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**FINAL**

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Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
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**Re: Comments on Notice of Proposed Rulemaking: *Capital Requirements of Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 91252, published on December 16, 2017, in RIN 3038-AD54**

Dear Mr. Kirkpatrick:

The International Energy Credit Association ("IECA") respectfully submits these comments ("Comments") to the Commodity Futures Trading Commission ("CFTC" or "Commission") on the above-captioned Notice of Proposed Rulemaking: *Capital Requirements of Swap Dealers and Major Swap Participants*, ("Proposed Capital Rule"), published on December 16, 2017, at 81 Fed. Reg. 91252, in RIN 3038-AD54.[1]

## I. IECA Comments on the Proposed Capital Rule

In the Proposed Capital Rule establishing capital requirements for swap dealers ("SDs") and major swap participants ("MSPs"), the Commission has proposed three separate approaches to setting capital requirements for SDs, namely: (i) permitting SDs to "elect a capital requirement based on existing bank holding company capital rules adopted by the Federal Reserve Board" ("Bank-Based Capital Approach"), (ii) permitting SDs to "elect a capital requirement based on the existing CFTC FCM capital rule, the existing SEC broker-dealer capital rule, and the SEC's proposed capital requirements for [security-based swap dealers] SBSDs" ("Net Liquid Assets Capital Approach"), or (iii) permitting "SDs that meet defined conditions designed to ensure that they are "predominantly engaged in non-financial activities" to compute their minimum regulatory capital based upon the firm's tangible net worth" ("Tangible Net Worth Capital Approach").[2] For MSPs, the Commission has proposed a minimum regulatory

[1] See "Notice of proposed rulemaking: extension of comment period," published on March 16, 2017, at 82 Fed. Reg. 13971, in RIN 3038-AD54, which extended the comment deadline until May 15, 2017.
[2] See Proposed Capital Rule, 82 Fed. Reg. 91252 at 91254.

capital requirement based upon the tangible net worth of the MSP applicable to any MSP for which there is not a prudential regulator.[3]

For all the valid justifications expressed by the Commission in its Proposed Capital Rule, the IECA supports the Commission's addition of a Tangible Net Worth Capital Approach for establishing the capital requirements for eligible SDs in proposed CFTC Regulations Section 23.101(a)(2) and for MSPs in proposed CFTC Regulations Section 23.101(b).[4]

## II. Concerns of the IECA

### A. The Definition of "Predominantly Engaged in Non-Financial Activities" is Too Restrictive.

The IECA agrees with the Commission's creation of the Tangible Net Worth Capital Approach for any SD that is "predominantly engaged in non-financial activities," but the IECA is concerned that the proposed definition of the term "predominantly engaged in non-financial activities" is too restrictive so that few, if any, non-bank entities will be able to qualify to use the Tangible Net Worth Capital Approach.

If a corporate group that is neither a bank holding company nor a bank forms a subsidiary to act as a SD in exempt and agricultural commodities, including entering into futures contracts and options on futures, then that corporate group's SD subsidiary may in fact only enter into swaps, futures and options, which the Commission has determined, in the context of defining "financial entity," are activities that are financial in nature as defined in Section 1843(k) of Title 12 (i.e., the Bank Holding Company Act). Assuming the Commission's use of a term in one context is to be read consistently with the Commission's use of that same term in a different context, the IECA is concerned that, while the entire corporate group is easily "predominantly engaged in non-financial activities," the specific subsidiary that is or will become registered with the CFTC as a SD, based solely on the swap dealing business of that SD subsidiary, will not be able to satisfy the Commission's proposed requirement that "a swap dealer is predominantly engaged in non-financial activities."

In determining whether a SD is eligible to use the Tangible Net Worth Capital Approach, if we presume that "predominantly engaged" means 85% or more of the entire non-banking corporate group's activities are "non-financial," then we also recommend that swaps and futures entered into in order to hedge exposure to commercial risk, whether entered into by the SD or by any other entity within that SD's corporate group, should not count toward the determination of whether 15% or more of the entire corporate group's activities are "financial activities." In other words, only swaps that involve "dealing" by the SD should count toward the calculation of "financial activities," which must constitute 15% or less of the entire non-banking corporate group's activities.

[3] Id.
[4] Id. at 91311.



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Accordingly, the IECA recommends that the Commission should consider the business of the SD's ultimate parent and determine whether the entire corporate group is "predominantly engaged in non-financial activities." If that is the case, then that corporate group's SD subsidiary should be eligible to use the Tangible Net Worth Capital Approach.

Such a less restrictive definition of "predominantly engaged in non-financial activities" will be much more likely to provide the meaningful relief and value to the liquidity of the swaps marketplace that we believe establishing the Tangible Net Worth Capital Approach is intended to provide.

**B. Recognition of Bilaterally-Negotiated Credit Support Provided for Uncleared Swaps that are Exempt from Clearing and Exempt from Margin Requirements**.

In proposed Section 23.101(a)(2), a SD qualifying to use the Tangible Net Worth Capital Approach must maintain Tangible Net Worth "equal to or in excess of the greatest of the following:" (A) $20 million plus the SD's "market risk exposure requirement" and its "credit risk exposure requirement;" (B) 8% of the sum of (1) "uncleared swap margin," plus (2) initial margin on security-based swaps, plus (3) initial margin required by clearing organizations for cleared proprietary futures and swaps; or (C) the "amount of capital required by a registered futures association" ("RFA") of which the SD is a member. In sum, any eligible SD using the Tangible Net Worth Capital Approach, must maintain a Tangible Net Worth that equals or exceeds the largest of (A), (B) or (C), as determined under proposed CFTC Regulation Section 23.101(a)(2).

Under clause (A) of proposed Section 23.101(a)(2)(ii), the terms "credit risk exposure requirement" and "market risk exposure requirement," which are used to calculate the minimum capital requirement under clause (A) of Section 23.101(a)(2)(ii), are defined in proposed CFTC Regulation Section 23.100 as the amounts that the SD is required to calculate, respectively, under: (i) "Section 23.102 if [the SD has been] approved to use internal credit risk models, or to compute under Section 23.103, if not approved to use internal credit risk models," and (ii) "Section 23.102 if [the SD has been] approved to use internal market risk models, or to compute under Section 23.103, if not approved to use internal market risk models." Under such clause A, the SD's Tangible Net Worth must equal or exceed $20 million plus the market risk exposure requirement and the credit risk exposure requirement calculated under Section 23.102 or Section 23.103, as applicable.

Under clause (B) of proposed Section 23.101(a)(2)(ii), the SD's Tangible Net Worth must equal or exceed 8% of the sum of the "uncleared swap margin," plus initial margin on security-based swaps, plus initial margin required by clearing organizations for cleared proprietary futures and swaps. In proposed Section 23.100, the term "uncleared swap margin" is defined as "the amount of initial margin a swap dealer would be required to collect from each counterparty for each outstanding swap position of the swap dealer.



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A swap dealer must include all swap positions in the calculation of the uncleared swap margin amount, including swaps that are exempt from the scope of the Commission's margin for uncleared swaps rules pursuant to Section 23.150 …" Section 23.150 exempts swaps from the CFTC's margin requirements if a counterparty to such swap is eligible for the end-user exception to clearing under CEA Section 2(h)(7)(A) or the hedging affiliate exception to clearing under CEA Section 2(h)(7)(D), plus swaps that are exempt because the counterparty is a cooperative.

Accordingly, for purposes of calculating the minimum capital requirement under clause (B) of proposed Section 23.101(a)(2)(ii), the SD must include initial margin for all swaps for which the counterparty is exempt from the margin requirements under Section 23.150. In essence, for purposes of the calculation in clause (B), the Commission requires the SD to assume that each such swap is "uncollateralized" or unsupported by credit support. In fact, in various places in the Proposed Capital Rule, the Commission refers to uncleared swaps that are exempt from the Commission's margin requirements as "uncollateralized exposures." For example, on page 91258, the Commission refers to its "statutory mandate - helping to ensure the safety and soundness of the SDs subject to its jurisdiction - to require an SD to reserve capital for all of its uncollateralized exposures, including the exposures that have been excluded or exempted from the Commission's margin requirements. This includes swaps where the counterparty is a commercial end user or an affiliate of the SD, as the uncollateralized exposures from these counterparties present risk to the financial condition of the SD." (Emphasis added.) See also footnote 36 which refers to swaps that are exempt from margin because a counterparty qualifies for an exception to clearing under CEA Section 2(h)(7)(A) or CEA Section 2(h)(7)(D).

The IECA wishes to make clear that characterizing all such swaps as "uncollateralized" is very often a mistake. We submit that the exemption from clearing and from the Commission's margin requirements under CEA Sections 2(h)(7)(A) and 2(h)(7)(D) are not intended to allow SDs to enter into swaps that are unsupported by reasonable levels of credit support, but are instead intended to allows the commercial end-user counterparty and the applicable SD to continue their historic business practices of (i) bilaterally negotiating the terms of each uncleared swap and (ii) bilaterally negotiating the terms of the credit arrangements each party will provide in support of such uncleared swaps. While such bilaterally negotiated credit support will not likely comply with the Commission's margin requirements under CFTC Regulation 23.156 or 23.157, very seldom will those uncleared swaps be unsupported by any credit support.

The Commission appears to recognize this distinction in its discussion of "Credit Risk Models" on page 91272 of the Proposed Capital Rule, when it includes the following discussion:

"The Commission in its margin requirements (see Regulations 23.150 through 23.161) has set forth the requirements for eligible collateral for uncleared swaps. In order to account for collateral in its VaR model for the credit risk charges, the Commission would expect an SD to account for only the collateral that complies with Regulation



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23.156 and is held in accordance with Regulation 23.157 for uncleared swaps that are subject to the Commission's margin rules. **An SD would be able to take into consideration in its VaR calculation collateral that does not comply with Regulation 23.156 and is not held in accordance with Regulation 23.157 for uncleared swaps that are not subject to the Commission's margin rules**." (Emphasis added.)

As a result, a SD could calculate its credit risk exposure requirement using a VaR model for credit risk charges and "take into consideration in its VaR calculation collateral that does not comply with Regulation 23.156 and is not held in accordance with Regulation 23.157 for uncleared swaps that are not subject to the Commission's margin rules." In so doing, the SD's credit risk exposure requirement would appropriately be reduced, in consideration of the credit support provided by the SD's commercial end-user or hedging affiliate counterparty, and the minimum capital requirement calculated under clause (A) of proposed Section 23.201(a)(2)(ii) would be reduced.

The IECA submits that if the calculation under clause (B) of Section 23.101(a)(2)(ii) produces a higher minimum capital requirement than the computation under clause (A), simply because clause (B) assumes that all swaps that are exempt from the CFTC's margin requirements under Section 23.150 are "uncollateralized," when the computation under clause (A) proves otherwise, then requiring such additional capital on the part of the SD is not required to address the SD's exposure to "credit risk." In such circumstances, requiring the SD to maintain its Tangible Net Worth equal to or higher than the greatest of (A), (B) or (C) is unreasonable and unsupported.

As a result, the IECA requests that the Commission modify proposed Section 23.101(a)(2)(ii) to specify that the Tangible Net Worth of an eligible SD must equal or exceed the amount calculated in accordance with clause (A) of Section 23.101(a)(2)(ii). Section 23.101(a)(2)(ii) could then specify that if an eligible SD elects not to use clause (A), then its Tangible Net Worth must equal or exceed the higher of clause (B) or clause (C).

### C. The CFTC and its DSIO Should Establish a Procedure for Expeditious Review and Approval of One or More Internal Capital Models Based on Accepted Industry Practices.

An eligible SD's use of clause (A) under Section 23.101(a)(2)(ii) will depend, in part, on the SD's receiving approval from the Commission's Division of Swap Dealer and Intermediary Oversight ("DSIO") or the RFA for the SD to use its internal capital models to calculate the credit risk exposure requirements and the market risk exposure requirements. The IECA submits that delay on the part of the Commission or the RFA should not be the basis for denying an eligible SD the right to utilize the Tangible Net Worth Capital Approach under clause (A) of Section 23.101(a)(2)(ii) to establish its capital requirement using such SD's internal capital models.

Accordingly, the IECA requests that the Commission establish a procedure whereby one or more internal capital models, based on industry-accepted practices, can



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be submitted to DSIO for review and approval. Thereafter, if an SD submits to the DSIO and the RFA its internal capital models, which utilize one of such approved methods, and if neither the DSIO nor the RFA have approved or rejected the SD's use of such internal capital models within thirty (30) days after such submission, then the SD's use of such internal capital models to calculate the minimum capital requirements for application of the Tangible Net Worth Capital Approach shall be deemed to have been approved.

The IECA suggests that it may be appropriate for the Commission to reserve to itself the right to subsequently review and reject the SD's use of any such internal capital models that have been deemed to have been approved, provided that a written analysis explaining any such rejection is also provided, and then, absent a finding of fraud on the part of the SD, such rejection would apply on a prospective basis only.

**D. Support of Other Comments Submitted to the Commission**.

In this regard, the IECA wishes to support and hereby urges the Commission to consider and accept the recommendations regarding the Proposed Capital Rule set forth in the Comments of The Commercial Energy Working Group ("Working Group Comments") and the Joint Comments of the Edison Electric Institute and the National Rural Electric Cooperative Association ("Joint EEI/NRECA Comments"), which were submitted to the Commission earlier today in this proceeding. In each entity's comments, the Commercial Energy Working Group ("Working Group"), the Edison Electric Institute ("EEI") and the National Rural Electric Cooperative Association ("NRECA") urge the Commission to modify the Proposed Capital Rule.

We particularly urge the Commission to consider the discussion in the Working Group Comments alerting the Commission to the adverse impacts on the liquidity of the swaps markets in energy commodities that could arise "particularly if commercial firms [that engages in swap dealing activity] cannot use the tangible net worth approach to meet its capital requirements."[5]

For the reasons set forth in the Working Group Comments, the Joint EEI/NRECA Comments and the Comments of the IECA set forth herein, the IECA respectfully encourages the Commission to modify the Proposed Capital Rule as more fully described therein and herein.

## III. About the IECA

The IECA is an association of over 1,400 credit, risk management, legal and finance professionals that is dedicated to promoting the education and understanding of credit and other risk management-related issues in the energy industry. For over ninety years, IECA members have actively promoted the development of best practices that reflect the unique needs and concerns of the energy industry.

[5] See page 3 of the Working Group Comments.



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The IECA seeks to protect the rights and advance the interests of a broad range of domestic and foreign energy market participants, representatives of which make up the IECA's membership. These entities finance, produce, sell, and/or purchase for resale substantial quantities of various physical energy commodities, including electricity, natural gas, oil and other energy-related physical commodities necessary for the healthy functioning of the energy markets and the "real economy". Many of these energy market participants rely on cleared and uncleared swap transactions to help them mitigate and manage (i.e., hedge) the risks of physical energy commodity price volatility to their commercial energy businesses, which millions of Americans and the American economy rely on for safe, reliable and reasonably-priced energy supplies.

## IV. Conclusion

The IECA appreciates the opportunity to provide these Comments and would welcome the opportunity to discuss these comments further should you require any additional information on any of the topics discussed herein.

Please direct correspondence concerning these comments to:


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Yours truly,
INTERNATIONAL ENERGY CREDIT ASSOCIATION

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