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Re: ***Margin and Capital Requirements for Covered Swap Entities***
FED: RIN 7100-AD74; Docket No. R-1415
FDIC: RIN 3064-AE21
OCC: RIN 1557-AD43; Docket ID OCC-2011-0008
FHFA: RIN 2590-AA45
FCA: RIN 3052-AC69

Ladies and Gentlemen:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits these comments in response to the Proposed Rule, *Margin and Capital Requirements for Covered Swap Entities* (the "**Proposed Rule**"),[1]

[1] *See* Proposed Joint Rule, *Margin and Capital Requirements for Covered Swap Entities,* 79 Fed. Reg. 57,347 (Sept. 24, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf.

jointly issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively the "**Prudential Regulators**"). The Working Group appreciates the Prudential Regulators' efforts to coordinate with the Commodity Futures Trading Commission ("**CFTC**") to put forth proposed rules for uncleared swaps that properly reflect Congressional intent and do not impose margin requirements on non-financial end-users.[2]

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 producers, processors, merchandisers, and owners of energy commodities. Among the members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

The Working Group requests the Prudential Regulators' consideration of these comments before issuing a final rule on margin requirements for uncleared swaps.

II. OVERVIEW OF POTENTIAL ISSUES FOR NON-FINANCIAL END-USERS.

The Working Group welcomes the Proposed Rule's recognition that swap dealers and major swap participants (collectively "**Covered Swap Entities**" or "**CSEs**") should not be required to exchange margin with non-financial end-users. As the Prudential Regulators note in the Proposed Rule, commercial end-users pose less risk to CSEs than financial counterparties.[3] Nevertheless, there are several aspects of the Proposed Rule that could create issues for non-financial end-users.

A. THE DEFINITION OF "FINANCIAL END-USER."

While the Proposed Rule makes an important change to the definition of "financial end-user" from the Prudential Regulators'[4] and CFTC's[5] 2011 proposed margin rules, the current proposed definition may require additional clarification to achieve its apparent goal of excluding certain non-financial end-users from such definition. Specifically, the definition of "financial end-user" no longer captures entities engaged in activity that is considered "financial in nature"

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[2] *See, e.g.*, CFTC Proposed Rule, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 79 Fed. Reg. 59,898 (Oct. 3, 2014), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-22962a.pdf.

[3] *See* Proposed Prudential Regulators' Rule at 57,357.

[4] *See* Proposed Joint Rule, *Margin and Capital Requirements for Covered Swap Entities*, 76 Fed. Reg. 27,564, 27,587 (May 11, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf.

[5] *See, e.g.*, CFTC Proposed Rule, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23,732, 23,743-44 (Apr. 28, 2011) (discussed as a "financial entity"), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf.

under Section 4(k) of the Bank Holding Company Act. As such, the proposed definition should not capture central trading entities[6] and entities that may be "financial entities" under Section 2(h)(7)(C) of the Commodity Exchange Act ("**CEA**") because they engage in physical trading activity that is deemed "financial in nature."

The definition then attempts to further reinforce the fact that it does not capture central trading entities by including in the list of entities excluded from the definition of "financial end-user" entities that qualify for the exemption from clearing pursuant to CEA Section 2(h)(7)(D).[7] However, this is unlikely to exclude central trading entities from the definition of "financial end-user" because, in order to qualify for the exemption in CEA Section 2(h)(7)(D), an entity must be acting as agent for an affiliate. In contrast, central trading entities typically enter into transactions as principal and then sleeve the risk to the relevant affiliate. As such, the exclusion from the definition of "financial end-user" for entities that are exempt from clearing pursuant to CEA Section 2(h)(7)(D), would not cover central trading entities, which is likely contrary to the Prudential Regulators' intent. In addition, under the Proposed Rule, the Prudential Regulators retain the right to determine that an entity should be treated as a "financial end-user."

As such, while central trading entities likely are not captured by the list of types of entities that are expressly financial end-users, the presence of an exclusion likely intended to definitively remove them from the definition of "financial end-user," but does not actually do so, creates regulatory confusion.

To clarify the treatment of central trading entities and entities that may be "financial entities" under CEA Section 2(h)(7)(C) of the CEA because they engage in physical trading activity that is deemed "financial in nature," the Working Group respectfully requests that the Prudential Regulators expressly exclude such entities from the financial end-user definition through means other than a reference to CEA Section 2(h)(7)(D). The Prudential Regulators could, for example, exclude entities that meet the following definition of "eligible non-financial trading entity" from the definition of "financial end-user":

> "Eligible non-financial trading entity" means a person that meets each of the following qualifications:
>
> (i) The person's ultimate parent is not a financial entity as defined in Section 2(h)(7)(C)(i) of the CEA;
>
> (ii) The person is a financial entity as defined in Section 2(h)(7)(C)(i)(VIII) of the CEA as a result of acting as principal to commodity interests and/or forwards or providing other services that are financial in nature to related affiliates and
>
> (iii) The person is not any of the following:

[6] Certain commercial end-users conduct derivatives trading for their overall enterprise through one (or a few) market facing entity(ies). Those entities, acting as principal, enters into swaps with third parties and then transfer the resulting risk to any number of affiliates through the use of inter-affiliate swaps.

[7] *See* Proposed Prudential Regulators' Rule § __.2.

a. a swap dealer;

b. a major swap participant;

c. a security-based swap dealer;

d. a major security-based swap participant;

e. a nonbank financial company that has been designated as systemically important by the Financial Stability Oversight Council;

f. a private fund as defined in Section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. § 80-b-2(a));

g. a commodity pool;

h. an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. § 1002);

i. a bank holding company;

j. an insured depository institution;

k. a farm credit system institution;

l. a credit union; or

m. an entity engaged in the business of insurance and subject to capital requirements established by an insurance governmental authority of a State, a territory of the United States, the District of Columbia, a country other than the United States, or a political subdivision of a country other than the United States that is engaged in the supervision of insurance companies under insurance law.

B. THE AVAILABILITY OF UNSECURED INITIAL MARGIN THRESHOLDS.

While the Working Group appreciates the availability of the $65 million unsecured initial margin threshold, the Proposed Rule would measure and implement this threshold at the group level rather than on an entity-by-entity basis.[8] CSEs and financial end-users with Material Swaps Exposure would have to not only monitor the use of the threshold but also allocate the use of the threshold among individual trading relationships. The Working Group respectfully suggests that the Prudential Regulators set a maximum unsecured threshold of $65 million between counterparties, not accounting for exposure across the respective corporate families, and rely on their anti-evasion authority to penalize any abuse of that paradigm.

In addition, it is unclear to the Working Group what set of transactions are to be included in the determination of credit exposure between counterparties and therefore the extent to which an unsecured credit threshold is being used. It is common in energy markets for counterparties to enter into both physical and financial transactions under the same master netting agreement (*e.g.*, an ISDA Master Agreement with a Physical Power Annex). In such a relationship, the net exposure between the counterparties is determined by considering the entire universe of trades under the same master netting agreement. The Working Group respectfully requests that the

[8] *Id.*

Prudential Regulators clarify that the Proposed Rule's determination of net exposure between counterparties is a function of all transactions between counterparties under a master netting agreement, not just the swaps.

Finally, to the extent the Prudential Regulators retain a definition of "initial margin threshold amount" that aggregates the credit exposure of an entity and its affiliates, the definition of "affiliate" should be amended. Currently, the proposed definition of affiliate captures "any company that controls, is controlled by, or is under common control with another company."[9] Where control is defined as "(1) ownership, control, or power to vote 25 percent or more of a class of voting securities of the company, directly or indirectly or acting through one or more other persons; (2) ownership or control of 25 percent or more of the total equity of the company, directly or indirectly or acting through one or more other persons; or (3) control in any manner of the election of a majority of the directors or trustees of the company."[10]

A standard that requires an entity to share its initial margin threshold with a minority-owned affiliate raises several concerns. For example, the entities would have to coordinate their trading and share information to monitor their initial margin thresholds. Moreover, an entity's minority-owned affiliate may be subject to a separate initial margin threshold with its majority-owned affiliates. As such, the Working Group requests that the definition of "affiliate" be amended to cover only majority-owned affiliates.

III. DEFINITION OF "MINIMUM TRANSFER AMOUNT."

The Proposed Rule states that a CSE is not required to collect or post margin until the total amount of margin to be collected on posted exceeds $650,000. The Working Group would like to confirm that the Proposed Rule allows a minimum transfer amount of up to $650,000, but does not require a minimum transfer amount.

IV. HARMONIZATION WITH INTERNATIONAL PROPOSALS FOR UNCLEARED MARGIN.

The Working Group appreciates the Prudential Regulators' efforts to coordinate with international regulatory authorities to set forth a rule that is generally consistent with recommended international standards for margin requirements. In particular, the Working Group appreciates the Prudential Regulators' consideration of the Basel Committee on Banking Supervision's ("**BCBS**" or "**Basel**") and the International Organization of Securities Commissions' ("**IOSCO**") framework for margin requirements for uncleared swaps. While the Proposed Rule, the Basel/IOSCO proposal, and even European Supervisory Authorities' ("**ESA**") proposal are generally consistent, certain differences between the proposals may lead to competitive imbalances in swap markets.

For example, the Basel/IOSCO and ESA margin frameworks require higher levels of swaps exposure before entities are subject to initial margin requirements than the Proposed Rule. Under the Basel/IOSCO and ESA frameworks, financial entities that belong to a corporate group

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9 *Id.*

10 *Id.*

with a notional amount of uncleared swaps above €8 billion will be subject to the proposed initial margin requirements.[11] In contrast, the Proposed Rule would subject financial end-users with a "Material Swaps Exposure" of $3 billion to initial margin requirements. The Working Group respectfully requests that the Prudential Regulators adopt the equivalent of the €8 billion threshold to harmonize the thresholds across jurisdictions to avoid any regulatory arbitrage.

Finally, the Prudential Regulators, the CFTC, and relevant foreign regulators should harmonize the timing of the implementation of their respective margin requirements to avoid potential regulatory arbitrage. In addition, the Prudential Regulators, the CFTC, and relevant foreign regulators should build in a mechanism through which they could amend the implementation schedule and the relevant thresholds subjecting market participants to margin requirements in the event that the new margin rules cause material disruption in financial markets as they are phased-in.

V. THE DEFINITION OF "ELIGIBLE MASTER NETTING AGREEMENT."

A. CROSS-BORDER RESOLUTION ISSUES.

The Working Group welcomes the Proposed Rule's provision to allow counterparties to net margin requirements if there is an eligible master netting agreement ("**EMNA**") between the parties. The Working Group, however, is concerned that the EMNA concept as defined in the Proposed Rule is being used to implement the Financial Stability Board's cross-border resolution efforts and to facilitate the International Swaps and Derivatives Association ("**ISDA**") Resolution Stay Protocol (the "**Protocol.**") Any attempt to implement those undertakings should be done as a stand-alone rulemaking and not obliquely through the Proposed Rule.

The Proposed Rule's definition of EMNA requires that the EMNA provide a CSE with:

> the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or apply collateral promptly upon an event of default, including upon an event of receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than: (i) In receivership, conservatorship, resolution under the Federal Deposit Insurance Act (12 U.S.C. §§ 1811 et seq.), Title II of the Dodd-Frank Act (12 U.S.C. §§ 5381 et seq.), the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 as amended (12 U.S.C. § 4617), or the Farm Credit Act of 1971 (12 U.S.C. §§ 2183 and 2279cc)....[12]

The Prudential Regulators' Proposed Rule further adds, "similar laws of foreign jurisdictions that provide for limited stays to facilitate the orderly resolution of financial institutions" to the list of regimes eligible to allow for stays of close out or termination rights.[13]

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11 Margin Requirements for Non-Centrally Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (Sept. 2013), *available at* http://www.bis.org/publ/bcbs261.pdf.

12 Proposed Prudential Regulators' Rule § __ .2.

13 *See* Proposed Prudential Regulators' Rule § __ .2.

In addition, the Prudential Regulators' Proposed Rule allows stays to be imposed by "a contractual agreement subject by its terms to any of the laws referenced."[14] The CFTC's definition of Eligible Master Netting Agreement does not include the language addressing foreign jurisdiction and contractual agreements. The differences in the definitions could produce materially different results.

The allowance for foreign jurisdictions and contractual provisions in the Proposed Rule could limit important bankruptcy protections for end-users. The reference to "contractual agreement" in the Proposed Rule is likely intended to address the Protocol regarding termination rights under an ISDA Master Agreement. Thus far, eighteen major global banks, which are all provisionally registered swap dealers with the CFTC,[15] have agreed to sign the Protocol. The Working Group understands that regulators may require all counterparties of systemically important swaps dealers to adhere to the Protocol or a similar document.[16]

The Protocol will limit the close-out rights of market participants not only when their direct counterparties become insolvent, but may also limit close-out rights in the event of a cross-default triggered by the default of a counterparty's affiliate in a foreign jurisdiction. The Protocol's limitations on close-out rights effectively remove a credit risk mitigant that market participants rely on when negotiating their current swaps. Requiring market participants other than systemically important swap dealers to adhere to the Protocol in order for their trading agreements to qualify as EMNAs effectively renegotiates those existing deals. In addition, market participants in the energy and commodity markets frequently use the EMNAs to trade swaps and physical commodities. Constraints on close-out rights in physical supply agreements would have a harmful effect on the energy supply chain and on the markets generally.

As such, the Working Group requests that the Prudential Regulators recognize and clearly state that market participants' rights to avoid stays and other limitations of their close-out rights should be protected. At the very least, the Prudential Regulators should advocate that global regulators not limit market participants' close-out rights until the relevant legislative and regulatory processes within the G-20 nations have been adhered to. With respect to the Proposed Rule, the Prudential Regulators should make clear that EMNAs need not provide for the efficacy of the Protocol or similar undertakings or foreign special resolution paradigms.

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14 *Id.*

15 The eighteen banks that have signed on to the ISDA Stay Protocol are the following: Bank of America Merrill Lynch; Bank of Tokyo-Mitsubishi UFJ; Barclays; BNP Paribas; Citigroup; Crédit Agricole; Credit Suisse; Deutsche Bank; Goldman Sachs; HSBC; JP Morgan Chase; Mizuho Financial Group; Morgan Stanley; Nomura; Royal Bank of Scotland; Société Générale; Sumitomo Mitsui Financial Group; and UBS. ISDA Press Release (Oct. 11, 2014), *available at* http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol. All of these banks are provisionally registered as swap dealers with the CFTC. *See* Provisionally Registered Swap Dealers (updated Nov. 14, 2014), *available at* http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.

16 Regulators may accomplish this by prohibiting the relevant swaps dealers from trading with counterparties that have not adhered to the Protocol, even if such counterparties are not subject to the respective regulator's jurisdiction.

B. OTHER ISSUES WITH RESPECT TO EMNAS.

The Proposed Rule requires that a CSE conduct a sufficient legal review to conclude that it has a well-founded basis to believe that, in the event of a legal challenge, the relevant authority would find an EMNA to be enforceable under the law of the relevant jurisdictions.[17] This raises a number of issues. *First*, a "would" standard could be difficult to satisfy as bankruptcy courts are courts of equity, making it very difficult to state with certainty that a particular agreement would be enforceable in an insolvency context. A "should" standard would be more appropriate and be in line with common industry practice. As such, the definition of "eligible master netting agreement" should be amended to incorporate the "should" standard and the phrase "legally enforceable" should be replaced with "duly executed agreement" to accommodate the "should" standard.

Second, the requirement to conduct a sufficient legal review could be quite burdensome for CSEs. It is common market practice for market participants to rely on enforceability opinions with respect to enforceability of their master trading agreements. For example, ISDA provides its members access to enforceability opinions with respect to the ISDA Master Agreement for a number of jurisdictions.[18] Similarly, CSEs should be able to satisfy their legal diligence obligations by periodically confirming the existence of an ISDA opinion with respect to the jurisdiction applicable to the EMNA.

VI. SEGREGATION AND OTHER TECHNICAL ISSUES.

Under the Proposed Rule, CSEs are required to segregate any initial margin they post to a counterparty with an independent third party custodian.[19] However, similar treatment is not provided to all initial margin posted to a CSE. Specifically, any initial margin posted to a CSE outside the scope of the Proposed Rule, such as initial margin posted by a non-financial end-user is not subject to the Proposed Rule's segregation requirements. This asymmetric structure makes it very unlikely that a CSE would ever post initial margin to a non-financial end-user counterparty as the cost and burden associated with putting in place and maintaining a custodial arrangement can be significant. As such, the Proposed Rule should be amended to make segregation requirements symmetrical. In the case of a CSE and non-financial end-user counterparty, neither counterparty should be required to have their initial margin segregated with an independent, third party custodian.

The Working Group has additional comments with respect to the drafting of the Proposed Rule that are more technical in nature. *First*, the Proposed Rule refers to obligations for CSEs to make "necessary efforts"[20] to collect margin and to make "appropriate efforts"[21] to collect

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17 *See* Proposed Prudential Regulators' Rule § __.2.

18 While ISDA's members are not recipients of he actual opinions, the opinions serve as evidence of the enforceability of the ISDA Master Agreement.

19 *See* Proposed Prudential Regulators' Rule § __.7.

20 *See* Proposed Prudential Regulators' Rule § __.5.

21 *Id.*

margin. Both a "necessary efforts" and an "appropriate efforts" standard are nebulous and may, in theory, not perfectly overlap. The Working Group suggests that the Proposed Rule be amended to include a "reasonable efforts" standard, as "reasonable efforts" is a commonly used standard in commercial and trading relationships.

Second, the determination of whether a financial end-user has a "Material Swaps Exposure" requires that entity to consider, among other things, the gross notional value of the uncleared swaps of both the entity and its affiliates. As drafted, that would require corporate families to not only include, but to double count, their inter-affiliate swaps. As inter-affiliate swaps are internal risk transfers that do not result in a corporate family increasing its overall level of risk, those transactions should not be considered when determining whether an entity has a "Material Swaps Exposure."

VII. Conclusion.

The Working Group appreciates this opportunity to provide comments on the proposed margin requirements for uncleared swaps and respectfully requests the Prudential Regulators' consideration of these comments as it develops any final rulemaking in this proceeding.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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