk Exposure cannot exceed a multiple of Regulatory Capital.**
36	
37	**Unsecured credit (i.e. Collateral Threshold) for an individual counterparty cannot exceed a specified percentage of Regulatory Capital.**

Appendix A

	B	C	D	E
1				
2	**Calculation of Regulatory Capital**			
3				
4	Common Shareholder or Member Equity			
5				
6	-	Goodwill and Intangibles		
7				
8	+	Equity Credit for Parent Guarantees of Swaps		
9	+	Equity Credit for Parent Guarantees of Long-term Debt		
10	+	Equity Credit for Parent Guarantees of other Liabilities		
11	+	Equity Credit for Subordinated Intercompany Debt		
12				
13	+	Preferred Stock and other Hybrid Securities		
14				
15	**Regulatory Capital**			
16				
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18				
19	**Calculation of Risk Exposure**			
20				
21	Aggregate value of non-cleared swaps with positive fair value			
22				
23	-	Master netting impacts (off-sets to line h.)		
24				
25	+	Other swap counterparty exposures		
26				
27	+	Counterparty "Independent Amount" Requirement		
28				
29	-	Counterparty collateral reflected on balance sheet		
30	-	Non-cash collateral provided by counterparties		
31				
32	**Net Counterparty Risk Exposure**			
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Appendix A

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13	0% to 100% of balance sheet amount based on structural characteristics.
14	
15	Replacement for "Net Capital" used in SEC Rule 15c3-1 for Broker-Dealers
16	
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21	Report all swaps with positive fair value, regardless of balance sheet classification
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23	Include swaps with negative fair value and all other off-setting swap and non-swap exposures as applicble
24	
25	Include non-swap exposures under master agreements governing swaps to the extent that aggregate counterparty exposure is greater than zero.
26	
27	Include any applicable "Independent Amount" for swap counterparties with aggregate exposure greater than zero.
28	
29	Report any applicable amount not already included as an off-set to values reported on lines h. or j.
30	Report any applicable amount that off-sets amounts reported on lines h. or j.
31	
32	Replacement for "Aggregate Indebtedness" used in SEC Rule 15c3-1 for Broker-Dealers
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