January 12, 2012

VIA ONLINE SUBMISSION
Mr. David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

RE: RIN No. 3038-AD54—Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011)

The National Corn Growers Association ("NCGA") and the Natural Gas Supply Association ("NGSA") submit the following comments in response to the Notice of Proposed Rulemaking, Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011) ("Proposed Capital Requirements Rule") issued by the Commodity Futures Trading Commission ("Commission"). References made herein to the Commodity Exchange Act ("CEA") refer to that statute as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act" or "Act"). Correspondence regarding this submission should be directed to:

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Founded in 1957, NCGA is the largest trade organization in the United States, representing 36,000 dues-paying corn farmers nationwide and the interests of more than 300,000 growers who contribute through corn checkoff programs in their states. NCGA and its 48 affiliated state associations and checkoff organizations work together to create and increase opportunities for their members and their industry.

Established in 1965, NGSA represents integrated and independent companies that produce and market approximately 40 percent of the natural gas consumed in the United States. NGSA encourages the use of natural gas within a balanced national energy policy and promotes the benefits of competitive markets to ensure reliable and efficient transportation and delivery of natural gas and to increase the supply of natural gas to U.S. customers.

Because of the potential for the Dodd-Frank Act to unnecessarily limit the hedging tools available to corn producers and to impede what is and has been a healthy, competitive and resilient natural gas market, NCGA and NGSA played an active role in the shaping of the Act during its passage and wish to continue this role in ensuring the Act's successful implementation.

COMMENTS

On June 23, 2011, NCGA and NGSA filed comments with the Commission regarding the Commission's Proposed Capital Requirements Rule applicable to swap dealers ("SDs") and major swap participants ("MSPs") pursuant to section 4s(e) of the CEA. Since submitting their initial comments, NCGA and NGSA have identified an additional necessary enhancement to the Commission's Proposed Capital Requirements Rule. Accordingly, NCGA and NGSA offer the following supplemental comments for the Commission's consideration, recommending that the Commission adopt a model-based approach for calculating the market risk component of the capital requirements. Doing so will result in capital requirements that are more appropriate to the actual market risks of SDs and MSPs.

I. The Proposed Capital Requirements Rule Requires Non-Financial Swap Dealers and Major Swap Participants to Use an Overly Simplified Approach to Calculate Commodity Market Risk, Which Will Result in Inappropriate Capital Requirements, Unfairly Harming Non-Financial SDs and MSPs and Their End User Counterparties.

NCGA and NGSA understand that the Commission's expectation was that the proposed capital requirements would not result in the need for many non-financial SDs to obtain additional capital. Unfortunately, the currently-proposed market risk component of the capital requirements calculation will drive higher capital requirements for many companies that may be regulated as SDs.[1] Higher capital requirements for companies regulated as SDs or MSPs will raise the costs of their swap transactions, likely resulting in two undesirable consequences: (1) SDs and MSPs will pass on such increased costs to end users through higher swap prices; and (2) some SDs and MSPs may leave the market, leaving fewer counterparties with which end users can enter into hedging transactions. Neither option would be beneficial to end users who produce and market commodities, including many NCGA and NGSA members.

The Dodd-Frank Act requires that the Commission's capital requirements for SDs and MSPs: (i) help ensure the safety and soundness of SDs and MSPs; and (ii) **be appropriate for the risk** associated with SDs' and MSPs' non-cleared swaps.[2] Capital requirements are intended to protect parties against market risks and counterparty credit risks. Importantly, such risks can vary depending on a variety of dynamic factors that are often unique to particular transactions, counterparties, and market and business portfolios. NCGA and NGSA understand that methods used to determine capital requirements based on such risks must be appropriate for the risks involved while also being administrable by the Commission.

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[1] The NCGA and NGSA have noted their concerns regarding the Commission's proposed rule Further Definition of "Swap Dealer," "Major Swap Participant," *et al.*, 75 Fed. Reg. 80,174 (Dec. 21, 2010) in a letter addressed to Mr. David Stawick dated February 22, 2011.

[2] CEA § 4s(e)(3)(A).

The Proposed Capital Requirements Rule prescribes calculations for market risk based on certain "standardized" procedures for assessing such risk. **For swaps based on commodities, the Commission has prescribed a "simple approach" or "simplified method"** whereby a firm's capital charge for directional risk equals 15 percent of its net position in uncleared swaps for each commodity plus a supplemental charge of 3.0 percent of the gross position in uncleared swaps for each commodity to cover basis, interest rate and forward gap risk.[3] **However, Commission staff recognizes that capital requirements based on internal risk measurement models are "<u>a better approach</u>"** for entities with significant business in options or commodities.[4] Specifically,

> **The Commission recognizes that internal models, including <u>value-at-risk (VaR) models, can provide a more effective means</u> of recognizing the potential economic risks** or exposures from complex trading strategies involving OTC derivatives and other investment instruments.[5]

Nonetheless, because of concerns about the adequacy of future Commission resources to approve and monitor use of internal models, the Commission has proposed to limit non-financial SDs and MSPs to the use of a simplified, non-model approach for calculating commodity market risk adders.[6] By contrast, financial SDs and MSPs are eligible to use internal models, including VaR Models, to determine their capital requirements.[7] The simplified, non-model approach to which non-financial SDs and MSPs are limited results in overly conservative capital requirements, placing such SDs and MSPs at a competitive disadvantage to financial SDs and MSPs. Such a disadvantage as compared to banks and other financial entities was not a result intended by Congress and is not suggested anywhere in Section 4s(e) of the CEA. Another unintended harm resulting from the overly simplified approach described above may be to drive non-financial SDs from the market, thereby reducing competition and harming liquidity.

II. <u>Recommendation</u>: The Capital Requirements Rule Should Be Modified to Allow Non-Financial Swap Dealers and Major Swap Participants to Use a Ten-Day First Percentile Value-at-Risk Model, Which More Accurately Measures Risk, Is Widely Accepted and Implemented, and Will Not Require Significant Commission Resources to Administer.

To accurately reflect market risk, ensure an efficient use of capital, and establish a level playing field for non-financial SDs and MSPs, NCGA and NGSA recommend that the Commission allow non-financial SDs and MSPs to use a more flexible, but still sufficiently

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[3] *See* Proposed Capital Requirements Rule at 27,811 & n.42, proposed 17 C.F.R. § 23.104(d)(6).

[4] *See id.* at 27,809, citing the Basel Accord. The nature and history of the Basel Accord, which provides a globally accepted framework for determining minimum capital requirements for banking institutions and was established by an international committee of banking supervisory authorities, are described further in the Proposed Capital Requirements Rule at page 27,805 note 15.

[5] *Id.* at 27,807.

[6] *Id.* at 27,808, proposed 17 C.F.R. § 23.103(e), 23.104(d)(6)

[7] *See id.* at 27,805, proposed 17 C.F.R. § 23.103(e).

standardized, model-based approach to calculate the market risk component of the capital requirements associated with their swap portfolios. Specifically, NCGA and NGSA recommend that the **Commission allow non-financial SDs and MSPs to calculate the market risk component of their capital requirements as three times the level established using the <u>ten-day first percentile value-at-risk ("VaR") model</u> approach for a SD's or MSP's full business portfolio.** This approach will establish a capital requirement that is three times[8] the potential loss that may occur one percent of the time—in other words, a relatively extreme outcome. This is a conservative measure, but, because it more accurately measures market risk, it may significantly reduce a non-financial SD's or MSP's capital requirements compared to the "simplified" method, while still ensuring safety and soundness of the SD or MSP. Many companies actually use a fifth percentile VaR model, which, by comparison, results in a lower capital requirement because it is based on potential losses that are likely to occur five percent of the time, *i.e.*, more frequently. In addition, this VaR model approach is based on widely accepted and well understood risk-management practices,[9] which could be reviewed and evaluated by the Commission in an expeditious, cost-effective, and definitive manner through back-testing.

As summarized below, adoption of the VaR-based model for determining the market risk portion of the capital requirement accomplishes two key objectives that further the Commission's goal and Congressional intent.

First, it aligns the capital requirement with market risks, while ensuring the safety and soundness of the swaps market. The VaR model approach provides the Commission with a well-established, functioning commercial benchmark for risk management. Back-testing capability will allow the Commission to demonstrate to Congress and market participants that the resulting capital requirements are appropriately sized for the market risk, ensuring efficient use of capital.

Second, it helps ensure a level playing field for non-financial SDs and MSPs relative to financial SDs and MSPs. Many entities already employ VaR models, since the model accommodates an entity's entire portfolio. By comparison, imposing the non-model approach at best would require non-financial SDs and MSPs to run two separate market risk calculation methods. At worst, such entities would be subject to higher capital requirements than financial SDs and MSPs, which would discourage their participation in the market. Ultimately, these effects would harm competition, reduce liquidity, and raise the price of swaps to end users. For these reasons, the Commission should adopt the VaR model approach for the calculation of the market risk component of the capital requirement.

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[8] Regarding the use of the factor of "three," extreme outcomes are more likely than a normal distribution would suggest, which is why the capital models include the result multiplied by a factor of three. The factor of three is based on a result from probability theory known as Chebyshev's Inequality which essentially establishes an upper bound on the number of standard deviations between the mean and a given percentile.

[9] Bank of International Settlements, *Basel Committee on Banking Supervision, Revisions to the Basel II Market Risk Framework* at 2 (July 2009); *see also* Committee of Chief Risk Officers, *Valuation and Risk Metrics* (Nov. 2002), *available at* www.ccro.org/whitepapers.

CONCLUSION

NCGA and NGSA welcome the opportunity to continue to discuss means by which the Commission can implement the provisions of the Dodd-Frank Act while maintaining sound functioning commodity markets. If we can provide any additional information, please do not hesitate to contact us.

Respectfully submitted,

National Corn Growers Association
Natural Gas Supply Association