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VIA ELECTRONIC SUBMISSION

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Notice of Proposed Rulemaking, *Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions* (Docket No. R-1538; RIN No. 7100 AE-52)

Dear Mr. deV. Frierson:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the **"Working Group"),** Sutherland Asbill & Brennan LLP hereby submits this letter in response to the request for public comment set forth in the Board of Governors of the Federal Reserve System's (the **"Board of Governors")** Notice of Proposed Rulemaking, *Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions* (the **"Proposed Rule").**[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 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.

[1] *See* Notice of Proposed Rulemaking, *Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions,* 81 Fed. Reg. 29,169 (May 11, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-05-ll/pdg2016-11209.pdf.

The Proposed Rule would limit the rights of counterparties to uncleared qualified financial contracts **("QFCs")** with certain entities of global systemically important banking organizations **("GSIBs").** Specifically, under the Proposed Rule, certain entities of GSIBs *(i.e.,* **"Covered Entities")** would not be permitted to transact under QFCs **("Covered QFCs")** unless those QFCs comply with the requirements of the Proposed Rule. Although the requirements of the Proposed Rule would be imposed expressly on Covered Entities, the resulting effect would (i) directly impact commercial energy companies, many of which are commercial end-users,[2] and (ii) inappropriately impact commercial end-users.

Commercial energy companies would be directly impacted by the Proposed Rule because they frequently trade Covered QFCs with Covered Entities and use Covered QFCs - which include commodity contracts, forward contracts, and swaps[3] - to facilitate their business operations and manage risk. Moreover, the Proposed Rule would adversely affect important markets for commercial energy companies because Covered Entities actively trade commodity contracts and frequently provide much needed liquidity to such markets. The liquidity provided by Covered Entities is critical in keeping prices stable and low for American consumers.

Commercial end-users of all types would be inappropriately impacted by the Proposed Rule. By its terms, the Proposed Rule would not apply to cleared derivatives, thus its impact is confined to over-the-counter markets.[4] Given that (i) a large segment of the derivatives market has already moved to cleared products[5] and (ii) a significant number of uncleared transactions

[2] As used in this comment letter, the term "commercial end-user" has the same meaning as provided in the preamble to the Prudential Regulators Joint Final Rule, *Margin and Capital Requirements for Covered Swap Entities* **("Prudential Regulators Margin Rule").** *See* 80 Fed. Reg. 74,840, 74,848 n.70 (Nov. 30, 2015), *available at* https://www.gpo.gov/fdsYs/pkg/FR-2015-11-30/pdf/2015-28671.pdf. Specifically, a commercial end-user is

> a company that is eligible for the exception to the mandatory clearing requirement for swaps under [S]ection 2(h)(7)(A) of the Commodity Exchange Act.... This exception is generally available to a person that (1) is not a financial entity, (2) is using the swap to hedge or mitigate commercial risk, and (3) has notified the [Commodity Futures Trading Commission]...how it generally meets its financial obligations with respect to non-cleared swaps or security-based swaps....

Prudential Regulators Margin Rule at 74,848 n.70.

[3] *See* Proposed 12 C.F.R. § 252.81 (cross-referencing 12 U.S.C. § 5390(c)(8)(D), which provides that a QFC "means any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the [FDIC] determines by regulation, resolution, or order to be a qualified financial contract...").

[4] *See* Proposed 12 C.F.R. § 252.88(a).

[5] *See* Remarks of CFTC Chairman Timothy Massad before the 3rd Annual OTC Derivatives Summit North America (Sept. 29, 2015), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-28 (noting that "approximately [75%] of the swap transactions are being cleared, as compared to only about [15%] in 2007"); *see also* Bank of England Quarterly Bulletin, Over-the-Counter (OTC) Derivatives, Central Clearing and Financial Stability at 283 (Q3 2015), *available at* http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2015/q306.pdf (stating that "[approximately 50% of interest rate contracts and 20% of credit derivative contracts outstanding globally are now centrally cleared" and that "[t]he proportion of the flow of new contracts which is centrally cleared is higher still: since the introduction of the clearing obligation in the United States in 2013, for example, 80% of new interest rate contracts and 70% of new credit derivative contracts have been centrally").

may be between financial institutions that are already subject to the ISDA 2015 Universal Resolution Stay Protocol, the Proposed Rule would apply to QFCs in the remainder of the over-the-counter markets. Commercial end-users make up a significant portion of this remainder. As such, if the Board of Governors were to issue a final rule based upon the Proposed Rule, it would knowingly change the rights of a segment of market participants that Congress took great lengths to protect in the Dodd-Frank Wall Street Reform and Consumer Protection Act **("Dodd-Frank Act"),**[6] namely the rights of commercial end-users.

The Working Group urges the Board of Governors not to issue a final rule in this proceeding. If the Board of Governors insists upon issuing a final rule, it should first issue a revised proposed rule after (i) giving proper weight to comments it receives on the Proposed Rule and (ii) obtaining input from the regulators whose jurisdictions would be impacted. Given the necessary changes to appropriately tailor the scope and effect of the proposals and the need for a more robust quantitative cost-benefit analysis, among other issues, the Proposed Rule does not provide a sufficient basis on which the Board of Governors can issue a final rule without questions of the rule's ability to withstand legal challenge. If the Board of Governors issues a revised proposed rule or a final rule in this proceeding, the Working Group urges the Board of Governors to consider the recommendations set forth herein.

II. COMMENTS OF THE WORKING GROUP.

The Working Group strongly objects to the Proposed Rule for the reasons listed below, which are further discussed in Section II.A herein, and urges the Board of Governors to reconsider issuing a final rule in this proceeding.

- The Proposed Rule would inappropriately bypass the legislative process to override the specific and carefully-planned statutory framework established by Congress in the U.S. Bankruptcy Code[7] and the Federal Deposit Insurance Act **("FDIA").**[8]

- Systemic risk would not be assuredly mitigated by the Proposed Rule - systemic risk could actually be increased in the physical commodity markets by the Proposed Rule.

- The default and other contractual rights that commercial energy companies have historically relied upon for more than just counterparty credit risk mitigation would be limited by the Proposed Rule, which would negatively impact physical markets, energy companies, and consumers.

- The cost-benefit discussion in the Proposed Rule makes unqualified assumptions about the costs, provides no evidence that the benefits would outweigh the costs, and does not discuss the potential impact to physical commodity markets.

6 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

7 11 U.S.C. §§ 101-1532 (2012 & Supp. III 2015).

8 *See* 12 U.S.C. §§ 1811-1835a (2012).

If, however, the Board of Governors issues a revised proposed rule or a final rule in this proceeding, the Working Group offers the recommendations listed below, which are further discussed in Section II.B herein.

- The Board of Governors should seek input from the regulators whose jurisdictions would be impacted by the one-way stay *(e.g.,* Commodity Futures Trading Commission **("CFTC")** or the Federal Energy Regulatory Commission **("FERC")).**

- The text of Proposed 12 C.F.R. § 252.83(b)(2) should be amended to clarify the circumstances in which a stay would apply.

- The Proposed Rule should provide an exception from the stay for certain types of contracts to help ensure functional physical commodity markets.

- If the Board of Governors insists on restricting cross-default rights, Proposed 12 C.F.R. § 252.84 should be revised to provide a limited exception to the restrictions to help ensure functional physical commodity markets.

- The burden of proof standard required under Proposed 12 C.F.R. § 252.84(j) to exercise a default right is not appropriate and should be removed.

Finally, Section II.C herein discusses issues regarding certainty of law and notes that the Proposed Rule, coupled with similar regulation by foreign financial regulators, erodes the right of firms to contract privately for treatment and protections under U.S. law.

A. OBJECTIONS TO THE PROPOSED RULE.

1. The Proposed Rule would inappropriately bypass the legislative process to override the statutory framework established by Congress in the U.S. Bankruptcy Code and FDIA.

The Proposed Rule would inappropriately bypass the legislative process to override the specific and carefully-planned statutory framework established by Congress in the U.S. Bankruptcy Code and FDIA. The Proposed Rule would generally prohibit a Covered Entity from being a counterparty to a QFC that provides a default right based upon the insolvency of a Covered Entity's affiliate. Thus, under the Proposed Rule, Covered QFCs would be subject to a contractual stay that currently does not apply under the U.S. Bankruptcy Code or FDIA.

Under the U.S. Bankruptcy Code, Congress provided specific Safe Harbor Provisions that would permit a counterparty to a QFC to: (i) enforce contractual rights to terminate, liquidate, or accelerate; (ii) benefit from exceptions from the automatic stay with respect to netting and setoff rights; and (iii) benefit from an exemption from a trustee's powers to avoid certain types of transfers received from a debtor.[9] Legislative history has repeatedly reflected that Congress

[9] As used in this comment letter, the "Safe Harbor Provisions" of the U.S. Bankruptcy Code refer to 11 U.S.C. §§ 362(b)(6), 362(b)(7), 362(b)(17), 546, 556, 559, 560, and 561 (2012).

views the Safe Harbor Provisions as reducing systemic risk. Further, neither the U.S. Bankruptcy Code nor FDIA prevent a counterparty from exercising cross-default rights against an affiliate of a party entering resolution.[10]

Notably, when Congress passed legislation that amended the U.S. Bankruptcy Code and FDIA,[11] Congress did so "to reduce 'systemic risk' in the banking system and financial marketplace,"[12] and "to minimize the risk of disruption when parties ... become bankrupt or insolvent" by allowing "the expeditious termination or netting of certain types of financial transactions."[13] Further, when Congress passed the Dodd-Frank Act to provide sweeping financial reform, it chose not to reform the Safe Harbor Provisions of the U.S. Bankruptcy Code and chose not to address cross-default rights under the U.S. Bankruptcy Code or FDIA. As such, the U.S. Bankruptcy Code and FDIA reflect careful consideration by Congress, which would be inappropriately undercut by the Proposed Rule.

In light of Congress's careful consideration with respect to the U.S. Bankruptcy Code and FDIA, the Proposed Rule appears to have been based on a flawed interpretation of a directive under the Dodd-Frank Act. Specifically, the Board of Governors notes that the Proposed Rule is issued in response to Section 165 of the Dodd-Frank Act, which "directs the [Board of Governors] to promote financial stability through regulation ... '[i]n order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions.'"[14] However, the Board of Governors' interpretation could give it an unfettered source of general rulemaking authority and make superfluous significant aspects of the U.S. Bankruptcy Code and FDIA.[15] Further, construing Section 165 of the Dodd-Frank Act, which can be paraphrased as "promote financial stability," as a congressional grant of rulemaking authority may amount to an unconstitutional delegation of legislative authority.[16]

The Board of Governors expressly seeks to alter the rights of counterparties under the U.S. Bankruptcy Code and FDIA as they are currently written. If there were any other aim, the Proposed Rule would be largely meaningless. However, the process by which the Board of

10 *See* Proposed Rule at 29,173.

11 *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 **("BAPCPA"),** Pub. L. No. 109-8, 119 Stat. 23 (2005); *see also* H.R. Rep. No. 109-31 Part I at n.77 (2005), *available at* https://www.congress.gov/109/crpt/hrpt31/CRPT-109hrpt31-pt1.pdf (noting that BAPCPA amended FDIA).

12 H.R. Rep. No. 109-31 Part I at 20.

13 *Id.*

14 Proposed Rule at 29,170 (citing 12 U.S.C. § 5365(a)(1)).

15 *See Cent. Forwarding, Inc. v. ICC.*, 698 F.2d 1266, 1284 (5th Cir. 1983) (noting that there are reasons for not reading a statute "as an unfettered source of general rulemaking authority" since "[s]uch a reading would make superfluous" other statutory provisions that have detailed guidelines).

See id. (stating that construing provisions of a statute, "which paraphrased says little more than 'go forth and do good,' as a congressional grant of rulemaking authority might well amount to an unconstitutional delegation of legislative authority").

Governors seeks to implement such changes subverts the typical means through which U.S. statutes are changed. Arguments that the Proposed Rule would not make changes to the U.S. Bankruptcy Code or FDIA are disingenuously arguing "form over function" in a way that significantly downplays the compulsory nature that the Proposed Rule would have. If the Board of Governors believes such changes are necessary, it should petition Congress for them.

2. Systemic risk would not be assuredly mitigated by the Proposed Rule — systemic risk could actually be increased in the physical commodity markets by the Proposed Rule.

The Proposed Rule may not reduce systemic risk and might actually increase systemic risk in the physical commodity markets. Because of material differences that exist between financial and physical commodity markets, the stay of cross-default rights contemplated under the Proposed Rule stands to have certain unintended consequences. As discussed further herein, efficiently operating physical commodity markets are wholly dependent on the ability of market participants to make and take delivery of physical commodities - a characteristic that differentiates these markets from financial markets. The physical markets' ability to operate efficiently, however, would be jeopardized by the restrictions on cross-default rights as currently proposed, and the Board of Governors should have contemplated the effects to physical commodity markets in the Proposed Rule.

Notably, under a physical commodity contract, a counterparty's ability to make or take delivery of the commodity may in some respects be more essential than a counterparty's ability to make associated payments. Delivery delays (of hours, let alone days) have palpable consequences in the physical market, and parties may incur penalties and damages well above the mere accrual of interest. For example, a ship containing commodities that does not dock or unload may incur demurrage and other fines. Similar adverse consequences could occur at the retail, every-day consumer level. For example, if delivery became uncertain under natural gas supply contracts, a power generator may not be able to switch quickly to a new supplier as a function of the stay on termination. This delay could harm both sourcing and pricing of natural gas. If several generators facing the same Covered Entity were similarly situated, the collective problem would be systemic. Ultimately, retail consumers also would be negatively affected by such price volatility. These penalties and costs can be significant, particularly when taking into consideration the domino effect of a delay in just one segment of a supply chain, which can *increase* systemic risk.[17] Further, in the event of a financial crisis, contractual stays on physical markets may even *exacerbate* the situation if a substantial number of physical commodities *(e.g.,* multiple tankers of crude oil) cannot be sold into the market. Such delays may cause a shortage of essential commodities (e.g., electricity and heating oil), leading to a potentially dire situation.

[17] The right to terminate is even more critical to parties that rely on one or more sole suppliers of commodities. These firms have critical dependence on the ability to perform and market knowledge of their suppliers.

3. The default and other contractual rights that commercial energy companies have historically relied upon would be limited by the Proposed Rule, which would negatively impact physical markets, energy companies, and consumers.

The Board of Governors would limit the default and other contractual rights that commercial energy companies have historically relied upon for mitigation of counterparty credit risk as well as operational risk. The loss of commercial counterparties to fully manage operational risk would negatively impact physical markets, energy companies, and consumers. Specifically, physical commodity markets must run smoothly and efficiently to meet consumer demand at affordable prices. A well-run global market for commodities allows for the growth, processing, transportation, and consumption of goods by the world population, including U.S. citizens. Critical to this market is industry participants' ability to manage risk to keep prices affordable for consumers. Such price stability is a function of managing both counterparty credit risk ***and*** operational risk.

The Proposed Rule fails to fully appreciate the importance of managing operational risk with respect to the physical commodity contracts that are included in the definition of "QFC." Physical commodity markets are different from markets for securities transactions or interest rate swaps because a number of operational considerations arise in the delivery of a bulk quantity of tangible goods. For example, delays in physical commodity delivery would interrupt the careful logistics that underpin the value chain for commodities that keep prices low for consumers and the industry. Most significantly, financial compensation is a grossly imperfect substitute for physical delivery of the commodity itself. A refinery requires physical crude oil to produce motor fuels - it cannot refine a financial payment.

It would be an error to assume that, through pricing, contracting parties can adequately address operational risks in the close-out of physical commodity contracts that become subject to a stay. Operational risks can vary and the associated costs are highly dependent on the facts and circumstances in which a delivery of commodities is either delayed or canceled. Often the mitigation of costs is a subjective determination made by market participants at one moment in time. Thus, "quantifying the risk" is, at best, an approximation that likely will not cover any costs actually incurred in the event of an operational failure.

Further, even if the cost of such risk could be accurately quantified and incorporated into a contract, a stay in termination may still hinder a counterparty's ability to mitigate costs by arranging delivery to or from a third party. In other words, if the Board of Governors' proposed restrictions on cross-default rights is applied to physical commodity contracts, it may actually *increase* the adverse consequences from operational risk. For example, it is foreseeable that the inability to redirect seafaring vessels full of commodities could result in such vessels becoming stranded as disputes are arbitrated or litigated, thus further disrupting the supply chain and possibly affecting commodity prices. To account for this, physical market participants would need to price the added risk into their contracts, likely passing the cost along to consumers for such everyday items as groceries and motor fuel — potentially the worst possible outcome.

4. The cost-benefit analysis in the Proposed Rule is incomplete and makes unquantified assumptions.

The cost-benefit discussion in the Proposed Rule makes unquantified assumptions about the costs, provides no evidence that the benefits would outweigh the costs, and does not discuss the potential impact to physical commodity markets. The Board of Governors' conclusions are more akin to policy statements than quantitative analysis. Even when discussing the potential impact to Covered Entities, the cost-benefit analysis fails to quantify any of the potential costs and instead uses imprecise language *(e.g.,* costs would be "relatively small"). [18] Further, the suggestion in the cost-benefit analysis that counterparties can "prudentially manage risk through other means, including entering into QFCs with entities that are not GSIB entities" suggests that the Board of Governors may be severely underestimating (i) the significant number of market participants that rely on Covered Entities for QFCs, (ii) the number of Covered Entities that transact Covered QFCs, and (iii) the important role that Covered Entities play in providing liquidity to the markets.

To meet its Administrative Procedure Act requirements and to potentially inform a reviewing court, the Board of Governors should engage in a robust, quantitative analysis before issuing any final rule in this proceeding. Arguably, the Board of Governors should re-propose the rule so that participants, particularly those affected by the rule, and regulators whose jurisdictions are impacted can meaningfully review and comment.

B. <u>RECOMMENDATIONS IF THE BOARD OF GOVERNORS ISSUES A REVISED PROPOSED RULE OR A FINAL RULE IN THIS PROCEEDING</u>.

Although it is the Working Group's strong preference for the Board of Governors to not issue a final rule in this proceeding, the Working Group offers the recommendations set forth herein in the event the Board of Governors issues a revised proposed rule or a final rule in this proceeding.

1. The Board of Governors should seek input from the regulators whose jurisdictions would be impacted by the one-way stay.

The Board of Governors should seek input from the regulators whose jurisdictions would be impacted by the Proposed Rule's one-way stay. The definition of "collateral agreement" in Proposed 12 C.F.R. § 217.2 provides that any Board-regulated entity must have a right to terminate a trading contract, and specifies that the exercise of such right may <u>**not**</u> be stayed (except for stays under OLA[19] or FDIA or similar laws). Thus, Proposed § 217.2 creates a "one-way stay." The one-way stay impacts entities regulated by other regulators *(e.g.,* entities regulated by the CFTC or the FERC); however, other regulators appear to have not had an opportunity to weigh in on the Proposed Rule. Given the broad implications of the Proposed

[18] Proposed Rule at 29,184.

[19] Orderly Liquidation Authority under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act **("OLA").** *See* 12 U.S.C. §§ 5381-5394 (2012).

Rule and the considerable impact it would have on other regulated entities, the Proposed Rule should have been subject to a full vetting process with input from other regulators.

The Board of Governors' approach of not including input from other regulators stands in stark contrast to the approach taken by Congress when it amended the U.S. Bankruptcy Code and FDIA under BAPCPA. Specifically, many of the provisions in BAPCPA that seek to reduce systemic risk and minimize the risk of disruption were based on recommendations issued by the President's Working Group on Financial Markets, among others.[20] The President's Working Group on Financial Markets "included representatives from the [CFTC], the Federal Deposit Insurance Corporation, the [Board of Governors], the Federal Reserve Bank of New York, the Securities and Exchange Commission, and the Department of the Treasury, including the Office of the Comptroller of the Currency."[21]

2. The text of Proposed 12 C.F.R. § 252.83(b)(2) should be amended to clarify the circumstances in which a stay would apply.

The Working Group respectfully requests that the Board of Governors revise Proposed 12 C.F.R. § 252.83(b)(2) to provide clarity regarding its intended effect. In sum, Proposed § 252.83(b)(2) would require a Covered Entity to ensure its Covered QFCs explicitly provide, among other things, that default rights could be exercised to no greater extent than they could be exercised under OLA and FDIA if the Covered QFC were governed by the laws of the United States or of a state of the United States.[22] Clarity is needed, however, because the actual text of the proposed regulation appears to produce a different, broader outcome than the intended effect described in the preamble to the Proposed Rule.

In the preamble to the Proposed Rule, the Board of Governors explains that the purpose of proposing to require these contractual provisions is to "provide certainty that all [Covered] QFCs would be treated the same way in the context of a receivership of a [Covered Entity] under [OLA or FDIA]."[23] The Board of Governors further notes that by requiring these contractual provisions to be incorporated into the Covered QFC, the Proposed Rule seeks to "ensure that a court in a foreign jurisdiction would enforce the effect of [OLA and FDIA], regardless of whether the court would otherwise have decided to enforce the U.S. statutory provisions themselves."[24] Based on the preamble to the Proposed Rule, it appears that the intended outcome of requiring these provisions is to ensure that if a Covered Entity enters into a resolution proceeding under OLA or FDIA ***then*** the Covered QFC would be treated the same as it would be under OLA or FDIA regardless of whether the contract was entered into in the United States. The Working Group believes this is the outcome the Board of Governors intended.

20 H.R. Rep. No. 109-31 Part I at 20.

21 *Id.* at n.79.

22 Proposed Rule at 29,178; *see also* Proposed 12 C.F.R. § 252.83.

23 Proposed Rule at 29,178.

24 *Id.*

However, the actual text of Proposed 12 C.F.R. § 252.83(b)(2) could be interpreted to produce a different outcome. Specifically, the proposed text of the regulation could be read to require Covered QFCs to be subject to the stay of default rights that would apply under OLA or FDIA ***even if*** the Covered Entity is ***not*** in a resolution proceeding under OLA or FDIA. Stated another way, if a Covered Entity becomes insolvent but is not in a resolution proceeding under OLA or FDIA *(e.g.,* a U.S. Bankruptcy Code proceeding), the proposed text of the regulation could be interpreted to require a stay of default rights to the same extent as they would be required under OLA or FDIA.[25] The Working Group does not believe this is the outcome the Board of Governors intended, nor is the outcome necessary or desirable.

To address this ambiguity, the Working Group respectfully requests that the Board of Governors revise Proposed § 252.83(b)(2) to make clear that the stay of default rights applicable under OLA or FDIA would apply only if the Covered Entity is in a resolution proceeding under OLA or FDIA.

3. The Proposed Rule should provide an exception for certain types of contracts to help ensure physical commodity markets operate smoothly.

The Working Group respectfully requests that the Board of Governors provide an exception to the definition of QFC to exclude certain types of contracts. Ideally, all contracts requiring physical delivery between commercial entities in the course of regulatory business would be excluded, such as: (i) contracts subject to a FERC-filed tariff; (ii) contracts that are traded in markets overseen by independent system operators or regional transmission operators; (iii) retail electric contracts; (iv) contracts for storage or transportation of commodities; (v) contracts for financial services with regulated financial entities *(e.g.,* brokerage agreements and futures account agreements); and (vi) public utility contracts.

Excluding these contracts from the definition of QFC would help ensure physical commodity markets operate smoothly and that customers' utilities are not unnecessarily disrupted. Further, the Working Group is not aware of any evidence indicating that excepting these contracts from a stay would impose systemic risk.

4. Proposed 12 C.F.R. § 252.84 should be revised to provide a limited exception to the restrictions on cross-default rights to help ensure functional physical commodity markets.

If the Board of Governors insists on restricting cross-default rights of Covered QFCs, Proposed 12 C.F.R. § 252.84 should be revised to provide a limited exception to the restrictions to help ensure functional physical commodity markets.

[25] Proposed 12 C.F.R. § 252.83 contemplates that a non-U.S. resolution authority could impose a foreign resolution regime with respect to QFCs between U.S.-based subsidiaries of a foreign parent and a U.S. company, even where such QFCs are by their terms governed by U.S. law. This would, in effect, insert foreign law and agencies into contractual arrangements formerly protected by U.S. law.

Specifically, following the insolvency of an affiliate of a Covered Entity, when a Covered Entity defaults on *any* physical delivery obligation to *any* counterparty, then its counterparties with obligations to deliver or take delivery of physical commodities within a short timeframe after the default should be able to immediately terminate all trades (both physical and financial) with the Covered Entity.[26] To be clear, this exception would be permissible only for failure to make or take delivery of the applicable commodity, and not for a failure to make a related payment. This change would slightly extend a counterparty's ability to not suffer a stay in the event of a direct default, which the Board of Governors preserves in the Proposed Rule.

Allowing a counterparty to exercise a default right under these limited circumstances would help ensure it can plan for physical delivery in a short period of time, thereby mitigating the potential consequences to physical markets as a whole.[27] This modification to the Proposed Rule is vital to ensure that physical commodity markets are able to function efficiently,[28] and the Working Group strongly encourages the Board of Governors to adopt this exception to the proposed restriction on cross-default rights should it issue a final rule in this proceeding.

5. The burden of proof standard required under Proposed 12 C.F.R. § 252.84(j) to exercise a default right is not appropriate and should be removed.

The burden of proof standard required under Proposed 12 C.F.R. § 252.84(j) to exercise a default right is not appropriate and should be removed. As the Board of Governors is aware, the Proposed Rule would require a Covered QFC to specify the following standards that a counterparty to a Covered QFC must meet when it is seeking to exercise a default right after an affiliate of a Direct Party becomes subject to a receivership, insolvency, liquidation, resolution or similar proceeding:

- the party seeking to exercise a default right bears the burden of proof that such exercise is permitted under the Covered QFC; and

- to exercise the default right, a clear and convincing evidence or similar or higher burden of proof is required.[29]

Specifically, the Working Group respectfully requests that the Board of Governors remove entirely Proposed § 252.84(j). "Clear and convincing evidence" is a high legal standard and not one commonly required in the termination of contracts. The Board of Governors

[26] For example, Party A may attempt to deliver commodities to an affiliate of a Covered Entity and that Covered Entity becomes insolvent. If the affiliate of the Covered Entity did not accept delivery, Parties B and C could terminate their trades with the affiliate of the Covered Entity or the Covered Entity. However, if the affiliate of the Covered Entity properly accepted delivery, but failed to make a related payment to Party A, Parties B and C would continue to have their cross-default rights restricted.

[27] See Section IIA.2 and Section II.A.3 of this comment letter.

[28] See Section II.A.2 and Section II.A.3 of this comment letter.

[29] *See* Proposed 12 C.F.R. § 252.840).

provides no analysis of how a counterparty could meet this standard or to whom, if anyone, such findings must be proved. Moreover, the Working Group strongly objects to Proposed § 252.84(j) because it would impose a higher burden of proof upon a non-Covered Entity than a Covered Entity. Further, this requirement and high standard of proof are unnecessary and would add costs that outweigh any benefit.

C. ISSUES REGARDING CERTAINTY OF LAW.

The Proposed Rule represents a step in the deterioration of the ability of private parties to contract for the treatment of specific laws. The Proposed Rule, in part, is designed to require non-U. S. courts reviewing the termination rights of counterparties to contracts governed by the laws of the jurisdictions in which such courts reside (e.g., a British court reviewing a contract governed by UK law to which a Covered Entity is a party) to give effect to the stay-and-transfer provisions of OLA and FDIA.[30] In effect, the Proposed Rule forces U.S. law into contracts where the contracting parties may have contracted for the benefits of non-U.S. law. The Board of Governors notes that foreign regulators have enacted similar regulations that would command adherence to their resolution regimes.[31]

Collectively, these regulations would, in effect, force counterparties of Covered Entities to submit to the resolution authority of jurisdictions that are different from (i) the courts to which contracting parties agree to submit and (ii) the laws pursuant to which such parties agreed to contract. This result overrides the interests of contracting parties who might seek the certainty of courts and legal systems for which they are contracting. This legal override feature also compounds the difficulty of assessing counterparty credit risk because multiple insolvency regimes may apply. Notably, if a counterparty is not readily familiar with the details of each such regime,[32] the counterparty may be prompted to seek additional advice from foreign counsel, which would increase associated legal expenses.

The Board of Governors should afford more serious and explicit consideration of the forced loss of contracting rights, particularly for U.S. firms. The Proposed Rule is silent, notably in the cost-benefit analysis, of the loss of contracting rights or the effects of the Proposed Rule on the competitiveness of firms in the physical commodity markets. Without accounting for the diminution of the ability of U.S. firms to fully avail themselves of particular legal systems by

[30] Proposed Rule at 29,178.

[31] *Id.; see also id.* at 29,176 (noting that "[a]s with the coverage of subsidiaries of U.S. GSIBs, coverage of the U.S. operations of foreign banks will enhance the orderly resolution of the foreign bank and its U.S. operations").

[32] A significant degree of legal uncertainty applies when foreign law trumps the law that contracting parties selected, and such uncertainty exists particularly for termination issues. For example, it is unclear if a foreign court would respect the contractual provisions or legal tenets around the determination of the close-out value or the dispute resolution provisions. Also less certain are rights to collateral that has been re-hypothecated or even the valuation of collateral not directly valued by reference to third-party price providers. Thus, while the Board of Governors and other foreign regulators cite regulatory certainty for justifying single point of entry resolution regimes, the mosaic of international regulations poses a substantial number of legal questions.

contract (and possibly to the exclusion of others), the Proposed Rule cannot represent the product of an open and well deliberated regulatory rulemaking.

m. CONCLUSION.

The Working Group appreciates this opportunity to provide comments on the Proposed Rule and respectfully requests that the Board of Governors consider the comments set forth herein.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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