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VIA ELECTRONIC SUBMISSION

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Proposed Rule; Reopening of Comment Period; Request for Additional Comment, *Capital Requirements of Swap Dealers and Major Swap Participants* (RIN 3038-AD54)

Dear Mr. Kirkpatrick:

I. INTRODUCTION

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Eversheds Sutherland (US) LLP submits this letter in response to the request for additional public comment on the Commodity Futures Trading Commission's (the "**CFTC**" or "**Commission**") proposed rule regarding capital requirements of swap dealers and major swap participants (the "**Re-Proposal**").[1] The Working Group appreciates the Commission requesting additional comment through the Re-Proposal as it is appropriate for the Commission to consider changes to its proposed capital rule issued in 2016 (the "**2016 Proposal**")[2,3] given the market and regulatory developments that have occurred since then.

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[1] *See* Proposed Rule; Reopening of Comment Period; Request for Additional Comment, *Capital Requirements of Swap Dealers and Major Swap Participants*, 84 Fed. Reg. 69,664 (Dec. 19, 2019), https://www.cftc.gov/sites/default/files/2019/12/2019-27116a.pdf.

[2] *See* Notice of Proposed Rulemaking, *Capital Requirements of Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 91,252 (Dec. 16, 2016), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2016-29368a.pdf.

[3] In addition, the CFTC proposed capital requirements for swap dealers in 2011 but refrained from finalizing those rules because of market and regulatory developments, such as the global consultation on appropriate margin standards for uncleared swaps. *See* Notice of Proposed Rulemaking, *Capital Requirements of Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 27,802 (May 12, 2011), http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2011-10881a.pdf. When the CFTC's margin rules for uncleared swaps were finalized, the CFTC issue the 2016 Proposal.

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 advocates regarding regulatory, legislative, and market developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

As with the Working Group's comment letter on the 2016 Proposal ("**WG Letter on the 2016 Proposal**"),[4] the Working Group is concerned that the CFTC's proposed approach for capital requirements for non-financial swap dealers ("**Non-financial SDs**") may create a significant barrier to entry that prevents non-financial companies from acting as swap dealers in commodity markets at or above a level that requires registration. As noted in the WG Letter on the 2016 Proposal, commodity derivatives markets have experienced a decline in liquidity since 2010 and would benefit from an increase, and be further harmed by a decrease, in the number of active market makers. However, the Working Group is encouraged that the majority of the questions raised in the Re-Proposal indicate that the Commission is open to considering meaningful improvements to the 2016 Proposal. The comments below respond directly to certain of those questions.

II. COMMENTS OF THE WORKING GROUP

1. The Definition of "Predominantly Engaged in Non-financial Activities" Should Be Applied at the Ultimate Parent Level

The 2016 Proposal limits the availability of the Tangible Net Worth Capital Approach to regulatory capital to entities that derive less than 15% of their revenue over the previous two years from financial activity and whose financial assets represent less than 15% of their consolidated assets over the past two years.[5] Even by the Commission's own admission, this proposed approach to eligibility for the Tangible Net Worth Capital Approach is not functional. Specifically, the Commission, in the 2016 Proposal, admits that only one swap dealer would qualify to use an approach intended to accommodate the needs of non-financial swap dealers generally.[6]

As noted in the WG Letter on the 2016 Proposal, conducting the "non-financial activities" analysis at the level of the swap dealer presupposes that there is one proper way to structure a swap dealer inside of a larger non-financial enterprise. Said another way, the 2016 Proposal's application of the non-financial analysis to the level of swap dealer effectively dictates the corporate structure and business model that Non-financial SDs must use if they would like to utilize the capital approach intended for them. As such, the

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[4] *See* The Commercial Energy Working Group Comment Letter on the 2016 Proposal (May 15, 2017), https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61220&SearchText=.

[5] *See* Proposed CFTC Regulation 23.100.

[6] *See* 2016 Proposal at 91,300

Working Group appreciates the Commission asking whether that analysis would be more appropriately done at the level of a swap dealer's ultimate parent.[7]

In short, the ultimate parent level is the proper level at which to determine whether a corporate enterprise, and its subsidiaries, are predominantly engaged in non-financial activity. Conducting the analysis at this level would provide flexibility to Non-financial SDs when structuring their business and still allow them to use the Tangible Net Worth Capital Approach. As suggested in the WG Letter on the 2016 Proposal, the 2016 Proposal could be amended to limit the applicability of this approach to swap dealers who only engage in swap dealing activity in swap markets for exempt and agricultural commodities. This would avoid creating an incentive to conduct swap dealing activity that is not tied to a larger physical commodities business within a non-financial enterprise.

In the alternative, if the CFTC would like to determine eligibility for the Tangible Net Worth Capital Approach at an entity level, the CFTC could improve and simplify the test by examining whether an entity is engaged predominantly in commodities-related swap dealing activity. Specifically, the CFTC could allow any swap dealer whose exempt and agricultural commodity-related swap dealing activity comprises 85% or more of its swap dealing activity to utilize the Tangible Net Worth Capital Approach.

The Re-Proposal also asks whether the Commission should consider any revisions to the 15% asset test and 15% revenue test.[8] The Commission should exclude financial hedges of physical commodity, interest rate, or other corporate risks from the being considered "financial activities" for purposes of the 15% tests. The use of financial derivatives to manage commercial risk is common for non-financial entities and is not indicative of an entity being engaged in financial activity. Also, such activity likely is not swap dealing activity. In addition, the CFTC should consider assets and revenue derived from trading and investing in physical commodities to be non-financial in nature as the inclusion of that activity as "financial in nature" under the Federal Reserve's definition of that phrase[9] was not because such activity is financial, but because certain banks need the ability to transact in physical commodity markets to support their financial derivatives activity.

2. Alternative Forms of Credit Support Posted by Non-Financial End-Users Should Be Factored into the Counterparty Credit Risk Charge

The Working Group appreciates the Commission asking whether swap dealers should "recognize alternative forms of collateral (*e.g.*, letters of credit or liens) provided by commercial end-users that are exempt from clearing and from the uncleared margin requirements in computing the [swap dealers'] counterparty credit risk charges for uncleared swap transactions."[10] In short, the Commission should allow swap dealers to recognize the credit risk reducing characteristics of such alternative forms of collateral.

As a general matter, alternative forms of collateral, such as parental guarantees, letters of credit, or liens on assets are frequently used by swap dealers as credit risk mitigants when non-financial end-users do not post cash collateral on uncleared derivatives.

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7 *See* Re-Proposal at 69,674.

8 *See* Re-Proposal at 69,675.

9 *See* 12 C.F.R. 242.3.

10 *See* Re-Proposal at 69,681 (CFTC question 16).

As swap dealers clearly see value in those types of credit supports, the 2016 Proposal should be amended to provide a degree of regulatory capital relief when those forms of collateral are present. Doing so would be consistent with (i) Congressional intent and (ii) the approach taken by the Prudential Regulators in their recently finalized rule on the standardized approach to counterparty credit risk.[11]

Specifically, the 2016 Proposal should be considered in the context of Title VII of the Dodd-Frank Act, which, among other things, imposed capital and margin requirements on swap dealers.[12] The drafters of the Dodd-Frank Act took particular care to ensure that regulators implementing these and other requirements "carefully follow Congressional intent"[13] and not impose capital requirements that were "punitive to the end-users"[14] and "not punish those who are trying to hedge their own commercial risk."[15]

While the capital requirements in the 2016 Proposal would not be imposed directly on non-financial end-users, it would have a material impact on their ability to hedge commercial risk as the 2016 Proposal is likely to, by its own admission, increase the cost of their swaps.[16] This was understood by the drafters of the Dodd-Frank Act and is seen in their directive to regulators: properly balance the cost of margin and capital requirements on derivatives with the economic impact on the ability of non-financial end-users to use derivatives to reduce and hedge commercial risk. The 2016 Proposal does not reflect that Congressional intent and should be amended to do so, potentially by not imposing capital requirements that frustrate the ability of non-financial end-users to utilize credit support, such as parental guarantees, letters of credit, or liens on assets, or, in the very least, taking an approach to the SA-CCR final rule's treatment of the alpha factor as applied to non-financial end-users' hedging transactions.

In addition, allowing swap dealers to recognize alternative forms of collateral with respect to the counterparty credit risk charged on non-financial end-users' hedging transactions would be consistent with the CFTC's historic view of hedging transactions as being less risky. Generally, non-financial end-users' derivatives transactions that hedge or mitigate commercial risk pose less risk than non-hedging transactions because if the non-financial end-user is required to payout under the hedge, they likely had a positive outcome with respect to the risk that they were hedging. The CFTC has recognized this risk-reducing characteristic of hedging in similar circumstances. For example, the CFTC's regulations

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11 *See* Final Rule; *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 84 Fed. Reg. 4,362, 4,401 (Jan. 24, 2020), https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2019-27249.pdf.

12 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 731, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

13 *See* Letter from Senate Committee on Banking, Housing, and Urban Affairs Chairman Christopher Dodd and Senate Committee on Agriculture, Nutrition, and Forestry Chairman Blanche Lincoln to House Financial Services Committee Chairman Barney Frank and House Committee on Agriculture Chairman Colin Peterson at 4 (June 30, 2010) (the "**Dodd-Lincoln Letter**"), https://archives-agriculture.house.gov/sites/republicans.agriculture.house.gov/files/pdf/letters/DoddLincolnEndUserLetter.pdf.

14 Dodd-Lincoln Letter at 4.

15 Dodd-Lincoln Letter at 2.

16 *See* 2016 Proposal at 91,296.

require less initial margin to be posted with respect to hedge positions than non-hedge positions for cleared derivatives.[17]

3. Netting or Offsets Should Be Permitted for Commodity Positions

The Commission requests comment on whether proposed CFTC Regulation 1.17(c)(5)(iii) should be modified to include the Basel III simplified standardized approach of market risk for commodity swaps, which would allow netting of commodity positions when determining market risk.[18] Doing so would be consistent with common and current prudent risk management practices and would allow Non-financial SDs to be more responsive to customer needs. In particular if Non-financial SDs were permitted to offset physical and financial commodity positions, where appropriate, their market risk associated capital requirements would more accurately reflect their exposure to market risk than if just their derivatives positions were considered given that non-financial enterprises typically view their risk across their total physical and financial portfolio.

If the Commission is concerned that allowing netting of commodity positions would create inconsistencies between its capital requirements and those of the Prudential Regulators, then it could easily limit the availability of such netting to entities not subject to capital regulation by a Prudential Regulator.

4. The Compliance Implementation Timeline for the Swap Dealers Newly Subject to Capital Requirements Should Be Significant

In the Re-Proposal, the Commission asks for feedback on the appropriate period of time between the effective date of any final capital rule and the date upon which swap dealers must be in compliance with that final rule. The Working Group believes that a period of two years is appropriate for non-swap dealers given the market implications of any final rule, the extensive systems changes that will be required, and the potential need for affected swap dealers to restructure their asset holdings.

The Commission could also consider an implementation approach where swap dealer compliance is phased-in based on whether the swap dealers are currently subject to capital requirements. In addition, to lessen any potential market implications, the CFTC could phase-in the actual level of capital that must be held over time. This could be particularly important in markets like the commodity swaps market where there are a number of swap dealers that have never been subject to regulatory capital requirements.

5. Swap Dealers with Non-U.S. Ultimate Parents Should Be Permitted to Use IFRS

The Commission asks whether U.S. person swap dealers with foreign ultimate parents should be allowed to utilize international financial reporting standards ("**IFRS**") in connection with their financial reporting obligations, regardless of whether they are predominantly engaged in non-financial activity.[19] In short, U.S. domiciled swap dealers

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17 *See* Final Rule, *Derivatives Clearing Organization General Provisions and Core Principles*, 76 Fed. Reg. 68,334, 69,377 (Nov. 8, 2011), https://www.govinfo.gov/content/pkg/FR-2011-11-08/pdf/2011-27536.pdf#page=45.

18 *See* Re-Proposal at 69,672.

19 Re-Proposal at 69,679 (CFTC question 11-a).

with non-U.S. ultimate parents should be permitted to do so. To the Working Group's knowledge, two of the three non-financial swap dealers are U.S. domiciled, but have foreign ultimate parents. Those entities produce financial statements in IFRS for corporate financial reporting purposes and requiring a conversion to GAAP would be a material cost and resources burden, but would likely not provide a material benefit to the Commission.

6. Financial Reporting Timelines Should Be Extended

In the Re-Proposal, the CFTC asks a number of questions with respect to its proposed capital-related financial reporting requirements and timelines for swap dealers.[20] As the Working Group stated in the WG Letter on the 2016 Proposal, non-financial swap dealers likely will have significant difficulty in complying with the timeframe for a number of the 2016 Proposal's reporting obligations.[21]

To rectify those potential issues, the Commission should:

- provide a ninety-day period for swap dealers that consolidate into parent entities that are not predominantly engaged in financial activities to submit their audited annual financial statements;

- amend the public disclosure requirements for swap dealers that consolidate into parent entities that are not predominantly engaged in financial activities to mirror those required by the Securities and Exchange Commission ("**SEC**") for stand-alone security-based swap dealers by replacing the quarterly public disclosure of financial information requirement with a bi-annual requirement; and

- change the unaudited financial report posting requirement for such swap dealers from a ten business day requirement to a thirty calendar day requirement following the date of the statements.

These changes would significantly reduce the reporting burden on Non-financial SDs, who would have to build new processes to address these requirements as they are not currently subject to similar obligations at the swap dealer level.

7. The Risk Margin Amount Should Reflect a Swap Dealer's Size and Complexity

The Re-Proposal asks whether the 8% risk margin amount included in the 2016 Proposal is set at the appropriate level.[22] The risk margin amount should not be a one-size-fits-all number. Rather, it should be tiered for the size and complexity of a swap dealer's business. The proposed 8% level may be appropriate for the largest and most complex swap dealers. However, a lower level, like the 2% level adopted by the SEC,[23] may be appropriate for a smaller single-asset class swap dealer, given the simplicity and lower risk profile of its business.

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20 *See* Re-Proposal at 69,679.

21 *See* WG Letter on the 2016 Proposal at 6.

22 *See* Re-Proposal at 69,668.

23 *See* Re-Proposal at 69,669 (discussing the SEC's 2% level).

8. The Capital Model Requirements and Approval Process Should Be Streamlined

While there is some degree of commonality across swap dealers, each swap dealer faces its own unique set of risks. Therefore, the capital model approval process should take into account the nature of commercial swap dealers' business activities. For Non-financial SDs, that would mean capital models should focus on the risks associated with the physical commodity markets and any capital model for such dealers need not account for non-applicable risks like interest rate risk, specific risk, and incremental risk. The Working Group would like to confirm that the models permitted under the 2016 Proposal need only account for risks relevant to a swap dealer's particular business and need not address every risk and requirement set forth in Appendix A to proposed CFTC Regulation 23.102.

In addition, capital models that a swap dealer reasonably believes are compliant with the CFTC and National Futures Association's ("**NFA**") rules should be provisionally approved upon submission, but still subject to review and approval. The model approval process will likely be both time consuming and resource intensive for the NFA with respect to swap dealers using the Tangible Net Worth Capital Approach. As such, there is the potential for the model approval process for Non-financial SDs to stretch beyond any compliance date set by the CFTC. This would impose additional costs and would be a material barrier to entry to the extent that commercial firms might have higher capital costs because they would be forced to use the standardized model in order to register in a timely manner.

III. CONCLUSION

The Working Group appreciates this opportunity to comment on the Re-Proposal and respectfully requests that the Commission amend the proposed approach for capital requirements for Non-financial SDs as suggested.

If you have any questions, please contact the undersigned.

Respectfully submitted,
/s/ Alexander S. Holtan
Alexander S. Holtan
David T. McIndoe

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