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VIA ELECTRONIC MAIL

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Re: Comments on the Consultation Paper on Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP

Dear Members of the European Supervisory Authorities:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the “**Working Group**”), Sutherland Asbill & Brennan LLP hereby submits these comments in response to the European Supervisory Authorities’ (“**ESA**”) request for comment on the Consultation Paper on Draft Regulatory Technical Standards on Risk-Mitigation Techniques (“**RTS**”) for OTC-Derivative Contracts Not Cleared by a Central Counterparty (“**CCP**”) under Article 11(15) of Regulation (EU) No 648/2012 (the “**Consultation Paper**”).¹ The Working Group appreciates the Consultation Paper’s similarity to the requirements for uncleared derivatives recommended last September by the Basel Committee on Banking Supervision (“**Basel**”) and the Board of the

¹ *Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* (Apr. 14, 2014), available at http://www.esma.europa.eu/system/files/jc_cp_2014_03_cp_on_risk_mitigation_for_otc_derivatives.pdf.

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International Organization of Securities Commissions (“IOSCO”).² With a few targeted changes and additional clarity on certain provisions, the Consultation Paper would constitute a workable basis for global margin standards.

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 many of the members of the Working Group and their affiliates participate in European derivatives markets. 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.

II. COMMENTS OF THE WORKING GROUP.

A. International Harmonization Is Necessary to Avoid Competitive Imbalances.

The Working Group appreciates the fact that the RTS closely mirror Basel’s and IOSCO’s margin recommendations. A high degree of similarity between the RTS and the Basel and IOSCO approach is likely to lay the groundwork for a global margin standard for uncleared derivatives. A global standard or, at the very least, a high degree of similarity between margin requirements in the world’s largest derivatives markets is essential to avoiding arbitrary, regulatory-created market distortions in what is a global market. As such, the Working Group requests that the ESA continue to work diligently with their counterparts in the United States and other jurisdictions to create a uniform margin framework similar to that recommended by Basel and IOSCO.

B. The RTS’ Applicability to Non-EU Counterparties.

With respect to uncleared derivatives between two EU-domiciled entities, the Consultation Paper makes it clear that only financial counterparties and non-financial counterparties that exceed an €8 billion notional threshold set forth in Article 10 of EMIR (“NFC+s”)³ are potentially subject to the RTS. Said another way, non-financial entities that are not NFC+s would not be subject to the RTS even if they exceed the €8 billion notional threshold. This approach is reasonable as it limits the application of the RTS to only those entities that have the potential to pose systemic risk. In addition, the proposal would be largely consistent with

² *Margin Requirements for Uncleared Derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (Sept. 2013), available at <http://www.bis.org/publ/bcbs261.pdf>.

³ *Consultation Paper* at 5.

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U.S. margin proposals, which generally would not subject non-financial entities to regulatory margin requirements.⁴

However, the Consultation Paper is unclear as to what extent non-EU counterparties are subject to the RTS' margin requirements. Specifically, the Consultation Paper requires "EU entities ... to collect margin from all third-country entities, unless explicitly exempted by the EMIR or under the €8 billion threshold, even from those that would be classified as non-financial entities below the threshold if they were established in the EU."⁵ To the extent that the RTS apply differently to non-financial counterparties located within Europe and those located outside of Europe, the Consultation Paper could potentially bifurcate liquidity between Europe and other jurisdictions, such as the U.S.

This language could be interpreted in two ways. *First*, it could be read to require margin requirements to apply to any transaction between an EU entity subject to the requirements of the RTS and a non-EU entity, regardless of whether the non-EU entity's corporate group exceeds the €8 billion notional threshold. *Second*, it could also be interpreted to require application of the margin requirements to any transaction between an EU entity and non-EU entity whose group is above the €8 billion threshold, even if the non-EU entity, were it actually domiciled in the EU, would be considered a non-financial counterparty below the NFC+ thresholds (an "NFC-").

If the first interpretation is correct, then the RTS will pose as a significant impediment to uncleared derivatives between EU counterparties subject to the RTS and a larger number of non-EU domiciled counterparties. Such an outcome would likely increase costs for non-EU counterparties that must transact in European derivatives markets and decrease liquidity and trading opportunities for EU counterparties subject to the RTS.

If the second interpretation is what the ESA intended, then the Consultation Paper will increase costs for non-EU domiciled non-financial counterparties with large hedging portfolios if they choose to transact in European derivatives markets. There is no justification for exempting EU domiciled NFC-s from the requirements of the RTS while subjecting NFC-s from outside of Europe to those requirements.⁶ If an entity within Europe is not subject to the RTS because its derivatives portfolio does not pose a potential systemic risk, then the same entity should not be subject to the RTS solely because it is domiciled outside of Europe. Doing so would constitute a significant impediment to many large corporate enterprises trading with EU domiciled banks.

Even if the ESA limits the cross-border application of the RTS in the manner requested above, non-financial counterparties that are active traders on U.S. futures exchanges will be at a

⁴ See Notice of Proposed Rulemaking, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23732, 23734 (April 28, 2011), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf>.

⁵ Consultation Paper at 7.

⁶ It should be noted that non-financial counterparties that participate in U.S. futures markets are likely at a greater risk of being NFC+s than those that do not. ESMA has yet to make an equivalency finding with respect to those markets, causing speculative positions in those markets to count towards the NFC+ thresholds.

significant disadvantage with respect to the RTS. Until ESMA makes an equivalency finding, transactions on U.S. futures exchanges are considered OTC derivatives for the purposes of EMIR.⁷ As OTC derivatives, non-hedge transactions on U.S. futures exchanges must be included in the determination of whether a non-financial counterparty is an NFC+. So, it is possible that a non-financial counterparty that only uses bilateral, uncleared derivatives to hedge its interest rate risk could be subject to the RTS purely because of speculative positions on a fully regulated U.S. futures exchange. This result is incongruous with the goals of EMIR and the Working Group requests that ESMA make the necessary equivalence findings as soon as possible.

C. The Consultation Paper's Use of Notional Thresholds.

As stated above, the RTS would only apply to financial counterparties and NFC+s that are part of corporate groups that have more than € billion notional in uncleared derivatives outstanding at certain points of time. The use of notional amount-based thresholds introduces compliance monitoring challenges for counterparties that enter into commodity-based derivatives.

Unlike with other forms of derivatives, the notional amount of a commodity-based derivative is fluid over the term of the transaction. For example, the notional amount of a €500 million interest rate swap will always be €500 million,⁸ but the notional amount for a financial crude oil swap with an underlying volume of 100,000 barrels will fluctuate with changes to the price of a barrel of crude oil. Fluctuating notional amounts will (i) make monitoring compliance with the € billion thresholds difficult and (ii) may drive a corporate group over the € billion threshold solely because changes in the price of commodities and not the trading behavior of that group. As such, the Working Group respectfully suggests that the ESA clarify that the notional amount of an uncleared derivative is set at the execution of the transaction and does not fluctuate with future price movements of the underlying instrument. Such an approach would be consistent with the CFTC's guidance on its Swap Dealer *de minimis* threshold, which is also based on notional value.⁹

In addition, the Consultation Paper states that "all of the group's non-centrally cleared derivatives, including foreign exchange forwards, swaps and currency swaps, shall be included" in the determination of whether a corporate group exceeds the € billion notional amount threshold.¹⁰ However, the Consultation Paper does not directly address whether intragroup

⁷ See *Questions and Answers, Implementation of the Regulation (EU) No 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR)*, Answer to OTC Question 1, available at <http://www.esma.europa.eu/system/files/2014-682.pdf>.

⁸ Unless the counterparties agree to have the notional amount fluctuate over time such as to correspond with the payment schedule of a loan.

⁹ See *Frequently Asked Questions (FAQ) - Division of Swap Dealer and Intermediary Oversight Responds to FAQs About Swap Entities*, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf.

¹⁰ *Consultation Paper* at 46.

transactions would be considered when calculating a group's notional amount of uncleared derivatives outstanding.

The Working Group respectfully suggests that the ESA exclude intragroup transactions from the determination of whether a counterparty is subject to the RTS. Intragroup transactions, by their nature, do not pose a net-risk to a corporate group and do not transmit risk into a market. They are largely entered into for internal risk allocation and accounting purposes. As such, a corporate group's level of intragroup transactions should not have a bearing on whether the entities in a corporate group are subject to the RTS.

D. Unsecured Margin Thresholds.

The Working Group welcomes the Consultation Paper's various exemptions for the initial margin requirement. One of the exemptions would permit financial counterparties to use unsecured credit thresholds with their financial or non-financial counterparties of up to €50 million. In contrast, the Consultation Paper as currently drafted does not permit two NFC+s to use an unsecured credit threshold when trading with one another.¹¹ The Consultation Paper does not explain why unsecured credit thresholds are not available between two NFC+s. The Working Group respectfully requests that the ESA clarify that unsecured credit thresholds are available for transactions between two NFC+s.

E. Clarification of Initial Margin Model Requirements.

As proposed, the RTS would allow counterparties subject to the RTS to use models that meet certain requirements to determine initial margin requirements. The Working Group appreciates the ESA permitting non-bank market participants to do so. However, the Working Group would like additional clarity on certain of the requirements necessary for a model to satisfy the RTS.

Specifically, the RTS would require a model to be calibrated on a historical period of at least three years, which must include a period of financial stress and such "stressed data" must represent at least 25 percent of the overall data set.¹² *First*, what constitutes a "period of financial stress"? Is it a function of increased volatility? Is a period of financial stress specific to the underlying instrument or a period of stress in financial markets generally?

Second, the RTS would require a model to compensate for the absence of a period of financial stress by replacing the oldest data in the data set with data from a period of financial stress. However, if that stressed data is stale or not representative of current market conditions, the margin model may not properly determine initial margin requirements. The Working Group suggests that the ESA provide market participants the flexibility to determine that a margin model would function best with a data set that includes more representative recent data rather than stale or irrelevant historical stressed data.

¹¹ *Id.* at 23.

¹² *Id.* at 30.

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F. Potential Retroactivity of Margin Requirements.

As currently drafted, the Consultation Paper's requirements would not apply to derivatives transactions executed before the RTS are in effect. However, it is unclear how or if the RTS would apply to transactions executed after the RTS are in effect, but before the RTS apply to a particular corporate group. For example, if an NFC+ commercial energy firm were to cross the €8 billion threshold in 2020, would the RTS apply to uncleared derivatives entered into in 2019?

Subjecting transactions executed prior to the corporate group becoming subject to the RTS to regulatory margin requirements would likely be a material change to the economics of those transactions not contemplated when the transactions were entered into. Accordingly, the Working Group respectfully suggests that the ESA make clear that uncleared derivatives executed prior to a counterparty becoming subject to the RTS are not subject to the margin requirements set forth in the RTS.

III. CONCLUSION.

The Working Group appreciates this opportunity to provide comments and respectfully requests that the ESA consider the comments set forth herein as they develop any final framework for the regulation of uncleared OTC derivatives.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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