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February 14, 2013

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

VIA ELECTRONIC MAIL

Re: *File Number S7-08-12; Comments Regarding the Commission's Proposed Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers.*

Dear Ms. Murphy:

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits these comments in response to the proposed regulations regarding capital, margin, and segregation requirements for security-based swap dealers (each, an "**SBSD**") and major security-based swap participants (each, an "**SBMSP**") by the Securities and Exchange Commission (the "**SEC**" or "**Commission**").[1] The Working Group appreciates the opportunity to provide the comments set forth herein and respectfully requests the Commission's consideration of such 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.

As commercial energy firms predominantly transacting in swaps that fall under the jurisdiction of the Commodity Futures Trading Commission (the "**CFTC**"), the Working Group submits this comment letter in recognition that the SEC, the CFTC, and the Prudential Regulators[2] are required to establish comparable margin and capital rules. Thus, the Working Group seeks to ensure that the Commission knowingly avoids any unforeseen consequences of its proposed rulemaking for the entire derivatives marketplace.

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[1] *See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers,* 77 Fed. Reg. 70,214 (Nov. 23, 2012) (the "**Proposed Rule**").

[2] The "Prudential Regulators" refer collectively to the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

I. COMMENTS OF THE WORKING GROUP.

1. The Working Group Supports the Proposed Voluntary Segregation Requirements for Non-Cleared Security-Based Swaps.

Section 761 of the Dodd-Frank Act provides that SBSDs and SBMSPs must notify their counterparties at the beginning of a security-based swap transaction that "the counterparty has the right to require segregation of the funds of other property supplied to margin, guarantee, or secure the obligations of the counterparty." In enacting this provision, Congress recognized that certain swap market participants value the ability to segregate initial margin posted with regard to uncleared security-based swaps. On the other hand, imposing mandatory segregation of initial margin on security-based swap transactions between SBSDs or SBMSPs and their counterparties might prove to be extremely costly and would serve as a massive liquidity drain. So too would the imposition of mandatory segregation with respect to derivatives in other asset classes.

Accordingly, the Working Group supports the inclusion of proposed Section 240.18a-4(d), with regard to segregation requirements for uncleared security-based swaps, as written. Providing uncleared security-based swap customers with the flexibility to elect or not elect segregation will substantially lower the costs imposed by the Proposed Rule, and will still allow market participants that deem segregation desirable to have the ability to elect such treatment.

2. The Working Group Supports the Proposed Netting Provisions.[3]

The Working Group believes that the use of reasonable netting and offset arrangements across a variety of exposures reduces counterparty credit risk and lowers the cost of trading by allowing the efficient use of capital. As such, the Working Group supports the SEC's proposed Section 240.18a-3(c)(5), which would allow for SBSDs and SBMSPs to include the effect of a netting agreement that allows the SBSD or SBMSP to net gross receivables from and gross payables to a counterparty upon the default of the counterparty, for purposes of determining margin requirements for uncleared security-based swaps. The Proposed Rule would allow for netting to occur where:

(i) the netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;

(ii) the gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and

(iii) for internal risk management purposes, the SBSD or SBMSP monitors and controls its exposure to the counterparty on a net basis.[4]

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[3] Note that outside the securities context, the Working Group endorses much broader netting in the calculation of margin between counterparties, such that all swap and non-swap exposures, and all financial and physical positions would be captured by these computations, rather than only netting swap transactions to calculate margin requirements.

[4] *See Proposed Rule* at Section 240.18a-3(c)(5)(i)-(iii).

Netting obligations under derivatives and other trading positions reduces the counterparty credit risk each party bears and it allows market participants to make the most efficient use of their capital.

3. *The Working Group Supports the Proposed Margin Exception for Commercial End-Users Hedging Commercial Risk.*

The Working Group generally supports the exception under the SEC's proposed margin requirements for commercial end-users that are engaging in uncleared security-based swaps with non-bank SBSDs in order to hedge or mitigate risk related to their commercial activities. However, if non-bank SBSDs not approved to use internal models do not collect cash or securities as collateral when trading with a commercial end-user, they will be required to hold regulatory capital to cover any unsecured credit exposure. As such, any unsecured credit thresholds likely will result in a pass-through of at least a portion of the cost of holding additional regulatory capital to the commercial end-user counterparty.[5]

The Working Group urges the Commission to modify this capital charge requirement to consider the entire credit relationship of an SBSD or SBMSP with a commercial end-user counterparty, particularly when such relationship, considered as a whole, is sufficiently secured via other means. Among other things, the Commission should allow all SBSDs and SBMSPs (not just those using internal models) to fully deduct all unsecured receivables from commercial end-users.

Alternatively, the Commission could allow SBSDs and SBMSPs *not* using internal models to take the same credit risk charge based on the uncollateralized credit exposure to the security-based swap counterparty, as is provided in the Proposed Rule for ANC broker-dealers and stand-alone SBSDs using internal models. As the Commission notes, this charge is "designed to balance the concern of commercial end users that delivering collateral to nonbank SBSDs could disrupt their ability to enter into hedging transactions with the need for nonbank SBSDs to account for their credit risk to commercial end users."[6]

4. *The Working Group Supports the Positive Tangible Net Worth Capital Test for Security-Based Major Swap Participants.*

The Working Group supports the Commission's proposed Section 240.18a-2, which would create a positive tangible net worth capital test for non-bank SBMSPs. This capital requirement is particularly appropriate for entities that have never been prudentially regulated before and effectively protects against any losses in the event of a potential liquidation. The Working Group believes that this capital requirement is more appropriate than the net liquid assets test (subject to certain haircuts and deductions) that applies generally to SBSDs.

As noted by the Commission, the specific quantitative requirements included in the proposed capital requirements for SBSDs have not been derived directly from econometric or

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[5] *See Proposed Rule* at Sections 240.15c3-1(c)(2)(xiv) and 240.18a-1(c)(1)(xiv).

[6] *Proposed Rule* at 70,241.

mathematical models, nor has the Commission performed a detailed quantitative analysis of the likely economic consequences of these proposed quantitative requirements. Until this analysis is carried out and appropriate reasoning is proffered by the Commission, the SBSD capital requirements are necessarily arbitrary. Instead, the Working Group believes that the positive tangible net worth test is a more appropriate litmus test, as it is an accurate reflection of the financial health of a given entity and its ability to protect its customers in the event of a financial failure.

5. *The Proposed List of Acceptable Forms of Collateral for End-Users Should Be Expanded to Include Non-Cash Collateral.*

The Commission should permit commercial end-users to deliver non-cash collateral to meet their margin obligations. Allowing these market participants to satisfy margin requirements with non-cash collateral is consistent with the Dodd-Frank Act and important to the operation of many commercial firms.

With respect to non-bank SBSDs and non-bank SBMSPs, Section 764 of the Dodd-Frank Act amended the Securities Exchange Act to require the Commission to "permit the use of noncash collateral, as … the Commission determines to be consistent with (i) preserving the financial integrity of markets trading security-based swaps; and (ii) preserving the stability of the United States financial system." Senators Dodd and Lincoln, in a letter to Congressmen Frank and Peterson, recognized that "individual 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 non-cash collateral."[7]

In the Proposed Rule, the Commission requests comment on whether it should define "eligible collateral," in a similar manner to the CFTC and the Prudential Regulators.[8] Regardless of whether and how this term is defined, the Working Group does not believe that the eligible forms of collateral under the SEC's margin rules should be any more restrictive than they are currently written. Limiting eligible collateral to cash, securities and money market instruments

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[7] *See* Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs, and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

See also, Floor colloquy between Rep. Frank and Rep. Peterson in response to the letter from Sen. Dodd and Sen. Lincoln. 156 Cong. Rec. H 5248 (daily ed. June 30, 2010). Rep. Frank and Rep. Peterson stated that the Dodd-Frank Act does not give regulators the authority to impose margin requirements on end-users and that margin requirements imposed on swap dealers and majority swap participants should be structured in a way to minimize the impact on end-users.

[8] For example, under the CFTC's proposed margin rule, eligible collateral would be limited for initial margin to cash, foreign currency to the extent the payment obligation under the security-based swap or swap is denominated in the currency, obligations guaranteed by the United States as to principal and interest, and a senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks, and the Federal Agricultural Mortgage Corporation, or any obligation that is an ''insured obligation,'' as the term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank. The CFTC's proposal would limit eligible collateral for variation margin to cash and obligations guaranteed by the United States as to principal and interest. *See Proposed Rule* at 70,265, n.536.

eliminates forms of collateral widely accepted in today's swap markets, such as liens on physical and financial assets, letters of credit and other arrangements such as offset rights for other trading relationships.[9] These other instruments and legal rights provide the credit support that trading relationships require and help firms lower costs by reducing a counterparty's funding obligations. So long as the collateral delivered can cover the relevant exposure in the event of a termination of the security-based swaps and the liquidation of the collateral, then the SEC should permit delivery of such assets.

The use of non-cash collateral would allow commercial end-users to engage in necessary business practices like hedging, while making allowances for any corporate structure and unique liquidity constraints. These types of arrangements have historically proven to be a successful means of managing credit risk and should not be unnecessarily disrupted.

6. *The Commission Should Require Counterparty Access to Internal Models, Upon Request.*

Proposed Section 18a-1(d) would require an application and approval process for SBSDs and SBMSPs to use internal models in order to calculate deductions for market and credit risk. The Working Group generally supports this process. However, the Working Group respectfully requests that the Commission require that SBSDs and SBMSPs provide their counterparties, upon request, with access to the model that will be used to assign initial margin requirements.[10] It is necessary for the counterparties of SBSDs and SBMSPs to have such access to adequately anticipate their working capital needs. Such transparency will also allow counterparties to make more informed choices as to their preferred trading counterparties and allow them to monitor and dispute initial margin calculations if they prove to be contrary to agreed-upon terms.

7. *The SEC Should Implement the Proposed Rules After the Relevant Mandatory Central Clearing is Fully Implemented.*

The Dodd-Frank Act's centralized clearing requirement and margin and capital requirements were intended to work in conjunction with one another to reduce systemic risk.[11] The central clearing requirement is intended to address the risk of those security-based swaps that are liquid and standardized enough to be centrally cleared. The margin and capital requirements for non-cleared security-based swaps are intended to address the risk posed by

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[9] Offset rights allow counterparties to effectively represent counterparty credit risk as a net exposure. Consequently, the use of offsets allows counterparties to make more efficient use of collateral, limiting potential liquidity concerns.

[10] The Working Group notes that access to the model would not include access into the SBSD's or SBMSP's credit determination regarding the relevant counterparty. The credit determination should be made separate and apart from the analysis of the amount of initial margin necessary to account for the risk associated with a particular swap. In other words, an SBSD or SBMSP should make a transparent determination as to the initial margin required to cover the risk inherent in the swap and would then increase that amount by an agreed upon percentage to account for the credit risk posed by the counterparty.

[11] S. Rep. No. 111-176 at 33 (2010), available at http://www.gpo.gov/fdsys/pkg/CFPT-111srpt176.pdf.

security-based swaps that are not capable of being cleared.[12] Accordingly, the clearing, margin, and capital requirements should be implemented in a logical order.

If the SEC imposes final margin rules under the Dodd-Frank Act prior to the full implementation of the Dodd-Frank Act's mandatory clearing requirement for the relevant security-based swaps (beyond the mandatory clearing determinations that have already been promulgated), then it will subject that portion of the market that is liquid enough to be readily clearable, but is not currently cleared, to unnecessarily higher margin requirements than if they were subject to mandatory centralized clearing. This higher margin requirement could potentially remove the liquidity from certain classes of security-based swaps that makes them capable of being cleared.

II. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets worldwide. The Working Group appreciates this opportunity to provide comments on the Proposed Rule and respectfully requests that the Commission consider the comments set forth herein as it develops its final rule regarding capital, margin, and segregation requirements for SBSDs and SBMSPs.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe

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[12] The only security-based swaps subject to the margin requirements for non-cleared security-based swaps should be those that are too customized or illiquid to be deemed subject to mandatory clearing and security-based swaps for which the end-user exception from mandatory clearing has been elected.