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VIA ELECTRONIC MAIL

Office of the Comptroller of the Currency
250 E Street SW
Mail Stop 2-3
Washington, DC 20219

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Gary K. Van Meter, Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102

Alfred M. Pollard, General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street NW
Washington, DC 20552

Re: *Margin Requirement – Key Concerns for Commercial Companies*

Dear Sir or Madam:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the "Working Group"), Sutherland Asbill & Brennan LLP hereby submits these comments. 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 energy producers, marketers, and utilities. 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 is submitting comments to you in light of the consultative document, "*Margin requirement for non-centrally-cleared derivatives*" (the "Consultative Document"), issued by the Basel Committee on Banking Supervision ("BCBS") and the Board of the

International Organization of Securities Commissioners ("IOSCO").[1] The Working Group supports efforts by regulators to harmonize margin paradigms internationally. This effort should not be exclusively focused on financial institutions, but should also account for the interests of commercial firms, many of which use derivatives as a key tool in managing risks in connection with their core businesses of bringing commodities and their byproducts to consumers across the world. A national or international margin paradigm that does not account for the interests of these firms will likely cause liquidity issues that discourage the use of over-the-counter derivatives by commercial firms at the expense of efficient risk management practices.

The Working Group appreciates the opportunity to provide further comments on proposed regulations for the provision of margin in connection with swaps that parties do not submit for central clearing.[2] The Working Group has been an active participant in the rulemaking process regarding such margin practices and appreciates all your consideration in this process.[3]

II. COMMENTS.

The comments provided herein are organized to follow the discussion of margin practices in the Consultative Document.

A. Margin Requirements Should Facilitate the Trading of Over-the-Counter Derivatives Between a Regulated Entity and Commercial Firm.

The Working Group supports the proposition that margin regulation should be appropriate to address the systemic risk presented by counterparties. Such regulation, however, should also allow the continued effective use of derivatives by commercial firms. The Consultative Document partially echoes these concepts. It reports a consensus within BCBS and IOSCO that "margin requirements need not apply to non-centrally-cleared derivatives to which non-financial entities that are not systemically important are a party, given that [ ] such transactions are viewed as posing little or no systemic risk . . . ."[4] The Working Group supports the view that such transactions pose little or no systemic risk.[5]

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[1] *Margin requirement for non-centrally-cleared derivatives*, Consultative Document, BCBS and IOSCO, Sept. 28, 2012 (the "Consultative Document").

[2] *Margin and Capital Requirements for Covered Swap Entities; Reopening of Comment Period*, Proposed Rule, 77 Fed. Reg. 60,057 (Oct. 2, 2012).

[3] *See* Working Group of Commercial Energy Firms Letter to CFTC regarding *Proposed Margin and Capital Requirements* (filed July 11, 2011); Working Group of Commercial Energy Firms Letter to Prudential Regulators regarding *Margin and Capital Requirements for Covered Swap Entities* (filed July 11, 2011); Working Group of Commercial Energy Firms Letter regarding *Rulemakings for Capital and Margin Requirements under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (filed Nov. 24, 2010).

[4] *Consultative Document* at 9.

[5] *Id.* BCBS and IOSCO propose universal two-way margin requirements. We believe such requirements are beneficial but that commercial firms should be allowed to negotiate such terms with any regulated entity. Many commercial firms have experienced credit and risk functions, and they may determine that a regulated entity's creditworthiness allows for some amount of unsecured exposure to that entity in exchange for other benefits.

Accordingly, margin regulations should allow regulated entities that are trading with commercial firms to (a) agree to sufficient unsecured thresholds that account for the creditworthiness of a commercial firm, (b) use initial margin determinations that are tailored to actual risk in commodity swap transactions and permit the netting of financial and physical exposures, and (c) accept forms of collateral that do not cause liquidity issues for commercial firms. We discuss these concepts in more detail below.

1. Use of Unsecured Credit Thresholds.

Margin regulations should allow regulated entities to continue with traditional credit practices and offer appropriately sized unsecured trading thresholds to commercial firms. The Consultative Document notes that "it may be desirable to apply different threshold amounts to different types of derivative market participants."[6] Unfortunately, the Consultative Document goes on to suggest that lower thresholds may be appropriate for non-regulated entities. We disagree. If a commercial firm is creditworthy (or has legally separable assets that are creditworthy), regulated entities, many of which have specialized knowledge in evaluating credit and collateral, should be permitted to afford appropriately sized unsecured credit thresholds. Doing so would allow commercial firms to use their working capital and available cash flow towards more productive ends, such as making infrastructure investments, hiring people and engaging in research or development.

2. Appropriate Initial Margin Requirements.

Initial margin requirements should not be punitive to the trading of derivatives related to physical commodities. Such derivatives are an important class of instruments for many commercial firms. *First*, regulators should promote the use of quantitative models for the determination of margin, but should use an internally determined five-day confidence factor, not a ten-day horizon.

Second, initial margin requirements can address market based risks without being punitive to over-the-counter swaps. This is particularly important for commercial firms, many of which use customized derivatives to address their unique risks. The Consultative Document has a default chart of an initial margin amount should a firm not use an approved quantitative model. We note that the initial margin amount is 15% of notional exposure.[7] Setting aside all complications of converting a swap with a notional volume denominated in commodity units to dollars, this percentage is excessive and not tailored to the risk and volatility characteristics of particular commodities. It infers that movements in the price of natural gas are similar in volatility to movements in the price of corn, aluminum, tar, orange juice and cotton. The Working Group recommends a more tailored approach to setting initial margin requirements for commodity derivatives, which in no case should be greater than 5%.

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6 *Consultative Document* at 10.

7 *Id*. at 32.

3. Appropriate Netting Should Be Permitted.

Finally, the Consultative Document discourages regulators from allowing the netting of initial margin amount across asset classes.[8] The Working Group expresses no view on the merits of that policy but encourages regulators to permit netting of financial and physical exposures for initial margin purposes. For example, if a regulated entity supplies a commercial firm with natural gas on a long term basis (and the value of that contract runs to the benefit of the firm), the financial institution should be able to offset any initial margin required should that commercial firm seek to lock in economics related to the supply arrangement through a swap.

Regulated entities should be able to accept all forms of collateral from a commercial firm that is a derivatives counterparty that such entities might otherwise accept in connection with a financing transaction. For example, first priority liens on fixed assets, proven reserves and inventory should be acceptable forms of collateral to support derivatives trading. As mentioned above, commercial firms often manage their cash balances closely, often preferring to put cash towards other business ends, like investments in green technology. Most financial institutions are skilled at evaluating assets for mitigating credit exposure. Appropriate haircuts should account for any concerns on the ability to liquidate such interests in the event of a default. Moreover, certain structuring techniques can be used to enhance the financial institutions' recourse to the secured assets.[9] Through haircuts and proper legal structuring, the concern for risks associated with the liquidity of margin assets that BCBS and IOSCO identify in the Consultative Document should be fully addressed.[10] While the Consultative Document does provide an expanded list of assets beyond cash and Treasury securities,[11] the scope of assets are not sufficient to encompass many of the valuable assets commercial firms might offer to secure any derivatives exposure.[12]

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[8] *Id.* at 18.

[9] We agree with the key principal in the Consultative Document that margin should be subject to an arrangement that fully protects the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law. *Id.* at 25. However, we do not support regulations for mandatory collateral segregation or a constraint on any financial institution's ability to rehypothecate collateral. The costs of such measures might be passed on to commercial firms, most of which fully understand the related risk and might prefer to avoid such immediate costs. At a minimum, we see no policy justification for not allowing the rehypothecation of cash so long as the posting party retains sufficient offset rights should the financial institution default or become insolvent.

[10] *Id.* at 21.

[11] *Id.* at 33.

[12] The Working Group agrees, however, that all assets should prevent "right-way" risk features, meaning their value increases inversely to exposure under the derivatives. *Id.* at 22 (discussing "wrong way risk").

B. Margin Regulations Should Not Require the Exchange of Variation Margin Among Affiliates.

BCBS and IOSCO propose that full variation margin should be exchanged between affiliates.[13] They assert that such proposal is "advisable as it presents no net costs to a group."[14] This is a fallacy, as additional working capital must be retained to account for the price volatility associated in the derivatives at issue. The proposed obligation to post variation margin would further divert assets that might be used for one purpose (research and development) to another purpose (securing a derivative exposure), which will prove largely meaningless if affiliates are consolidated for accounting purposes. There is a cost—it is the cost of capital.

III. CONCLUSION.

The Working Group appreciates the consideration that your agencies have given through this process. As you move toward finalization of the margin regulations, the Working Group wanted to underscore the interest of commercial firms in workable margin regulations. The Working Group is grateful for the opportunity to present these comments to you.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe
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Alexander S. Holtan
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[13] *Id.* at 27.

[14] *Id.*