July 11, 2011

VIA ELECTRONIC SUBMISSION

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Farm Credit Administration
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Re: Comments on the Proposed Rule on Margin and Capital Requirements for Covered Swap Entities (RIN 1557-AD43, 7100-AD74, 3064-AD79, 3052-AC69, 2590-AA45)

Dear All:

The Edison Electric Institute ("EEI"), the Electric Power Supply Association ("EPSA"), the National Rural Electric Cooperative Association ("NRECA"), the American Public Power Association ("APPA"), and the Large Public Power Council ("LPPC") (hereafter "Joint Associations")[1] respectfully submit these comments in response to the proposed rule ("Proposed Rule") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration (collectively, the "Prudential Regulators")

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1 The comments contained in this filing represent the position of the Joint Associations, but not necessarily the views of any particular member of the Joint Associations with respect to any issue. The Joint Associations are authorized to note the involvement and support of these comments and recommendations from the Transmission Access Policy Study Group (an association of transmission dependent electric utilities located in more than 30 states), ACES Power Marketing, and The Energy Authority.

regarding capital and margin requirements for swap dealers and major swap participants ("MSPs").[2] The Joint Associations have been active participants in the many aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") implementation process and welcome the opportunity to continue to discuss commercial end user-related issues with the Prudential Regulators and their staffs.[3]

The Dodd-Frank Act reflects Congress' intent to provide commercial end users with broad exemptions from the new registration and clearing requirements of the Commodity Exchange Act, as amended ("CEA") applicable to swaps and certain participants in the swap markets. Accordingly, the Joint Associations respectfully submit that in implementing the requirements of the Dodd-Frank Act the Prudential Regulators should ensure that the end user clearing exception will serve as a cost-effective and commercially practical means for end users to continue to use swaps to hedge or mitigate commercial risk. In particular, the Prudential Regulators should, consistent with Congress' intent, allow commercial end users to negotiate the terms of their swaps free from *any* mandatory minimum margin rules (including prescribed credits thresholds, exposure calculations, or collateral valuations requirements), collateral restrictions, or other documentation requirements.

Although the text of the Proposed Rule appears to focus only on "the credit risk posed by the counterparty and the risk of such swaps" (*i.e.*, the credit risk associated with the swaps between the swap dealer or MSP and its counterparty),[4] the Joint Associations understand that the Prudential Regulators intend to require swap dealers and MSPs to consider imposing margin requirements on commercial end user transactions only when the exposure associated with a particular bilateral relationship, measured on an enterprise-wide basis (*i.e.*, including loans, letters of credit, revolving credit arrangements and other extensions of credit, in addition to swap exposure), exceeds prudent credit risk management thresholds.[5] As a result, the Joint

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2 Margin and Capital Requirements for Covered Swap Entities. 76 Fed. Reg. 27,564 (May 11, 2011).

3 To avoid confusion. the Prudential Regulators should unambiguously distinguish between "commercial" or "non-financial" end users (*i.e.*. non-financial entities that are eligible to elect not to clear swaps that hedge or mitigate commercial risk) and financial entities that are not required to register as swap dealers or MSPs, but that are nevertheless not eligible to rely on the end user exception. The Joint Associations believe that referring to both categories of entities as "end users" is confusing. particularly because so-called financial end users include hedge funds and other financial entities that are not. in fact. "end users" of swaps to hedge or mitigate *commercial* risk.

4 76 Fed. Reg. at 27,587.

5 *See* 76 Fed. Reg at 27,574 ("[c]redit exposure can arise from a number of activities that regulated firms are permitted to engage in with a counterparty—making a loan, opening a committed line of credit, providing payments processing or transaction services, or engaging in swaps transactions."); *see also* 76 Fed. Reg. at 27569-70 ("[T]he proposed rule *permits* covered swap entities to adopt, *where appropriate*, initial and variation margin thresholds below which a covered swap entity is not required to collect initial and/or variation margin from counterparties that are end users because of the lesser risk posed by these types of counterparties to covered swap entities and financial stability with respect to exposures below these thresholds . . . Under the proposed rule, a covered swap entity would not be required to collect initial or variation margin from a nonfinancial end user counterparty as long as the covered swap entity's exposures to the nonfinancial end user were below the credit exposure limits *that the covered swap entity has established* under appropriate credit processes and standards.") (emphasis added).

Associations understand that the Prudential Regulators intend to allow swap dealers and MSPs to negotiate and enter into bilateral credit support arrangements with commercial end users, including arrangements that do not require the commercial end user to post margin in most circumstances (*i.e.*, anytime the commercial end user's enterprise-wide exposure is below a certain credit threshold). Moreover, the Joint Associations understand that the Prudential Regulators intend that, to the extent that the enterprise-wide exposure associated with a particular bilateral relationship does not exceed the applicable credit threshold, such credit support arrangements could permit either party to accept any type of credit support or collateral it found to be appropriate to secure its exposure, including letters of credit, a lien on the commercial end user's assets, or other mutually agreed upon non-cash collateral. In other words, the Prudential Regulators suggest that they do not intend to impose margin requirements that would materially affect the current credit relationships between commercial end users and their prudentially-regulated financial institution counterparties. According to the Prudential Regulators, as a practical matter, the current credit support arrangements between commercial end users and their swap dealer and MSP counterparties generally would continue to be permitted under the Proposed Rule. [6]

Notwithstanding the Prudential Regulators' intended interpretation of its proposal, the Joint Associations respectfully submit that the Proposed Rule is inconsistent with the statutory framework and Congress' intent which establish that there should be *no* mandatory margin requirements imposed upon commercial end user swaps, regardless of any enterprise-wide credit risk threshold.[7] Accordingly, the Joint Associations respectfully request that the Prudential Regulators amend the Proposed Rule to expressly allow commercial end users to continue to negotiate the terms of their swaps with swap dealers and MSPs without imposing any mandatory margin requirements by regulation. In addition, the Prudential Regulators should revise the Proposed Rule to allow swap dealers and MSPs to continue following their current practices when transacting with commercial end users, including: (1) negotiating credit support arrangements (including unsecured credit) based upon the credit profile of each counterparty; (2) accepting a wide variety of mutually agreeable credit support including letters of credit, liens, other acceptable pledges, and other forms of non-cash collateral; and (3) not imposing any standard swap documentation, collateral valuation, specific swap exposure calculations, or other credit management requirements in connection with commercial end user swaps. It is unnecessary and inconsistent with Congress' intent for the Prudential Regulators to impose margin requirements, limitations on acceptable forms of credit support, or other documentation requirements on swaps entered into by commercial end users.

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[6] *See* 76 Fed. Reg. at 27570, fn 37 ("In the case of a nonfinancial end user with a strong credit profile, under current market practices a derivatives dealer would not require margin—in essence, it would extend unsecured credit to the end user with respect to the underlying exposure. For counterparties with a weak credit profile, a derivatives dealer would likely make a different credit decision and require the counterparty to post margin.").

[7] In addition, the text of the Proposed Rule does not refer to any enterprise-wide measure of exposure. Rather, it references only "a credit exposure limit that has been established by a covered swap entity with respect to its swaps . . . with a counterparty, that appropriately takes into account and addresses the credit risk posed by the counterparty and the risks of such swaps." 76 Fed. Reg. at 27,587.

I. Description of the Joint Associations and their Interest in the Proposed Rule

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry. EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members.

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for nearly 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers.

Formed in 1942, NRECA is the national service organization for more than nine hundred rural electric utilities and public power districts that provide electric energy to approximately forty-two million consumers in forty-seven states or twelve percent of the nation's population. Kilowatt-hour sales by rural electric cooperatives account for approximately eleven percent of all electric energy sold in the United States. Because its electric customers are members of the cooperative, the cooperative operates on a not-for-profit basis and all the costs of the cooperative are directly borne by its consumer-members.[8]

APPA is the national service organization representing the interests of government-owned electric utilities in the United States. More than two thousand public power systems provide over fifteen percent of all kilowatt-hour sales to ultimate customers. APPA's member utilities are not-for-profit utility systems that were created by state or local governments to serve the public interest. Some government-owned electric utilities generate, transmit, and sell power at wholesale and retail, while others purchase power and distribute it to retail customers, and still others perform all or a combination of these functions. Government-owned utilities are accountable to elected and/or appointed officials and, ultimately, the American public. The focus of a government-owned electric utility is to provide reliable and safe electricity service, keeping costs low and predictable for its customers, while practicing good environmental stewardship.[9]

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[8] 13 C.F.R. §121.201, n.1. The vast majority of NRECA's members meet the definition of "small entities" under the Small Business Regulatory Enforcement Fairness Act.[8] Only four distribution cooperatives and approximately twenty-eight generation and transmission entities do not meet the definition. The Regulatory Flexibility Act incorporates by reference the definition of "small entity" adopted by the Small Business Administration (the "SBA"). The SBA's small business size regulations state that entities which provide electric services are "small entities" if their total electric output for the preceding fiscal year did not exceed four million megawatt hours.

[9] Most of APPA's members also meet the definition of "small entities" under the Small Business Regulatory Enforcement Fairness Act.

The Large Public Power Council is an organization representing twenty-four of the largest government owned and operated public power systems in the nation. LPPC members own and operate over 75,000 megawatts of generation capacity and nearly 34,000 circuit miles of high voltage transmission lines. Collectively, LPPC members own nearly ninety percent of the transmission investment owned by non-federal government-owned electric utilities in the U.S. LPPC member utilities supply power on a not-for-profit basis to some of the fastest growing urban and rural residential markets in the country. Members are located in eleven states and Puerto Rico and provide power to some of the largest cities in the country, including Los Angeles, Seattle, Omaha, Phoenix, Sacramento, Jacksonville, San Antonio, Orlando, and Austin.

The Joint Associations' members are not financial entities. Rather, they are physical commodity market participants that rely on swaps primarily to hedge and mitigate commercial risk. Regulations that make effective risk management options more expensive for commercial end users of swaps in the electric industry will likely lead to higher energy prices if the costs associated with new regulations are passed through to energy consumers, or will result in more volatile prices if commercial end users decide to hedge a smaller portion of their commercial risk using swaps. Accordingly, as end users of commodity swaps to hedge commercial risk, the Joint Associations' members have a direct and significant interest in margin requirements that may adversely affect the end user clearing exception.

II. Summary of the Joint Associations' Comments

The Prudential Regulators should clarify that the Proposed Rule will not materially impact the manner in which swap dealers and MSPs and commercial end users currently negotiate and enter into non-cleared swaps. In particular, the Joint Associations respectfully request that the Prudential Regulators revise the Proposed Rule to:

- Not impose mandatory margin requirements, with or without enterprise-wide credit exposure thresholds, on commercial end user swaps;
- Allow commercial end users to continue to negotiate credit support arrangements bilaterally based upon the credit profile of each counterparty;
- Permit commercial end users to continue to use a wide variety of mutually agreeable non-cash collateral, including letters of credit, liens, or other acceptable pledges; and
- Not impose any swap documentation, collateral valuation, specific swap exposure calculations, or other credit management requirements in connection with commercial end user transactions.

III. The Prudential Regulators Should Allow Commercial End Users to Comply with the Terms of their Bilaterally Negotiated Credit Support Arrangements Rather Than Mandatory Minimum Margin and Collateral Rules.

A. *The Dodd-Frank Act does not authorize the Prudential Regulators or the CFTC to adopt margin requirements, with or without enterprise-wide credit exposure thresholds, that apply to commercial end users.*

The Dodd-Frank Act directs the Prudential Regulators and the Commodity Futures Trading Commission ("CFTC") to establish margin requirements for swap dealers and MSPs in order "[t]o offset the greater risk to the swap dealer or [MSP] and the financial system arising from the use of swaps that are not cleared."[10] CEA Section 4s(e)(2)(A) authorizes the Prudential Regulators to adopt margin requirements for swap dealers and MSPs that are banks, whereas CEA Section 4s(e)(2)(B) authorizes the CFTC to adopt margin requirements for swap dealers and MSPs that are not banks.[11] Notably, the Dodd-Frank Act *does not* authorize the Prudential Regulators or the CFTC to adopt margin requirements, regardless of any enterprise-wide credit exposure thresholds, that apply to commercial end users. On the contrary, by their own terms these provisions apply only to swap dealers and MSPs and, in particular, to non-cleared swaps entered into *between swap dealers and MSPs*.

Requiring swap dealers and MSPs to collect margin from commercial end users, regardless of the amount, places extra-statutory limits on, and diminishes the benefits associated with, the end user exception to mandatory clearing.[12] Congress deliberately included an exception to the general clearing requirement for commercial end users to preserve the ability of these low-risk entities to negotiate bilaterally for credit support arrangements that are more appropriately tailored and cost-effective than the margin requirements imposed by a clearinghouse. As Senator Blanche Lincoln explained, "[i]t is clear in this legislation that the regulators only have the authority to set capital and margin requirements on swap dealers and [MSPs] for uncleared swaps, not on end users who qualify for the exemption from mandatory clearing."[13] Yet, as the Prudential Regulators acknowledge in the Proposed Rule, even though "the [end user exception] permits a nonfinancial end user taking advantage of the exemption to avoid posting margin to [a clearinghouse] . . . the proposed rule's approach to margin

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

11 CEA Section 4s(e)(3)(A)-(B).

12 The Prudential Regulators asked: "Question 1(a). Does the nonfinancial end user exemption from the mandatory clearing requirement suggest or require that swaps and security-based swaps involving a nonfinancial end user should or must be exempt from initial margin and variation margin requirements for non-cleared swaps and security-based swaps? 1(b) If so, upon what statutory basis would such an exemption rely? 1(c) Should that determination vary based on whether a particular non-cleared swap or non-cleared security-based swap is subject to the mandatory clearing regime or not (i.e., whether the nonfinancial end user is actually using the clearing exemption)?" 76 Fed. Reg. at 27570. This section responds to the Prudential Regulators' questions 1(a)-(c).

13 156 Cong. Rec. S5904 (daily ed. Jul. 15, 2010)(statement of Sen. Lincoln).

requirements for derivatives with nonfinancial end users could be viewed as lessening the effectiveness of the clearing requirement exemption for these nonfinancial end users as concerns margin."[14] The Dodd-Frank Act does not require, and Congress did not intend, this result.[15]

Other requirements in the Dodd-Frank Act could inadvertently compound the cost of complying with the margin requirement for end users. For example, the Dodd-Frank Act provides that when margin requirements apply, the amount of margin required must be high enough to "offset the greater risk to the swap dealer or [MSP] and the financial system arising from the use of swaps that are not cleared."[16] If commercial end users are required to post margin for non-cleared swaps at a level that is *higher* than the margin that would be required by a clearinghouse if those swaps were cleared, any benefit associated with electing to use the end user exception would be eliminated.[17]

The Prudential Regulators note in the Proposed Rule that "[t]he plain language of section[s] 731 and 764 provides that the [Prudential Regulators] adopt rules for covered swap entities imposing margin requirements on all *non-cleared swaps*. Those sections do not, by their terms, exclude a swap with a counterparty that is a commercial end user."[18] The Joint Associations respectfully disagree.

The Prudential Regulators appear to rely on CEA Section 4s(e)(2)(A), which states that "[t]he prudential regulators . . . shall jointly adopt rules for swap dealers and [MSPs] . . . imposing . . . both initial and variation margin requirements on *all* swaps that are not cleared by a registered derivatives clearing organization."[19] However, by its own terms, CEA Section 4s(e)(2)(A) requires the Prudential Regulators to "adopt rules for *swap dealers and [MSPs]*," not their counterparties.[20] Moreover, CEA Section 4s, as a whole, pertains to the "Registration and Regulation of Swap Dealers and Major Swap Participants," not to commercial end users. Congress did not explicitly exclude commercial end users from margin requirements because CEA Section 4s generally, and CEA Section 4s(e)(2)(A) in particular, should be read in context to pertain only to swaps between swap dealers and MSPs. Thus, the Joint Associations submit

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[14] 76 Fed. Reg. at 27,570.

[15] Indeed, on June 20, 2011, Senator Debbie Stabenow and Representative Frank Lucas sent a letter to the Prudential Regulators and the CFTC expressing concern that "[d]espite clear congressional intent to the contrary, the proposal issued by the prudential regulators could require Swap Dealers and MSPs to collect margin from nonfinancial end-users," also noting that the Proposed Rule "does not provide sufficient clarity that the use of other forms of noncash collateral is permitted." June 20, 2011 Letter from Sen. Stabenow and Rep. Lucas at 3.

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

[17] Moreover, nothing in the Proposed Rule would prevent a swap dealer or MSP from using the margin requirement to impose costly new collateral requirements on commercial end users that are not reasonably related to the risk posed by the end user or its uncleared swaps to the swap dealer or MSP, or the financial system.

[18] 76 Fed. Reg. at 27,569 (emphasis original).

[19] CEA Section 4s(e)(2)(A) (emphasis added).

[20] *Id.* (emphasis added).

that the appropriate reading of CEA Section 4s(e)(2)(A) is that it authorizes the Prudential Regulators to impose margin requirements only on swap dealers and MSPs for their transactions with other swap dealers and MSPs. Accordingly, the Joint Associations urge the Prudential Regulators to reconsider their interpretation of CEA Section 4s and refrain from adopting any margin requirements that apply to transactions with commercial end users.

B. *The Prudential Regulators and the CFTC should adopt "comparable" margin requirements.*

CEA Section 4s(e)(3)(D) provides that the Prudential Regulators and the CFTC must adopt margin requirements applicable to swap dealers and MSPs that are "comparable" to the maximum extent practicable.[21] To avoid uncertainty and inconsistent regulatory treatment, the Prudential Regulators and the CFTC should adopt margin requirements that regulate all swap dealers and MSPs in the same way.[22] Creating a system in which the same type of transaction or market participant would be subject to different margin requirements depending on whether it was governed by rules adopted by the Prudential Regulators or the CFTC would be inefficient and commercially burdensome. Congress explicitly encouraged the Prudential Regulators and the CFTC to adopt comparable margin requirements so that all swap dealers and MSPs could compete on equal terms when negotiating the same type of transaction, with the same type of counterparty.

Contrary to CEA Section 4s(e)(3)(D), the Proposed Rule differs from the CFTC's proposed margin rule. Consistent with Congress' intent, the CFTC's proposed margin rule would not impose *any* minimum margin requirements on uncleared swaps to which a commercial end user is a party, and would permit the use of various types of non-cash collateral to secure any exposure associated with those transactions. In contrast, although the Prudential Regulators might permit swap dealers and MSPs to set an enterprise-wide credit exposure threshold below which no margin for swap exposure would be required, the Proposed Rule would still create a regulatory obligation for swap dealers and MSPs to establish a threshold for commercial end user swaps, and for commercial end users to comply with a minimum margin requirement and specific collateral restrictions above that threshold. As a result, the CFTC's proposed margin requirements and the Proposed Rule manifestly are not "comparable" to the "maximum extent practicable."[23] The Prudential Regulators should modify the Proposed Rule as it applies to commercial end users in a manner that is consistent with the CFTC's margin requirements and the underlying purpose of CEA Section 4s(e)(3)(D).

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[21] CEA Section 4s(e)(3)(D). CEA Section 4s(e)(3)(D) requires the CFTC and Prudential Regulators "to the maximum extent practicable, [to] establish and maintain comparable . . . minimum initial and variation margin requirements, including the use of non-cash collateral." *Id.*

[22] The language used in various parts of CEA Section 4s(e) to describe the authority and obligations of the Prudential Regulators and the CFTC is nearly identical.

[23] CEA Section 4s(e)(3)(D).

C. *Regulations that permit commercial end users and their counterparties to negotiate the terms of their swap transactions (including applicable credit support arrangements) are cost-effective and accurately reflect the specific risks posed by different categories of swaps and swap market participants.*

The Proposed Rule would establish different margin requirements for different "risk categories" of swaps based on the counterparty's relative risk. The Joint Associations agree that effective margin requirements cannot be imposed using a "one size fits all approach." Rather, as contemplated in the Proposed Rule, margin requirements implementing CEA Section 4s(e)(3) should permit the swap dealer or MSP to weigh the specific risks associated with a particular swap and swap counterparty (*e.g.*, the relative credit risk posed by the commercial end user and the exposure associated with other transactions or credit exposures that may exist between the parties) and to enter into well-tailored credit support arrangements that reflect the individual characteristics of each trading relationship.

However, the Proposed Rule would unnecessarily impose margin requirements on *all* non-cleared swaps, including swaps between a swap dealer or MSP and a commercial end user swaps where the enterprise-wide counterparty exposure exceeds a certain credit exposure threshold. Congress intended for regulators to weigh the potential costs that margin requirements and other regulations may have on commercial end users that rely on swaps as essential risk management tools.[24] Requiring commercial end users to comply with mandatory margin requirements is inconsistent with CEA Section 4s(e)(3)(A)(ii), which provides that any margin requirements must be "appropriate for the risk associated with the non-cleared swaps" held by the swap dealer or MSP.[25] As Senator Dodd emphasized, "[i]t is . . . the intent of this bill to distinguish between commercial end users hedging their risk and larger, riskier market participants. Regulators should distinguish between these types of companies when implementing new regulatory requirements."[26] Flexible margin requirements that are comparable to the CFTC's proposed margin rule and that permit swap dealers and MSPs to negotiate with end users to establish credit support arrangements tailored to each counterparty's individual commercial needs and risks would be more cost-effective and more consistent with Congress' intent.

[24] CEA Section 4s(e)(3)(A)(ii) provides that any margin requirements must be "appropriate for the risk associated with the non-cleared swaps" held by the swap dealer or MSP. *Id.*

[25] *Id.*

[26] 156 Cong. Rec. S5901 (daily ed. Jul. 15, 2010) (statement of Sen. Dodd).

The Prudential Regulators should protect commercial entities from potentially significant costs (both direct and indirect) by permitting end users and their counterparties to set the terms of their transactions without unnecessary regulatory restrictions. Swaps entered into by commercial end users for the purpose of hedging or mitigating commercial risk pose minimal risk to their counterparties or the market as a whole.[27] In fact, because commercial end users rely on swaps to *reduce* their commercial risk, their hedging transactions *increase* the stability of the swaps market and the broader financial system. As Rep. Peters explained, commercial end users who use derivatives to hedge legitimate business risks should be exempt from margin requirements because "they *do not pose systemic risk* and because [end users] . . . use these contracts as a way to provide consumers with lower cost goods."[28] Moreover, as the Proposed Rule itself explains: "persons using derivatives predominantly to hedge or mitigate risks arising from their business, rather than to speculate for profit, are likely to pose less risk to the covered swap entity (*e.g.*, because losses on a hedging-related swap will usually be accompanied by offsetting gains on the related position that it hedges)."[29] Accordingly, the Prudential Regulators should amend the Proposed Rule to eliminate any regulatory margin or collateral requirements that restrict the ability of commercial end users to negotiate freely with their counterparties. Such restrictions likely would result in overbroad regulations that reduce a significant volume of legitimate, risk-reducing market activity (*e.g.*, hedging commercial risk).[30]

IV. Permitting the Use of a Wide Variety of Non-Cash Collateral is Consistent with the Plain Language of the Dodd-Frank Act and Well-Established Commercial Practice.

CEA Section 4s(e)(3)(C) provides that "[i]n prescribing margin requirements . . . the prudential regulator . . . shall permit the use of noncash collateral, as [it]. . . determines to be consistent with . . . (i) preserving the financial integrity of markets trading swaps; and (ii) preserving the stability of the United States financial system."[31] Nevertheless, to the extent that the enterprise-wide exposure associated with a particular bilateral relationship exceeds the

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27 Question No. 6a in the Proposed Rule states, "[s]hould nonfinancial end users also be separated into high-risk and low-risk categories . . ." 76 Fed. Reg. 27,572. The Joint Associations respectfully submit that all commercial end users are low risk entities, but certain commercial end users (*i.e.*, entities that engage in swaps *solely* to hedge or mitigate commercial risk) represent a particularly low risk to their counterparties or the financial system.

28 *See* 156 Cong. Rec. H5244-45 (daily ed. Jun. 30, 2010) (statement of Rep. Peters) (emphasis added); *see also*, 156 Cong. Rec. H5230 (daily ed. Jun. 30, 2010) (statement of Rep. McMahon) ("These end-user companies pose little or no systemic risk to our economy, and this bill protects them from unnecessary and burdensome margin and clearing requirements.").

29 76 Fed. Reg. at 27,572.

30 To the extent that the Prudential Regulators adopt margin requirements that require commercial end users to post collateral when their swap exposure exceeds a certain credit threshold, the Joint Associations urge the Prudential Regulators to ensure that such thresholds appropriately take into account the credit worthiness and financial condition of commercial end users so as not to burden them with margin requirements that are unreasonable relative to underlying credit risk.

31 CEA Section 4s(e)(3)(C).

applicable credit threshold, the Proposed Rule would prohibit commercial end users from providing swap dealer or MSPs with *any* form of collateral other than cash and certain limited types of government securities. The Joint Associations respectfully submit that the Prudential Regulators' justifications for not allowing the use of non-cash collateral are insufficient with respect to commercial end users, and inconsistent with both the statutory standard and current commercial practice.

According to the Prudential Regulators, the "proposed rule does *not* allow for the use of non-cash collateral, other than the limited types of highly-liquid, high-quality debt securities described above, to satisfy the margin requirements [associated with exposure above a credit exposure threshold," because using non-cash collateral is "complicated by procyclic considerations" and it is "difficult to establish accurate haircuts by regulation."[32] The Proposed Rule also suggests that "counterparties that wish to rely on other non-cash assets to meet margin requirements could pledge those assets with a bank . . . in a separate arrangement, such as a secured financing facility, and could draw cash from that arrangement to meet margin requirements."[33] Rather than explain why the use of non-cash collateral by commercial end users would be inconsistent with preserving "the financial integrity of markets trading swaps" or "the stability of the United States financial system,"[34] the Proposed Rule simply states that permitting the use of non-cash collateral is unnecessary because, according to the Prudential Regulators, the Proposed Rule would allow enterprise-wide credit exposure thresholds that, if set high enough, would effectively eliminate the need for collateral of any kind.[35]

The Joint Associations respectfully submit that the Prudential Regulators' interpretation of CEA Section 4s(e)(3)(C) is unnecessarily restrictive and may inadvertently create significant cost, cash flow, and operational challenges for commercial end users that use swaps to hedge commercial risk. Many commodity market participants rely on a wide range of credit support, including mortgages and other liens on physical assets, letters of credit, pledges of stock, guarantees, deposit accounts or cash management agreements, and other arrangements, to provide credit support for their swap transactions. In the electric industry, swaps (and the physical commodity transactions they hedge) often are unsecured or secured by credit support that would not satisfy the Prudential Regulators' narrow requirements. Such credit support arrangements are not analogous to the dollar-for-dollar margin commonly used in cleared transactions or transactions between financial entities. For example, utilities and other energy market participants often rely on their highly-reliable source of cash flow (*i.e.*, payments from retail energy consumers) and valuable tangible assets (*i.e.*, power plants) as much as or more

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32 76 Fed. Reg. at 27,578.

33 *Id.* The asset-backed financing arrangement described by the Prudential Regulators as an alternative to non-cash collateral or other more flexible credit support arrangements would require commercial end users to establish and post collateral for large standby credit facilities that would be substantially more expensive, but not substantially more effective, than the direct use of non-cash collateral.

34 CEA Section 4s(e)(3)(C).

35 76 Fed. Reg. at 27,578.

than daily cash margining or other formal credit support arrangements to support their payment obligations on swaps. Instead, commercial end users have a well-established history of using a combination of unsecured credit and diverse collateral responsibly in the course of their ongoing relationships and in a manner that reduces commercial risk and promotes the stability of the United States financial system.[36]

The Prudential Regulators should continue to permit commercial end users to rely on any form of non-cash collateral that is mutually agreeable to both parties. Although it may be "difficult to establish accurate haircuts by regulation" or to provide objective criteria for valuing non-cash collateral through a rule-based approach, the Dodd-Frank Act does not require the Prudential Regulators to perform this function, particularly with respect to commercial end users.[37] To the extent the Prudential Regulators impose restrictions on what constitutes eligible collateral, the Proposed Rule should provide sufficient flexibility to accommodate the diverse business needs, assets, and various forms of credit support available to commercial end users as Congress intended and CEA Section 4s(e)(3)(C) requires.[38]

V. Swap Documentation, Collateral Valuation, Specific Swap Exposure Calculations, and Other Credit Management Requirements are Unnecessary for Commercial End User Transactions.

CEA Section 4s(i) provides that "[e]ach registered swap dealer and [MSP] shall conform with such standards as may be prescribed by *the Commission* by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps."[39] The Dodd-Frank Act does not require the Prudential Regulators to establish particular swap documentation, collateral valuation, specific swap exposure calculations, or other credit management requirements. Moreover, because the CFTC has already proposed similar rules for the documentation and valuation of swaps, the Proposed Rule is duplicative and unnecessary.[40]

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36 CEA Section 4s(e)(3)(C).

37 76 Fed. Reg. at 27,578.

38 In addition, to the extent the Prudential Regulators impose valuation requirements on non-cash collateral, such valuation requirements should only apply to collateral posted over and above the specified threshold.

39 CEA Section 4s(i) (emphasis added).

40 Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 6,715 (Feb. 8, 2011). *See also* comments filed by EEI, NRECA, APPA, and LPPC on April 11, 2011 in response to the proposed Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants rule.

Nevertheless, the Proposed Rule would require swap dealers and MSPs to enter into credit support arrangements that include specific collateral valuation provisions with all counterparties, including commercial end users, and would make compliance with the terms of these provisions a regulatory (in addition to contractual) obligation.[41] For example, swap dealers and MSPs would be required to include in their trading documentation "methods, procedures, rules, and inputs for determining the value of each swap" and to calculate and collect variation margin "[n]o less than once per week with respect to a counterparty that is a nonfinancial end user."[42]

It is unnecessary for the Prudential Regulators to impose any specific documentation, collateral valuation, exposure calculations, or credit management requirements on swaps entered into by commercial end users. The terms of a bilaterally negotiated, non-cleared swap are mutually agreed upon by the parties and legally enforceable. The parties to a swap are already obligated to perform their contractual obligations. There is no need for separate regulatory requirements that obligate the parties to a swap to comply with the terms of their contractual agreements.

The fact that some commercial end users may voluntarily agree to margin provisions in connection with a non-cleared swap with a swap dealer or MSP does not mean that the Prudential Regulators should *require* that such documentation be in place for every swap transaction. As a practical matter, the way in which many of the Joint Associations' members routinely document and provide credit support for their risk management and other commercial transactions may not fit easily within the framework in the Proposed Rule. Non-cleared swaps are bilaterally negotiated contracts, often with customized terms that are tailored to meet the parties' specific needs and circumstances surrounding the transaction. It is unnecessary and impractical for the Prudential Regulators to regulate the many ways in which commercial end users and their counterparties agree to value and manage their mutual risks.

The Prudential Regulators should not impose additional documentation or compliance requirements that would serve only to convert a contractual breach into a separate regulatory violation. The Prudential Regulators should not adopt prescriptive regulations that specify how each swap dealer, MSP, and indirectly, commercial end user must manage its respective credit risk.[43] Similarly, the Prudential Regulators should not prescribe any specific settlement or valuation cycle. Daily or even weekly margin calculations are impractical (and unnecessary) in

[41] In addition, The Proposed Rule would require swap dealers and MSPs to calculate exposure associated with *all* non-cleared swaps, including non-financial commodity swaps entered into by non-financial end users for the purpose of hedging or mitigating commercial risk, even though these calculations would be separate from (and in addition to) any credit analysis required under the parties' mutually negotiated trade documentation.

[42] 76 Fed. Reg. at 27,598.

[43] For example, although a minimum transfer amount of $100,000 may be reasonable in many situations, higher amounts are justified in certain circumstances. 76 Fed. Reg. at 27,589. The Prudential Regulators should not subject the details of every non-cleared swap to prescriptive requirements or unnecessary regulatory oversight.

many cases. Instead, a swap dealer and a commercial end user should be allowed to continue to agree to a variety of credit support arrangements and to accept non-cash collateral, even if it is difficult to value on a regular basis without violating any regulatory obligations. Engaging in commercial transactions with or without margin, based on reciprocal evaluation of each party's credit and proposed collateral is more efficient than imposing specific credit and collateral valuation requirements, particularly for swap dealers and MSPs transacting with commercial end users under well-established business practices that are tailored to their specific credit risk assessments. The Joint Associations respectfully submit that such an approach does not increase the risk posed to swap dealers or MSPs, the swaps markets, or the United States financial system as a whole.

In addition, the Prudential Regulators should clarify that commercial end users and their counterparties may negotiate transaction terms that require two-way posting of collateral. Although nothing in the Proposed Rule prohibits credit support arrangements that provide for two-way margin, the Prudential Regulators specifically ask whether "requiring a covered swap entity to post initial margin to end user counterparties raise[s] any concerns with respect to the safety and soundness of the covered swap entity . . ." and whether such an approach would be "consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?"[44] Bilateral credit arrangements do not raise any concerns with respect to the safety and soundness of the covered swap entity. On the contrary, bilaterally negotiated swaps that provide for two-way posting of collateral allow both parties to the transaction to manage their risks effectively and on equal terms. Permitting the parties to a non-cleared swap to enter into reasonable and mutually agreeable credit support arrangements is consistent with the statutory criteria that the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act and current commercial practice. Nothing in the Proposed Margin Rule prohibits credit support arrangements that provide for two-way margin, and the Prudential Regulators should not amend the Proposed Rule to prohibit this beneficial practice.

VI. Conclusion

We encourage the Prudential Regulators to ensure that commercial end users are not subject, directly or indirectly, to regulatory requirements that Congress intended to apply only to swap dealers and MSPs. Accordingly, we encourage the Prudential Regulators to establish regulatory requirements that accurately reflect the risk associated with individual counterparties and transactions, and that preserve the benefit of the end user clearing exception by permitting commercial end users to continue to negotiate the terms of their swaps, including credit support arrangements, free from unnecessary restrictions on the amount, type, or terms of collateral that must be posted.

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[44] 76 Fed. Reg. at 27,575.

Please contact us at the numbers listed below if you have any questions regarding our comments.

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