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July 11, 2011

Via Email

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(OCC), Docket ID OCC-2011-0008
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219
regs.comments@occ.treas.gov

Robert E. Feldman
Executive Secretary
Attention: Comments
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Administration
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Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve
System
Docket No. R-1415, RIN 7100 AD74
20th Street and Constitution Avenue, NW
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Alfred M. Pollard
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Attention: Comments / RIN 2590–AA45
Federal Housing Finance Agency
Fourth Floor
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Re: COMMENTS OF THE COALITION OF PHYSICAL ENERGY COMPANIES
Margin and Capital Requirements for Covered Swap Entities, RIN No. 2590-AA45

Ladies and Gentlemen:

On May 11, 2011, the Department of the Treasury, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (the "Agencies") issued a Notice of Proposed Rulemaking concerning "Margin and Capital Requirements for Covered Swap Entities" ("Margin and Capital NOPR" or "NOPR") in the Federal Register.[1] The Margin and Capital NOPR was issued by the Agencies to provide regulations to implement Sections 731 and 764 of the Dodd-Frank Wall

[1] *Margin and Capital Requirements for Covered Swap Entities*, 76 Fed. Reg. 27564 (May 11, 2011).

Street Reform and Consumer Protection Act ("Dodd-Frank").[2] The Coalition of Physical Energy Companies ("COPE")[3] hereby submits comments on the Margin and Capital NOPR.

The members of COPE are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale. COPE members utilize swaps to hedge the commercial risk of their physical businesses.

Physical Energy Companies Must Be Able To Cost-Effectively Hedge Commodity Price Risk

COPE members represent a wide spectrum of energy market participants, including the oil and gas production, processing, and transmission sectors, electricity generation (including renewables), and retail service to energy consumers. As physical energy companies, COPE members are faced with the demands of managing and operating their nonfinancial energy businesses. These are challenging businesses which, for effective management, require not only that the operational elements of producing, processing, and merchandising oil, gas, and power are properly conducted, but also that the significant energy price volatility be hedged to provide for the confident implementation of capital and operating budgets, servicing of debt, and the provision of stable earnings to investors.

Cost effectively fixing the revenue line and otherwise addressing commodity price risk through over-the-counter (OTC) swaps is a critical element of effectively managing a physical energy company. Accordingly, these companies limit their exposure to price volatility and place their focus on their physical businesses. In the context of this NOPR, limiting exposure to commodity price volatility represents not only the direct volatility of commodity prices but also the margin costs which would be associated with daily posting of cash margin for swaps driven by commodity prices. They are the opposite sides of the same coin.

While COPE members are diverse in terms of specific businesses, they have the following important concerns in common: (1) they are exposed to commodity price volatility that must be hedged to efficiently and conservatively operate their businesses and (2) their limited cash reserves are absolutely critical to running their physical businesses and are better utilized by investing in those physical businesses rather than sitting in an escrow account as margin.

The foregoing does not mean that COPE members oppose appropriate credit requirements imposed upon them by their bank Swap Dealer and Major Swap Participant Counterparties ("Covered Entities"). COPE members understand that their Covered Entity counterparties subject them to comprehensive and professional credit analysis starting with the beginning of their swaps relationship and extending throughout its term. That analysis is used to negotiate appropriate credit arrangements in the swap trading documentation agreed to among the parties and used to govern the relationship.

Given the nature of several COPE members' hedging relationships, their Covered Entity swap counterparties are often also their lenders. This dual role played by Covered Entity counterparties highlights the significant nature of the credit analysis underlying the overall relationship between a bank and its nonfinancial end user swap counterparty. This relationship

[2] Public Law No. 111-203, 124 Stat. 1376 (2010).

[3] The members of COPE are: Apache Corporation; El Paso Corporation; Iberdrola Renewables, Inc.; Kinder Morgan; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; NRG Energy, Inc.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources Partners LP.

may include a variety of banking services, which includes lending, in addition to that of swap counterparty.

A good illustration of the lender/swap counterparty relationship can be found in credit agreements that provide for first priority lien status to a swap counterparty that has entered into a permitted hedge *pari pasu* with first lien secured lenders. Very often, that swap counterparty must be an affiliate of a lender. The asset securing the loan and the swap may be oil or gas reserves; gas liquids (such as propane, butane, or ethane); a power plant or fleet of power plants; or the company's assets, including any or all of the foregoing. Under such arrangements, a "permitted hedge" is a swap that hedges commodity price volatility and speculative transactions which do not specifically hedge the direct commodity price risk of the asset are not permitted.

The outcome of this structure is that the Covered Entity is fully secured for its extension of credit, and that credit extension is hedged by the swap assuring stable cash flows to service the loan. The nonfinancial end user borrower/swap counterparty can thereby achieve stable cash flows which permit it to operate its business without revenue volatility risk. Also, since the swap is secured with a *pari pasu* lien, the borrower is not exposed to mark-to-market margining, permitting it to put its cash to work for productive purposes.

This structure is common in the oil and gas market and is not uncommon in power generation. It is a tried and true conservative arrangement that is well-developed among lenders to the energy sector. In addition to the obvious benefit of securing cash flows for the benefit of both lender and borrower, it also benefits from the *right-way-risk* paradigm. Right-way-risk means that as exposure increases, the value of the pledged asset also increases. That paradigm underlies the energy commodity market in which *pari pasu* swaps are used.

In addition to the use of liens to secure swap exposure, energy market participants often use letters of credit ("LOCs") for the same purpose. LOCs are often issued by Covered Entities that are lenders to energy companies. The issuance of LOCs and other banking relationships between Covered Entities and energy market nonfinancial end user swap counterparties give Covered Entities a highly informed window into the creditworthiness of such swap counterparties. As Covered Entities are in the business of prudently extending credit, they are very good at understanding credit and market risk and managing the same.

Finally, as stated above, physical energy companies are subjected to comprehensive, professional credit analysis by the Covered Entity counterparties for the entire spectrum of banking services. Many physical energy companies have managed their businesses such that they merit investment grade credit ratings which they have worked to maintain for many years. It is COPE members' experience that Covered Entities do not rely upon ratings but, rather, subject borrower/swap counterparty to in-depth credit review before extending credit. The high quality and stability of a borrower's balance sheet and management thereof may result in the extension of an appropriate amount of unsecured credit to both rated and unrated entities. This hard-earned creditworthiness has been the basis for unsecured lending and extensions of credit in an OTC swap relationship. There is no indication or pending effort to disturb this structure for Covered Entity lending and the same should be true for OTC swaps.

The current mix of unsecured credit, letters of credit, liens, and other appropriate collateral has served energy companies and their Covered Entities swap counterparties well. It has permitted the Covered Entities to ensure that they only take prudent risk while permitting energy companies to hedge their price volatility risk economically. Given the fact that physical energy companies' net worth is often dominated by assets and that such companies have cash requirements driven by new infrastructure, exploration, and operating costs needs, these extensions of credit permit them to hedge commodity price risk.

If physical energy companies had to post cash collateral, many would have to either cut back on hedging or stop completely. This is not because these companies are unprofitable or are in any financial trouble; rather, it stems from the flip side of the right-way-risk paradigm. That is, *when the company's assets are most valuable* (an increasing commodity price scenario), hedges are moving into the money to the swap counterparty. Thus, while the energy company has hedged its price risk at a lower price than the current market, under a pure mark-to-market margin regime it will have to post material amounts of cash as commodity prices rise.[4] If the energy company does not have access to virtually unlimited liquidity, it could default notwithstanding the fact that it is more than financially sound. Given energy commodity price volatility, the above perverse scenario is very real and very dangerous.

COPE members desire to continue hedging with Covered Entities; they value their banking relationships and work to manage their exposures to permit them to conservatively run their businesses. OTC swaps permit COPE members to manage price volatility and fix their cash flows, which permit the companies to efficiently plan, operate, and meet investor needs in a stable, predictable fashion. COPE members are not energy speculators and are only able to use non-cleared swaps under Dodd-Frank because they are using them to mitigate or hedge commercial risk. They are physical energy providers.

Therefore, COPE requests that the Agencies permit Covered Entity swap counterparties to nonfinancial physical energy companies to continue to extend credit as they do today, including with respect to swaps margin practices.

The Margin and Capital NOPR Must Be Clarified

Although the Margin and Capital NOPR can be read to affect current practices for nonfinancial end users, COPE understands that it is not the Agencies' intent to affect the *status quo* for such entities except in limited circumstances.

It is COPE's understanding that the Agencies' intent in the NOPR is to recognize the broad relationship a Covered Entity will often have with a nonfinancial end user commercial firm and focus on enterprise-wide exposure rather than solely on exposure related to derivatives. Thus, the Agencies will require a Covered Entity to exercise prudent banking practices to manage its relationship with a nonfinancial end user commercial firm in order to keep its exposure to that firm from lending, swaps, or any other banking activity within prudent enterprise-wide exposures.

As stated in the NOPR:

"In particular, the proposed rule *permits* covered swap entities to adopt, *where appropriate*, initial and variation margin thresholds below which a covered swap

[4] Requiring the posting of cash collateral by physical energy companies when commodity prices are rising would exacerbate those price increases by diverting capital away from the increased production of those commodities. For example, if oil prices are rising and an oil producer (as are several COPE members) is forced to post cash margin, it would be using cash for margin that could otherwise be invested to increase its oil production and help mitigate the rise in oil prices. The deployment of an oil producer's cash reserves to increase production when oil prices are rising to help alleviate the burden on U.S. consumers should be encouraged, particularly in a right way risk environment.

entity is not required to collect initial and/or variation margin from counterparties that are end users because of the lesser risk posed by these types of counterparties to covered swap entities and financial stability with respect to exposures below these thresholds. _The Agencies note that this threshold-based approach is consistent with current market practices with respect to nonfinancial end users, in which derivatives dealers view the question of whether and to what extent to require margin from their counterparties as a credit decision_.[37]

Under the proposed rule, a covered swap entity would not be required to collect initial or variation margin from a nonfinancial end user counterparty as long as the covered swap entity's exposures to the nonfinancial end user were below the credit exposure limits that the covered swap entity has established under appropriate credit processes and standards. The Agencies preliminarily believe that this approach is consistent with the statutory requirement that the margin requirements be risk-based, and is appropriate in light of the minimal risks that nonfinancial end users pose to the safety and soundness of covered swap entities and U.S. financial stability, particularly in cases of relatively small margin exposures."[5]

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[37] _In the case of a nonfinancial end user with a strong credit profile, under current market practices a derivatives dealer would not require margin—in essence, it would extend unsecured credit to the end user with respect to the underlying exposure_. For counterparties with a weak credit profile, a derivatives dealer would likely make a different credit decision and require the counterparty to post margin.[6]

Consistent with the foregoing, COPE understands that it is _not the Agencies' intent_, where a Covered Entity has exposures to a nonfinancial commercial end user that are within the _enterprise-wide_ credit exposure limits the Covered Entity has established under appropriate credit processes and standards, to: (1) mandate any particular form of documentation or agreement; (2) limit the appropriate form of collateral; or (3) mandate margin.

In order to ensure that the final rules and regulations can be unambiguous and clear, COPE urges the Agencies to clarify the above intent and revise the proposed regulatory text in the Margin and Capital NOPR. Given the importance and complexity of these issues, it is essential that (1) there be no confusion as to the Agencies' expectations of Covered Entities, and (2) nonfinancial end user commercial firms can hedge their risk without concern that they may be faced with problematic margin requirements and limited eligible collateral.

[5] Margin and Capital NOPR at 27569-70 (emphasis added).

[6] _Id._ at 27570, fn 37 (emphasis added).

Congress Did Not Intend To Impose Margin Requirements On Nonfinancial Energy End Users Or To Limit Eligible Collateral

Contemporaneous with the enactment of Dodd-Frank, it was made clear by its principal authors that Congress did not intend that the statute bring about requirements for margin to be posted by nonfinancial end users or to limit the type of collateral that can be posted.

In a letter dated June 30, 2010 (the "Dodd-Lincoln Letter"), Senators Chris Dodd and Blanche Lincoln, respectively Chairs of the Senate Banking and Agriculture Committees, wrote to Representatives Barney Frank and Colin Peterson, respectively Chairs of the House of Representatives Financial Services and Agriculture Committees, to emphasize their intent that nonfinancial end user margin was not required or intended by Dodd-Frank. They wrote:

> Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool. Regulators, namely the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the prudential regulators, must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk. This letter seeks to provide some additional background on legislative intent on some, but not all, of the various sections of Title VII of H.R. 4173, the Dodd-Frank Act.
>
> The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.
>
> Again, Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction. In cases where a Swap Dealer enters into an uncleared swap with an end user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the Congressional intent to protect end users from burdensome costs.
>
> ************
>
> Congress recognized that the individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management. That is why Congress specifically mandates that regulators permit the use of noncash collateral for counterparty arrangements with

> Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation.[7]

Consistent with the Dodd-Lincoln Letter, Dodd-Frank specifically permits financial end users to opt out of clearing (with its associated margin costs) if they are hedging or mitigating commercial risk,[8] and provides that non-cash collateral be permitted by regulators in any margin rule.[9]

Thus, it is clear that Congress intended nonfinancial end users that are hedging commercial risk to be treated differently from other OTC swap counterparties with respect to both clearing and margin. COPE requests that the Agencies make clear that such entities are to be treated differently from financial entities and that under the proposal set forth in the NOPR, they will be permitted to continue their current OTC swap hedging of commercial risk.

<u>Nonfinancial Energy End Users Will Reduce Hedging or Move Their Swaps Business If They Are Required To Post Cash Margin</u>

The Margin and Capital NOPR addresses margin, collateral, and documentation in the context of a Covered Entity entering into "a non-cleared swap" with a counterparty that is not a covered entity.[10] In such a case, a Covered Entity must: collect any required initial margin,[11] collect variation margin daily,[12] and execute trading documentation as required by the regulations.[13] In addition, the NOPR limits eligible collateral to cash or certain US Government-backed securities.[14] The proposed regulations, if read literally, appear to require that every counterparty that is not a Covered Entity be subject to initial and variation margin which must be posted in cash or an equivalent[15] in addition to documentation requirements established by regulators.

While COPE does not understand the above construct to be the Agencies' intent, if COPE is in error and the regulations are intended to be read in accordance with this interpretation, COPE members will be greatly harmed by the financial consequences of compliance. The likely result will be that COPE members will cease hedging their risk or will enter into swaps with entities that are not subject to these regulations. Either outcome would be negative for both the Covered Entities and the Agencies, as well as COPE members. Covered Entities would lose their swaps business with nonfinancial end user commercial firms and be exposed to borrowers

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[7] Dodd-Lincoln Letter at 1.

[8] Dodd-Frank § 723 (as codified at 7 U.S.C. § 2(h)(7)).

[9] *Id.* at § 731 (as codified at 7 U.S.C. § 4s(e)(3)(C)) ("In prescribing margin requirements . . . the prudential regulator[s] . . . shall permit the use of noncash collateral . . . .").

[10] *See*, *e.g.*, Margin and Capital NOPR at 27569 ("Treatment of Derivatives With Commercial End User Counterparties").

[11] *Id.* at 27588 ("Initial Margin").

[12] *Id.* at 27589 ("Variation Margin").

[13] *Id.* ("Documentation of margin matters").

[14] *Id.* ("Eligible Collateral").

[15] If nonfinancial end users were prescribed from posting non-cash collateral, the NOPR would appear to be in violation of Section 731 of Dodd-Frank which specifically permits non-cash collateral.

who are in turn exposed to price volatility and, as a consequence, are more risky. Alternatively, non-covered entities may enter into swaps with non-banks. The transactions, regulated by the Commodity Futures Trading Commission, would not be subject to the same restrictions. As noted above, COPE members value their banking relationships and appreciate the efforts the Agencies take to ensure the soundness of their regulated institutions, but they will have no choice but to cease doing swaps business with them. In other words, everyone comes out a loser.

Specific Comments on the Margin and Capital NOPR

As stated above, COPE believes that the Agencies need to unambiguously clarify in the final rules that as a general matter, the NOPR is not intended to disrupt the *status quo* with respect to the swap relationship between Covered Entities and nonfinancial energy end users.

As nonfinancial end users are a particular and unique subset of the entities addressed by the NOPR, the Agencies should better distinguish them from other counterparties of Covered Entities in the final rules. Nonfinancial end users not only pose less of a systemic risk to the economy, but are also structured differently from financial entities. Their creditworthiness does not stem from their cash or financial holdings, but rather from their balance sheet, assets, and business activities.

Congress recognized the need for nonfinancial end users to be able to access the OTC swaps market and to cost-effectively hedge commercial risk. It is incumbent upon the Agencies to honor both the specific requirements of Dodd-Frank and the intent of Congress.

Accordingly, the Agencies should structure their final rules to address nonfinancial end users separately from financial entities. With such a structure, the Agencies can address and provide clarity concerning the differing characteristics and legislative intent for the treatment of such entities for purposes of margin requirements. Such clarity should include: (1) the propriety of current prudent credit evaluation practices conducted by Covered Entities; (2) the acceptability of lien-based arrangements, LOCs, and unsecured credit; and (3) the ability of Covered Entities and nonfinancial end users to negotiate appropriate documentation that the parties find acceptable.

In addition to the foregoing, the Agencies should further clarify the NOPR as follows:

The Agencies should better define "the credit exposure limits that the covered swap entity has established under appropriate credit processes and standards."[16] COPE understands these to be enterprise-wide exposure limits as to any particular nonfinancial end user. The Agencies should include regulatory text that makes clear that the referenced exposure limits are indeed enterprise-wide. For example, the regulations could provide that:

> "This subpart does not apply to any swap or security-based swap transactions between a covered swap entity and a nonfinancial end user entered into when a covered swap entity's exposure to the nonfinancial end user is below Credit Exposure Limits.
>
> <u>Credit Exposure Limits</u> means the maximum enterprise-wide extension of credit a covered swap entity has determined to be prudent for a nonfinancial end user using appropriate credit processes and standards."

[16] Margin and Capital NOPR. at 27570.

If the Agencies were to establish a clear threshold for applicability of the regulations with respect to nonfinancial end users, such as that suggested above, the regulations would clearly limit the potential imposition of margin on a nonfinancial end user to any new transactions occurring only when it has exceeded its enterprise-wide credit limit with a Covered Entity. Of course, as the OTC swap relationship is a bilateral one, the Covered Entity would not be able to unilaterally impose margin requirements but could decline new business without appropriate collateral or credit support.

The Agencies should also make clear that these regulations create obligations for Covered Entities and not for nonfinancial end users. The regulations should recognize that Covered Entities have more tools than just swap-related margin to address circumstances when enterprise-wide credit limits are within sight. Covered Entities can limit other activities that give rise to exposure. They can interface with the counterparty to obtain additional data and to request particular risk-mitigating steps. They can also decline further swaps transactions. What they cannot and should not be able to do is retroactively impose margin.

Conclusion

The ability to margin stems from a bilateral negotiated arrangement. Unless both parties have agreed, neither party can unilaterally affect a negotiated requirement of the arranged terms. Covered Entities understand this and are adept at managing exposure with or without margin rights. The Agencies should oversee their regulated entities to assure that they properly use appropriate credit processes and standards to extend credit for swaps business and otherwise. As the Agencies know, exposure is exposure and money is fungible. All extensions of credit should be subject to the same standards. Good credit borrowers should not have their loans called in and good credit counterparties should not be required to post margin.

Accordingly, if the Agencies do not intend to upend the *status quo* in which Covered Entities secure swap exposure to nonfinancial end users, including COPE members, via a variety of negotiated means within prudent, enterprise-wide credit limits, it is imperative that the Agencies clarify that intent in the actual regulatory text. Market participants can then move forward with certainty, and the Agencies can fulfill their regulatory mandate under Dodd Frank without causing current commodity hedging practices that underpin the businesses of energy market participants to collapse under the weight of unnecessary and legally questionable cash margin requirements.

Respectfully submitted,

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SELECTED QUESTIONS ASKED IN CAPITAL AND MARGIN NOPR

1. (a) Does the nonfinancial end user exemption from the mandatory clearing requirement suggest or require that swaps and security-based swaps involving a nonfinancial end user should or must be exempt from initial margin and variation margin requirements for non-cleared swaps and security-based swaps?

Yes. Nonfinancial end users should be exempt from initial margin and variation margin requirements for non-cleared swaps and security-based swaps.

(b) If so, upon what statutory basis would such an exemption rely?

The exemption is based upon the logical relationship to the exemption of nonfinancial end users from the mandatory clearing requirement. Congress did not intend to exempt nonfinancial end users from clearing and its associated margin requirements only to have such margin requirements imposed on the very swaps that were exempted from clearing through a margin requirement.[17]

(c) Should that determination vary based on whether a particular non-cleared swap or noncleared security-based swap is subject to the mandatory clearing regime or not (i.e., whether the nonfinancial end user is actually using the clearing exemption)?

No. All swaps entered into by nonfinancial end users should be exempt. Customized swaps which are not susceptible to clearing should not be treated differently than clearable swaps. It is clear that Congress intended nonfinancial end users to have a unique status when hedging or mitigating commercial risk.

6. (a) Should nonfinancial end users also be separated into high risk and low-risk categories for purposes of the margin requirements?

No. Covered Entities should be given the task of undertaking a credit evaluation of each nonfinancial end user and applying appropriate credit requirements. This should not be an *a priori* regulatory determination.

9. Is it appropriate to distinguish between financial and nonfinancial counterparties for the purpose of this risk-based approach?

Yes. Congress recognized that nonfinancial end users should be treated differently than financial firms under Dodd-Frank. Nonfinancial end users are commercial firms that are hedging risk associated with a nonfinancial business (typically a physical business). Their risk profile cannot be equated to a financial firm.

15. With respect to either alternative for calculating initial margin requirements, should swap or security based swap positions that pose no counterparty risk to the covered swap entity, such as a sold call option with the full premium paid at inception of the trade, be excluded from the initial margin calculation?

Yes. A transaction that does not pose mark-to-market risk should be excluded.

[17] *See* Dodd-Lincoln Letter at 2 ("Congress recognized that imposing the clearing and exchange trading requirement on commercial end users could raise transaction costs where there is a substantial public interest in keeping such costs low (i.e., to provide consumers with stable, low prices, promote investment, and create jobs).")

59. (a) Should the types of eligible collateral listed be broadened to include other types of assets (e.g. securities backed by high-quality mortgages or issued with a third-party guarantee)?

Yes. Eligible collateral should include letters of credit, liens on assets and other pledges of certifiable value. Section 731 of Dodd-Frank specifically requires that non-cash collateral be eligible collateral.

61. What criteria and factors could be used to determine the set of acceptable non-cash collateral?

Non-cash collateral should be an asset that can be foreclosed upon and monetized. Acceptability of the non-cash collateral should be determined by the Covered Entity.