HUNTON & WILLIAMS LLP
1900 K STREET, N.W.
WASHINGTON, D.C. 20006-1109

TEL 202 • 955 • 1500
FAX 202 • 778 • 2201

FILE NO: 76142.000002

February 22, 2011

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC MAIL

Re: *Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter in response to the Commodity Futures Trading Commission's (the "Commission") request for comment concerning the Commission's Notice of Proposed Rulemaking on *Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties* (the "Proposed Rules").[1]

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 public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") vests the Commission with new and expanded authority to regulate a wide array of participants in swap markets. Swap dealers and major swap participants (together, "Regulated Entities"), will be required to develop and implement comprehensive measures to assure compliance with both substantive and procedural requirements under the Commission's new regulations set forth under the Act. Such regulations have been the subject of several key proposed rulemakings for which the Working Group has previously submitted comments and are

[1] 75 Fed. Reg. 80,638 (Dec. 22, 2010).

the subject of additional key proposed rulemakings for which the Working Group anticipates submitting comments.

The Working Group appreciates the opportunity to provide these comments in response to the Proposed Rules and respectfully requests that the Commission consider the comments set forth herein. The Working Group looks forward to working with the Commission to further refine the Proposed Rules prior to the effective date of Title VII. Because the Commission has not finalized the regulatory definitions of terms such as swap dealer, major swap participant and swap, members of the Working Group have felt compelled to comment on proposed rulemakings applicable to swap dealers and major swap participants in light of the potential that one or more aspects of the proposed definitions of such terms, which are unclear in material respects, could be interpreted in such a way as to cause them to be deemed swap dealers or major swap participants.

I. COMMENTS OF THE WORKING GROUP.

A. GENERAL.

Section 731 of the Act instructs the Commission to issue business conduct standards for swap dealers and major swap participants. The Commission adopted a very comprehensive and granular approach when promulgating the Proposed Rules. This approach, however, results in a set of proposed rules that are quite prescriptive and do not produce benefits to the market that justify the accompanying burden. As discussed herein, the Commission might avoid the imposition of costs to the entire market, including end users, through a more focused approach to implementing external business conduct standards under Section 731 of the Act.

In addition to the discussion contained in this letter, the Working Group has identified certain specific provisions of the Proposed Rules for which it wishes to provide directed comments. Such provisions of the Proposed Rules and the comments of the Working Group appear in Appendix A attached to this letter.

1. THE OTC MARKETS PRIMARILY ARE NOT RETAIL MARKETS.

The futures markets and the swaps markets are very different. Accordingly, the Commission should craft regulations that are appropriate for each market. Concepts that apply in the futures markets might not translate well to the OTC swap markets. Futures contracts are fungible with terms that a market participant cannot negotiate. Thus, almost all of the information about such futures contracts can be provided by the exchanges on which futures are traded. Moreover, the Commission, self-regulatory organizations and exchanges have adopted uniform risk disclosure for futures contracts.

The swap markets, particularly the over-the-counter ("OTC") swap markets, are very different from futures markets. A portion of the swap markets operate on a standardized basis that is similar to the futures markets. However, there is a substantial portion of the market where parties meet to negotiate customized swap contracts. Here contracts are not "off-the-shelf" and counterparties do not merely place orders for financial positions through a Regulated Entity. Instead, the parties trade on a principal to principal basis. The Regulated Entity might provide information to a counterparty, but it does so for trading relationship reasons. It does not understand its relationship with its counterparty to be that of an advisor. In fact, often swap trading documentation contains an explicit disclaimer of such advisory capacities.[2] Simply put, in most bilateral swaps, a Regulated Entity is not an agent or advisor of their counterparty.

The Commission should be cognizant that the external business conduct standards set out in the Proposed Rules inherently change the relationship between a Regulated Entity and its non-Regulated Entity counterparties from "principal to principal" to "advisor to client." As one example, the requirement that a Regulated Entity make a suitability determination with respect to its non-Regulated Entity counterparties forces the Regulated Entity to judge what is appropriate (or even best) for its counterparty.[3] This fundamental change in such relationship is a dramatic shift in the swap markets.

Another fundamental shift in the swap markets that will flow from the proposed external business conduct regulations is liability with respect to disclosure and representations. In today's bilateral swap market, parties are responsible for their own information. If a counterparty makes misstatements, it becomes subject to potential actions for breach of contract or, in the extreme, fraud. Under the Proposed Rules, Regulated Entities can no longer simply rely on such information; rather, they must conduct some degree of due diligence to verify certain information and support their reliance on any representations and warranties. In doing so, they become partially responsible for such information, meaning they now potentially face a charge that they should have known one or more material facts about their counterparties.

The Commission should craft regulations that are appropriate for OTC swaps markets, particularly for customized swaps, and should not assume that requirements or practices in the futures markets translate to the bilateral swap markets. Simply grafting concepts from the futures markets onto OTC swap markets will have a chilling effect on OTC swap markets. Given the amount of resources that a Regulated Entity must devote to each trade under the

---

[2] Section 3(g) of the 2002 ISDA Master Agreement states that each party is "entering into this Agreement…as principal and not as agent of any person or entity." It is also common practice for market participants to include representations to the fact that each counterparty is capable of understanding a swap, that each counterparty relied on its own judgment when entering into a swap and that neither counterparty is acting as a fiduciary or agent of the other.

[3] Proposed CFTC Rule 23.434.

Proposed Rules, the elevated duties and the attendant legal risks, Regulated Entities likely will have at least three principal reactions to the Proposed Rules. *First*, they will limit trading of negotiated swaps to only the non-Regulated Entity counterparties that are well known to them. *Second*, for all other non-Regulated Entity counterparties and potential non-Regulated Entity counterparties, they will increase prices. *Third*, they might choose to exit the business of entering into swaps with non-Regulated Entity counterparties all together. Thus, for medium size businesses the swap markets might effectively shrink and become more expensive at the same time. Viewed across the bilateral swap market, this result could be very costly.

While Congress mandated that the Commission impose business conduct standards under the Act, that mandate does not obviate the Commission's responsibility to design and implement regulations where the benefits of regulation are in proportion to the costs. Accordingly, the Working Group respectfully recommends that the Commission not impose concepts appropriate for retail markets on non-retail markets.

2. A CLASS OF MARKET PARTICIPANTS DOES NOT REQUIRE THE PROTECTIONS IN THE PROPOSED RULE.

The Act and the Commodity Exchange Act (the "CEA") promote the protection of retail investors. For example, access to swaps is limited only to those swaps that are available on a designated contract market ("DCM") for counterparties that do not qualify as an eligible contract participant ("ECP").[4] The ECP standard, as set forth by Congress, is intended to limit access to bilateral swaps to those entities and individuals that have the level of sophistication necessary to evaluate the implications of entering into such a swap. However, by promulgating the Proposed Rules, the Commission seems to be of the opinion that the ECP definition is an insufficient measure of sophistication and that certain swap market participants need additional customer protections. If the Commission in fact thinks that there is a class of ECPs that needs the additional protections included in the Proposed Rules but not required by the Act, then the Commission should further refine the definition of ECP in an additional rulemaking so those protections apply to those ECPs alone.

There is a class of market participants that are not Regulated Entities that need little, if any, regulatory protection. These participants typically are entities with experienced, sophisticated investment and trading operations. Each is capable of negotiating on equal-footing with the swap dealer community. For this class of counterparties, the Proposed Rules will provide many unnecessary protections with a corresponding increase in costs. Therefore, in the absence of a proposed rule to define ECP beyond the definition set forth in the Proposed Rules, the Working Group respectfully suggests that the Commission except Regulated Entities from

[4] *See* Section 2(e) of the Commodity Exchange Act.

the external business conduct standards in the Proposed Rules when facing counterparties that are sophisticated enough to evaluate swap transactions without support from their counterparty.

Such an approach would be consistent with other regulatory regimes in financial markets. For example, the U.S. Securities and Exchange Commission, under Rule 144A issued under the Securities Act of 1933, as amended, has recognized that a class of entities known as qualified institutional buyers generally do not need the protection of regulators when transacting in securities.[5] We submit that classes of market participants similar to qualified institutional buyers also do not need most of the customer protections set forth in the Proposed Rules.

The Working Group does not feel that it should be a Regulated Entity's responsibility to determine whether or not a counterparty is of a class similar to a qualified institutional buyer. To this end, the Working Group suggests that counterparties that are of such a class should register as such with the Commission or a self regulatory organization. This would allow swap dealers and major swap participants to rely on such registration. Further, if a trade is executed with a counterparty that, at the time of execution, was of this higher class of ECP, the regulatory treatment of the swap should remain the same throughout the term of the swap, even if the counterparty loses it status.

3. MAJOR SWAP PARTICIPANTS ARE NOT DEALERS AND THE COMMISSION SHOULD NOT APPLY THE SAME BUSINESS CONDUCT STANDARDS.

Many of the external business conduct standards set forth in the Proposed Rules are appropriate only for true market intermediaries that transact with unsophisticated counterparties. These intermediaries, among other things, provide access to the swap markets for their counterparties. In contrast, major swap participants are not intermediaries; they are a type of counterparty that the Act deems to be systemically significant. Entities that are major swap participants will likely be active traders in swap markets, and by definition will not be swap dealers. More likely than not, they will trade mostly with swap dealers or other sophisticated entities. Most, if not all, of the external business conduct standards imposed by the Proposed Rules are unnecessarily burdensome for such entities, as they do not typically face a customer in a swap. Thus, the Commission should propose different external business conduct standards for major swap participants in a separate rulemaking.

---

[5] The Working Group believes that the eligible contract participant sufficiently delineates the line at which regulatory protection of market participants is warranted. However, we recognize that it may not be feasible at such time to adopt this standard.

However, even with the ECP standard, the Commission should provide criteria for such investors that are broader than discretionary investments. Many sophisticated and creditworthy parties in the energy swap markets might not have financial assets of a very large size, perhaps investing any cash proceeds back into their business or providing a solid dividend to their shareholders.

The Working Group recognizes that Congress did not differentiate between swap dealers and major swap participants in drafting Section 731 of the Act. However, Congress did not compel the Commission to apply the same requirements to both classes of entities. In creating two distinct classes of entities, Congress acknowledged that swap dealers and major swap participants play different roles in swap markets. Accordingly, Title VII of the Act can reasonably be interpreted to allow the Commission to craft different rules for major swap participants and swap dealers where appropriate.

4. TRANSACTION LEVEL REQUIREMENTS INCREASE COSTS.

To the greatest extent possible, the Commission should establish external business conduct standards that do not inhibit the negotiation, execution and settlement of swaps. The swap markets have developed into robust and efficient markets on the paradigm of parties using (i) relationship and enabling documents and (ii) trade specific documents. Under this paradigm, best trade execution is encouraged by reducing the confirmation terms to only economic terms or specific elections. All other terms are handled in separate documentation.

To the extent that the external business conduct standards under the Proposed Rules require additional steps and deliverables in the trade execution process, trade execution will become both slower and more costly. These timing and pricing elements will result in all swap market participants experiencing less efficient trading solely by reason of regulatory requirements. The Working Group supports regulation that promotes transparent, liquid and efficient markets. The external business conduct standards set out in the Proposed Rules should be modified to reduce the regulatory drag they impose on trade execution.

Often, counterparties enter into swaps to take advantage of favorable current market conditions. If the requirements of the Proposed Rules are imposed on a swap-by-swap basis, the multitude of pre-trade obligations imposed on swap dealers and major swap participants will substantially limit counterparties' ability to execute swaps in a timely manner that would allow them to meet their economic needs. If parties are unable to execute swaps in a timely manner there will be implications for swap markets beyond just limiting the ability to take advantage of current market conditions. Increasing the period of time to enter into a swap might decrease the number of transactions in markets, thereby diminishing liquidity and increasing volatility. In addition, an increased cycle time will increase the risk for swap dealers that market conditions will change during the period of time between when the terms of the swap are negotiated and when the swap is executed. To compensate for this risk swap dealers will take various actions, which will likely include increasing their bid/offer spreads.

5. THE COMMISSION SHOULD PROVIDE A MORE COMPLETE ESTIMATE OF COST AND BENEFITS ASSOCIATED WITH THE PROPOSED RULE.

Section 15(a) of the CEA requires the Commission to "consider the costs and benefits" of any proposed rule. In the Proposed Rule, the Commission gives only cursory attention to this requirement. It relies on broad sweeping and general conclusory statements to satisfy its obligations. It states that "adhering to the new requirements under the proposed rules will not be unduly burdensome.…Indeed, the proposed rules, in part, reflect requirements in other markets as well as current industry practices in the swaps markets."[6]

The Working Group believes that the burden on swap dealers and major swap participants to comply with the Proposed Rules will be substantial for each transaction, for each market participant and for the swap markets in general. As discussed above, the Working Group respectfully suggests that simply because certain requirements work in one market does not mean they are appropriate for other markets, particularly the energy swap markets.[7] The Working Group would urge the Commission, prior to issuing a final rule, to conduct a more in depth analysis as to the actual impact of the Proposed Rules on swap markets as a whole, and analysis on its impact on individual swap markets, such as energy swap markets. The Working Group therefore requests that the Commission (i) consider the costs and benefits associated with the *Proposed Rule* in the manner prescribed by CEA Section 15(a), (ii) issue a supplemental rule in this proceeding setting forth empirical data supporting its conclusions regarding the costs and benefits of the Proposed Rules, and (iii) notice the supplemental rule in the Federal Register for public comment.

6. ALL OF THE PROPOSED RULES SHOULD NOT APPLY IF A SWAP DEALER OR MAJOR SWAP PARTICIPANT TRADES WITH ANOTHER SWAP DEALER OR MAJOR SWAP PARTICIPANT.

Certain of the Proposed Rules do not apply if a swap dealer or major swap participant trades with another swap dealer or major swap participant. The Working Group believes this exception should apply to all of the Proposed Rules.[8] These entities, by their nature, are sophisticated users of derivatives. They have no need for the customer protection measures of

---

6 *Proposed Rules* at 80,656.

7 *For example see Proposed Rules* notes 47, 50, 52. The "best practices" upon which the Commission relies on in certain circumstances is the work of the Counterparty Risk Management Policy Group, which was comprised almost entirely of representatives from the largest banks.

8 Regulated Entities, however, should not be excepted from the anti-fraud and anti-manipulation provisions. However, as discussed in Section II.B.4, such provisions should be eliminated to the extent the are redundant with Part 180 of the Commission's regulations.

the Proposed Rules. To this end, the Working Group respectfully suggests that the Commission amend the proposed definition of "counterparty" in proposed CFTC Rule 23.401 to not include swap dealers and major swap participants.

B. ELECTIVE RULEMAKINGS.

Section 4s(h) of the CEA mandates that the Commission promulgate certain specific business conduct standards for swap dealers and major swap participants. Though the Commission was granted the authority to promulgate business conduct standards in addition to those required under Section 4s(h) of the CEA, the explicit requirements set forth by Congress should serve as the contours for the overall regulatory framework imposed on swap dealers and major swap participants when they transact with counterparties.[9] The requirements set forth by Congress include verification of an entity's status as an ECP, provision of disclosure on risks and conflicts of interest and provision of pricing information. These requirements, with some degree of clarification and adaptation discussed in Section II.C below, will provide additional information to market participants without changing the fundamental bilateral nature of OTC swap markets.

However, as noted above, the additional business conduct standards proposed by the Commission under its authority in CEA Section 4s(h)(3)(D), such as the suitability standard, would fundamentally alter the relationship between counterparties and the swap markets. These additional business conduct standards far exceed the scope of the other requirements set forth by Congress, and arguably exceed what Congress envisioned when they drafted Section 731 of the Act. Accordingly, the Commission should not include such elective rules in its final rules under Section 731 of the Act.

1. SUITABILITY STANDARDS.

Proposed CFTC Rule 23.434 requires Regulated Entities to determine if a swap is suitable for any non-Regulated Entity counterparty. Congress, in the Act, did not impose a "duty of care" on Regulated Entities; absent such statutory authority it is inappropriate for the Commission to assert such a duty by rule. The purpose of limiting access to bilateral swaps to ECPs is arguably to ensure that all market participants have the resources available to determine whether a swap is suitable for them. In that light, the proposed suitability requirement is both unnecessary and burdensome.

As discussed earlier, a determination of suitability is a judgment by one party about what is appropriate for another party. It requires that the evaluating party identify the interest of the other party and then make a judgment about what is in the interest of that party. It forces the

[9] CEA Section 4s(h)(3)(D).

determining party to substitute its judgment for the judgment of the management of the other party. This concept is an anathema to concepts of "principal to principal" trading.

At the least, Regulated Entities should be allowed to rely on a representation of a non-Regulated Entity counterparty that they have the internal staff or external advisors necessary to evaluate the suitability of a swap. Regulated Entities should not be obligated to conduct due diligence on each counterparty as a prerequisite to relying on such counterparty's representation as to suitability. That duty would open Regulated Entities to substantial potential liability, which, as noted above in Section II.A.1, would serve as a strong disincentive to entering into swaps with such counterparties.

If the Commission elects to retain the suitability standard and the accompanying duties, then Regulated Entities should not be required to determine suitability on a swap-by-swap basis. The Commission should allow Regulated Entities to satisfy the requirement with due diligence conducted and representations received prior to entering into a trading relationship that are memorialized in a master trading agreement or other written agreement. Suitability analysis conducted at the outset of a trading relationship should remain valid for all types of swaps that the counterparties were contemplating entering into at the start of the trading relationship.

2. SCENARIO ANALYSIS.

Proposed CFTC Rule 23.431(a)(1) requires swap dealers and majors swap participants to offer the option for "scenario analysis" to non-Regulated Entity counterparties to a swap not offered for trading on a derivatives clearing organization ("DCO") or swap execution facility ("SEF"). Regulated Entities are required to offer scenario analysis if such swap is a "high risk complex bilateral swap," an undefined term.[10] The provision of scenario analysis is not required under the Act. Accordingly, the Working Group respectfully recommends that this element of the Proposed Rules be set aside for reconsideration after the required rulemakings under the Act are accomplished. The creation of a scenario analysis, both in tabular and narrative form, is a resource intensive exercise, and likely will have an adverse impact on pricing of a swap. If a counterparty has employed or is represented by sophisticated persons with experience in the complex swap to be traded, then requiring Regulated Entities to provide modeling services and other additional disclosure is unnecessary.

As with other aspects of the external business conduct standards as set forth in the Proposed Rules, the provision of scenario analysis promotes improper reliance by non-Regulated Entity counterparties on swap dealers or major swap participants. These counterparties are ECPs and should have the experience and sophistication to engage in and evaluate such deals. Scenario analysis, or portions thereof, are often proprietary. Thus, issues of confidentiality and

[10] Proposed CFTC Rule 23.431(a)(1)(ii).

liability must be addressed in the Proposed Rules. Without addressing confidentiality and liability issues it is difficult for Regulated Entities to assess the implications of the Proposed Rules, and more importantly, it is difficult for Regulated Entities to begin to implement the compliance and risk management policies needed to attempt to comply with the Proposed Rules.

If the Commission elects to retain the provisions of the Proposed Rule regarding scenario analysis, it should define "high-risk complex bilateral swap."[11] Such further definition should be done pursuant to a separate rulemaking process to afford market participants of sufficient notice and opportunity to comment. A Regulated Entity is obligated to provide scenario analysis only with respect to such swaps. Thus, whether or not a swap is a "high-risk complex bilateral swap" is a predicate issue. Without guidance from the Commission, the determination is effectively left to the discretion of Regulated Entities, subject to second guessing by the Commission or in the event of any litigation surrounding a swap transaction. Again, the Working Group anticipates that swap pricing might increase to address such legal uncertainty.

In addition, the Working Group recommends that if the Commission elects to include scenario analysis in the Proposed Rules, then scenario analysis should always be available at the election of the non-Regulated Entity counterparty and not required. The Working Group also requests that the Commission provide proper protections for Regulated Entities that provide scenario analysis to their counterparties. Scenario analysis is complex, forward looking and based on a wide variety of assumptions. Absent fraud, Regulated Entities should not be subject to liability for scenario analysis that turns out to be inaccurate.

3. TRADING.

Proposed Rule 23.410(c) would prohibit swap dealers and major swap participants from trading ahead of or front running a counterparty.[12] For trades executable on a DCM and for which a Regulated Entity is merely an intermediary, the front running provisions are not objectionable. However, proprietary desks affiliated with a Regulated Entity should be permitted to trade freely so long as they are unaware of the counterparty's order through the Regulated

---

[11] Based on the characteristics set forth in proposed CFTC Rule 23.431(a)(1)(iii), a simple load following transaction, even if "energy only," could be considered a high risk complex bilateral swap. Many other commonly crafted load products would also be captured. Counterparties engaged in such deals would not consider such transactions to be high-risk and complex. Those that engage in these swaps know how to evaluate such swaps. The "best practices" documents relied upon by the Commission when describing high risk complex bilateral swaps were crafted by banks and, thus, do not take into account the idiosyncrasies of OTC energy swap markets. *See* note 50 to the *Proposed Rules*. So, at a minimum, the Commission should revise their description of high risk complex bilateral swaps to be applicable to all swap markets.

[12] The Working Group understands front running to be a trade done in anticipation of a known trade that can be reasonably expected to move the market.

Entity. Without such a provision, the Working Group questions the efficacy of this rule, as swap dealers might have little incentive to accept orders in respect of swaps that can be executed electronically. In fact, the front running rule, if not properly tailored might result in swap dealers refusing to accept orders for such transactions altogether.

The Commission should remove the front running prohibition in the context of bilaterally negotiated and settled swap transactions. The case law that the Commission cites as support for its application of the front running rule to bilateral markets is applicable to only exchange-based markets.[13] In bilateral swap markets, entities should not be prohibited from trading in the same or related products as their counterparties while negotiations are ongoing.[14] As some swaps take several months to negotiate, the front running rules could severely limit a Regulated Entity's ability to be in the market.

In light of Commission's new anti-fraud and anti-manipulation authority, which is robust and provides the Commission with powerful measures to abate abusive trading practices, separate front running provisions are not necessary.

The Commission, if it pursues a front running rule, should define "front running" in a manner appropriate for swaps markets. While front running is clearly understood in a securities market, its application to swaps markets is unclear. For example, parties can trade exposures to commodities by entering into physically settled contracts as well as entering into cash settled swaps. If front running is left undefined, the Commission's final regulation could be interpreted as forcing a swap dealer to stop or severely limit its physical trading. This result could be quite harmful to both swap markets and underlying physical markets. If the Commission does not eliminate the front running rules, as the Working Group suggests it should, then it should specifically except swap markets with actual physical underlyings from such rules. The swap markets and the physical markets for commodities are correlated. As the prices in physical and swap markets are a function of one another, it is very difficult to manipulate those markets by front running. The Working Group is unaware of any material example of trading in anticipation of entering a bilateral swap with a counterparty that has resulted in market manipulation or detrimental effects to the counterparty.

---

[13] The Commission, in footnote 34 to the *Proposed Rules*, cites to *United States v. Dial*, 757 F.2d 163, 168 (7th Cir. 1985).

[14] With respect to the bilateral swap markets referencing energy commodities, the Working Group requests the Commission provide examples of front running.

4. PROPOSED ANTI-FRAUD AND ANTI-MANIPULATION RULES ARE REDUNDANT.

The Commission has proposed new anti-fraud and anti-manipulation rules in the Proposed Rule as well in separate rulemakings specifically targeted at such issues.[15] The Working Group realizes that Section 731 of the Act places explicit anti-fraud and anti-manipulation requirements on transactions between Regulated Entities and special entities. However, those requirements and the Proposed Rule's anti-fraud and anti-manipulation rules are largely duplicative of the Commission's general authority to combat fraud and manipulation. The Working Group requests that the Commission clarify that the Proposed Rules do not impose additional anti-fraud and anti-manipulation requirements on Regulated Entities and strike the anti-fraud and anti-manipulation rules from the Proposed Rules to the extent that they are redundant to Part 180 of the Commission's regulations.

C. REQUIRED RULEMAKINGS.

1. VERIFICATION OF COUNTERPARTY STATUS.

The Proposed Rules require Regulated Entities to confirm a counterparty's status as an ECP or special entity. The Working Group agrees with the Commission's view that a Regulated Entity should be permitted to rely on a counterparty's representations as to its status as an ECP or special entity. This position recognizes that the determination of legal status can be quite fact dependent and subject to "second guessing."

Traditionally, in derivatives markets, if a counterparty's regulatory status was not established by representations, it was accomplished through a registration process with a regulator or a self regulatory organization. To that end, the Proposed Rules with the imposition of verification requirements for regulatory status, can be characterized as a large shift in regulatory oversight from the Commission to swap dealers and major swap participants if there is a limited ability to rely on counterparty representations.

The Working Group also supports the relief from the requirement to verify status when executing through a SEF or a DCM.

---

[15] *See* proposed CFTC Rule 23.410 and Advanced Notice of Proposed Rulemaking *Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 75 Fed. Reg. 67,301 (November 2, 2010) and Notice of Proposed Rulemaking *Prohibition of Market Manipulation*, 75 Fed. Reg. 67,657 (November 3, 2010).

2. DISCLOSURE REQUIREMENTS.

The disclosure standards and responsibilities contained in proposed CFTC Rule 23.431 should be bifurcated between cleared and uncleared swaps. If a swap is available for clearing, then each DCO that clears a particular swap should prepare the disclosure statement with the required information for each contract that it clears, and should make this disclosure generally available. This would assure that uniform disclosure about a swap contract is provided to each counterparty that trades it. Because the clearing house is the definitive source for this information, no other party should be obligated to provide it. The same disclosure paradigm should remain even if the swaps are not cleared because a counterparty has availed itself of the end user exemption to mandatory clearing.

With respect to swaps that are not available for clearing, the Commission should promulgate a form of generic risk disclosure regarding swap contracts. Generic disclosure assures that counterparties receive a standard minimum amount of disclosure.

The Proposed Rules also require certain disclosures about conflicts of interest and compensation.[16] The Commission should permit Regulated Entities to use generalized disclosure based on a uniform disclosure provided by the Commission for both matters. Specific disclosure for individual swaps should be required only for any compensation received by the Regulated Entity in connection with the swap.

The Commission should clarify the nature of conflicts of interest that warrant disclosure. Simply taking an opposite position in a swap could be said to be a form of conflict of interest. Also, a swap dealer or an affiliate might be entering other swaps that take an opposite view from that of the counterparty for reasons unrelated to the swap with the counterparty. Or, the swap dealer might also have a physical business that would benefit from a price movement that would be adverse to the counterparties economic position under the swap. All of these examples are not ill intentioned conflicts of interest and are likely known or expected by the counterparty. Thus, such types of conflicts of interest should not be subject to a disclosure requirement.

The Working Group also recommends that the Commission recognize that disclosures might vary across swap categories and issue a form of general disclosure for each category of swap. Traditionally, in commodities derivatives markets, there has been no concept of material non-public information. In respect of swaps referencing energy commodities, the Working Group recommends that the final rules under Section 731 of the Act formally recognize that no disclosure obligation exists with respect to knowledge regarding the underlying commodity, the physical markets in which it trades or any particular entity's positions or business in such commodity.

---

[16] Proposed CFTC Rule 23.431(a)(3).

The Commission, in setting disclosure standards and taking administrative actions in respect of alleged disclosure deficiencies, should not advance a theory of strict liability. A Regulated Entity should only be required to make disclosures about risks or factual matters known to it. Moreover, a Regulated Entity should only be required to make general disclosures regarding material aspects of a swap.

The Working Group respectfully requests that the Commission allow Regulated Entities to satisfy their risk disclosure obligations in master trading documents entered into at the outset of a trading relationship and not on a swap-by-swap basis. Regulated Entities should be permitted to make disclosures based on the generic disclosure provided by the Commission for each class of swap to be traded under that master trading agreement. Regulated Entities should only be required to make specific swap-by-swap disclosures regarding compensation, and that information should be permitted to be included in any confirmation.

Finally, the Commission asks why, if it is beneficial to the market, has industry not developed standard risk disclosure statements for swaps?[17] The Working Group believes such documentation has not been produced because of the bilateral nature of the market. Counterparties trade on a principal-to-principal basis, so such standard or generic disclosure has not been appropriate or necessary.

3. PROVIDING DAILY MARKS.

When swaps are centrally cleared, each party engages a futures commission merchant through which it clears its position in a swap. The futures commission merchant should be providing any daily mark to a counterparty with respect to such swap as, after the novation process that allows central clearing, a Regulated Entity and its counterparty are no longer party to a swap. The Working Group acknowledges that Section 731 of the Act requires a swap dealer or major swap participant to provide a non-Regulated Entity counterparty with the option to receive a daily mark on a cleared swap from such swap dealer or major swap participant. The Working Group respectfully requests that the daily mark requirement imposed by proposed CFTC Rule 23.431(c)(1) be deemed satisfied if that counterparty can access that information directly from the DCO or its futures commission merchant.[18]

---

[17] *Proposed Rule* at 80,644.

[18] In the event that a swap dealer also serves as a counterparty's FCM, then such entity should be subject to this requirement.

Proposed CFTC Rule 23.431(c)(2) requires Regulated Entities to provide non-Regulated Entity counterparties with a daily mark on uncleared swaps.[19] Requiring a Regulated Entity to provide daily marks on each swap it has with a counterparty is burdensome and provides little to no benefit to that counterparty. The purpose for exchanging daily marks with a counterparty is to determine the exposure between the counterparties. Where entities have a trading relationship, they determine exposure on a net or portfolio basis in connection with collateral management. Counterparties might only exchange marks on individual swaps if there is a material dispute as to that exposure. The Working Group respectfully requests that the Commission permit a Regulated Entity to satisfy the obligation to provide a daily mark on uncleared swaps on a portfolio basis.

Proposed CFTC Rule 23.431(c)(3) requires a Regulated Entity to disclose the "methodology and assumptions used to prepare the daily mark" for an uncleared swap. Regulated Entities should not be required to disclose anything but the most basic and generic information with regards to valuation methodology. Generally, each party should arrive at its own valuation of a swap transaction. To require detailed disclosure of valuation and valuation methods is to invite improper reliance on such valuation. In the collective view of the Working Group, if a counterparty cannot arrive at a valuation independently (or through the help of an independent adviser), then that counterparty likely does not meet the ECP requirements, and should not enter into the swap transaction. More fundamentally, this requirement rests on an assumption that a swap dealer has duties to its counterparties. When entering into a bilateral swap transaction, a swap dealer does so as principal and not an agent or advisor of its counterparty.

The final rules should provide that, absent fraud, the Regulated Entity should have no liability with respect to the mark. The Regulated Entity cannot control how the counterparty will use such marks. They might use them for a variety of purposes beyond the control of the Registered Entity, including, for example, for accounting or financial reporting purposes.[20]

The Commission, when issuing final rules with respect to the provision of marks, should permit the counterparty to elect *not* to receive any marks. Counterparties might prefer to rely on their own market surveillance to mark swaps. Thus, they might wish to avoid any adverse pricing effects that an additional post-trading obligation on the dealer might cause.

---

[19] The Working Group is not certain why Congress made the provision of marks with respect to cleared swaps elective, but mandatory with respect to uncleared swaps. A policy objective is not readily discernable.

[20] The Working Group also recommends that this liability standard apply with respect to any pre-execution mark provided by the Regulated Entity.

4. REQUIREMENTS WITH SPECIAL ENTITIES.

Though Section 731 of the Act distinguishes special entities from other market participants, the Commission should be careful to craft external business conduct standards that, ultimately, do not harm such entities. In short, increased obligations and liability with respect to special entities for Regulated Entities will increase swap pricing for special entities. To this end, the Working Group urges the Commission to pay careful attention to commenters that are special entities, In addition, the Working Group suggests that the Commission allow counterparties to agree upon the capacity in which a Regulated Entity is acting and should relieve Regulated Entities from any higher duty of care if a special entity has an independent representative.

We note that the Commission has not yet published a notice of proposed rulemaking in respect of the definition of "swap." If the Commission expands the definition of swap to encompass certain contracts with physical delivery, the import of these rules could be enormous and highly detrimental to special entities. In particular, if the trading with special entities for the physical delivery of energy products such as electricity or natural gas becomes subject to the same rules as traditional swap products, then special entities will almost invariably see increased prices and volatility for such products.

Most special entities are fully competent to trade as principal when executing swaps. The Working Group acknowledges that some municipalities have experienced losses associated with swap transactions in connection with municipal finance transactions. However, in the collective experience of the Working Group, when trading with respect to energy commodities, special entities are generally highly sophisticated and wield a notable amount of market power. In the energy markets, the need for the treatment afforded by the Proposed Rules is entirely unclear.

The Working Group believes that swap dealers will increase pricing of swaps when facing special entities as such swap dealers compensate for increased duties and liabilities under the Proposed Rules. At the same time, our expectation is that some swap dealers will stop trading with special entities altogether. This decision may be based on a perception that the associated liability in trading with special entities outweighs any commercial benefits. If the community of swap dealers serving special entities shrinks, then such special entities will lose pricing power and the volatility and spreads on their swaps will increase.

The threshold for a swap dealer being an advisor to a special entity should look to traditional principles of agency. Recommendation of a swap, by itself, should not be the basis of establishing an advisory relationship. A swap dealer, with the consent of its special entity counterparty, should be able to except itself out of the advisory relationship by expressly stating it is not acting as an advisor. The Working Group generally supports the provisions of the Proposed Rules that require affirmative disclosure of capacity. Furthermore, if a special entity has an independent representative, then a Regulated Entity should not be burdened with a higher

duty of care. A Regulated Entity should be able to rely on the representations of an entity asserting that it is qualified to act as an independent representative.

D. RECOMMENDATIONS TO ENTER SWAPS.

The Commission should issue guidance to clearly define when a Regulated Entity is "recommending" a swap to a counterparty. The concept of a "recommendation" features prominently in the Commission's release in its discussion of the requirements of Regulated Entity to make suitability determinations.[21] The Commission should go beyond agreeing to consult precedent and interpretive guidance under Federal securities and banking requirements to provide meaning to this concept. The swaps markets are quite different than other financial markets as parties are not offering to transfer title to a financial asset, but rather to enter into a contract with another party. At a minimum, the Working Group suggests that "recommending" a swap does not apply to any activity that constitutes negotiation or the marketing of a swap.

The Working Group also notes that recommendation of a swap by a Regulated Entity to a counterparty should not elevate that entity to a commodity trading advisor ("CTA").[22] A CTA functions in a retail market and a swap dealer plays an entirely different role in a principal-to-principal market and their actions in such market should not lead them to be required to register as a CTA in addition to registering as a swap dealer.

E. OPEN COMMENT PERIOD.

As the Commission proposed the definitions of "swap dealer" and "major swap participant" towards the end of the rulemaking process, and have yet to propose a definition of "swap," market participants have not been able to offer fully informed comments on the Commission's proposed rules, especially comments regarding the cost implications of such rules. In addition, given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on all of the proposed rules. The resulting comprehensive comments will allow the Commission to better understand how their proposed rules will impact swap markets.

---

21 *Proposed Rule* at 80,647.

22 *Id.*

II. CONCLUSION.

The Working Group supports tailored regulation that brings transparency and stability to the swap markets in the United States. We appreciate the balance the Commission must strike between effective regulation and not hindering the uncleared energy-based swap markets. The Working Group offers its advice and experience to assist the Commission in implementing the Act. Please let us know if you have any questions or would like additional information.

Respectfully submitted,

/s/ David T. McIndoe
David T. McIndoe
Mark W. Menezes
R. Michael Sweeney, Jr.

Counsel for the
Working Group of Commercial Energy Firms

APPENDIX A

Proposed Rule	Description of Requirement	Comment
23.402(a)(1)	Have policies and procedures designed to ensure compliance with the Proposed Rule and prevent evasion of any provision of the CEA or any Commission regulation.	Under this requirement, a Registered Entity must have a policy with respect to each and every statutory provision or regulation that potentially applies to such Regulated Entity. As many of these regulations only apply in very limited circumstances, the scope of an entity's policies should be limited only to material provisions of the CEA or the Commission's regulations.
23.402(b)	Diligently supervise compliance.	The Commission has proposed this requirement in connection with other proposed rules under the Act. This requirement should be removed from the Proposed Rules.
23.402(c)-(d)	Use reasonable due diligence to know and retain a record of the essential facts concerning each counterparty, guarantor or any person exercising any control. Includes evaluation of party's prior experience with swaps, financial wherewithal and flexibility, trading objectives and purposes.	Each counterparty should be able to represent this in a master agreement. The requirement that a Regulated Entity must know its counterparty sufficiently as to avoid (i) assisting or (ii) having reckless disregard of the fact that the counterparty will use the swap as part of a scheme to defraud is a very difficult standard. Regulated Entities should be able to assume, absent specific knowledge, that its counterparties are not seeking to commit fraud.
23.402(h)	Retain records in accordance with regulation 1.31.	Additional guidance is needed to clarify what it means to retain "written record of compliance" with requirements of subpart H. For example, a master agreement might qualify as a "written record of compliance" if it contains certain representations from the counterparty.
23.430(a)	Verify that a counterparty meets the eligibility standards for an ECP before offering to trade.	Representations from counterparty as to its status should be sufficient to discharge verification requirement. Offer should be construed to have its traditional legal meaning. Please see the comments of the Working Group at Section II.C.1. of this comment letter.

Proposed Rule	Description of Requirement	Comment
23.430(b)	Verify whether the counterparty is a Special Entity.	Representation from a party as to its status should be sufficient to discharge verification requirement. Please see the comments of the Working Group at Section II.C.1. of this comment letter.
23.431(a)(1)	Prior to entering into a swap, disclose the material risks of the swap.	Should permit Regulated Entities to use standardized disclosure language. The Commission should develop standard language to be used. Bilateral swaps are a product of negotiation; thus they do not need the same level of risk disclosure. Any risk disclosure should be permitted to be made in a master trading agreement or other written document at the onset of a trading relationship. Please see the comments of the Working Group at Section II.C.2. of this comment letter.
23.431(a)(1)(i)	Prior to entering into a swap that is not available for trading on a DCM or SEF, notify counterparty that it can request a scenario analysis. Provision of analysis upon request.	Scenario analysis should not be included in the Proposed Rules. In the event that the Commission retains the concept, it should be available at the option of a non-Regulated Entity counterparty and not required. Please see the comments of the Working Group at Section II.B.2. of this comment letter.
23.431(a)(1)(ii)	For a high-risk complex bilateral Swap, provide a scenario analysis.	Scenario analysis should not be included in the Proposed Rules. In the event that the Commission retains the concept, it should be available at the option of a non-Regulated Entity counterparty and not required. Please see the comments of the Working Group at Section II.B.2. of this comment letter.
23.431(a)(1)(iii)	Use policies and procedures to determine whether a bilateral swap is a high-risk complex swap.	If the Commission does not further define "high-risk complex swap," the characterization of such a swap is a subjective exercise. In the absence of a definition, then determination by a committee of knowledgeable representatives of the Regulated Entity should be sufficient.

Proposed Rule	Description of Requirement	Comment
23.431(a)(1)(iv)	Provided scenario analysis in both tabular and narrative formats and disclose all material assumptions and calculation methodologies.	Providing scenario analysis in both formats is burdensome and should not be included in the Proposed Rules. In the event that the Commission retains the concept, it should be available at the option of a non-Regulated Entity counterparty and not required. Please see the comments of the Working Group at Section II.B.2. of this comment letter.
23.431(a)(2)	Prior to entering into a swap, disclose material terms of swap.	Most of this should be covered by acknowledgement requirements. Please see the comments of the Working Group at Section II.C.2. of this comment letter.
23.431(a)(3)	Prior to entering into a swap, disclose all material incentives and conflicts of interest. Includes (i) price and mid-market value and (ii) compensation from any source.	Further definition of "material incentives" and "material conflicts of interest" is needed. For instance, the mere fact that a Regulated Entity takes positions contrary to its position in the counterparty swap should not be a disclosure item/ The Commission specifically seeks comment on whether swap dealers should be required to disclose their profit. They should not be required to do so. It is not statutorily required and is proprietary in nature. Please see the comments of the Working Group at Section II.C.2. of this comment letter.
23.431(c)	For cleared swaps, notify a counterparty of their right to receive daily mark from the DCO. For uncleared swaps, provide the counterparty with a daily mid-market value of the swap and disclose (i) the methodology and assumptions used to prepare the daily mark and (ii) any other information "to ensure fair and balanced communication."	FCMs and DCOs should satisfy the daily mark requirement for cleared swaps and Regulated Entities should be permitted to provide a daily mark at the portfolio level. Please see the comments of the Working Group at Section II.C.3. of this comment letter.

Proposed Rule	Description of Requirement	Comment
23.432(a)	Notify any non-swap dealer and non-major swap participant counterparty that they have the sole right to select the DCO at which a swap subject to mandatory clearing will be cleared.	As this is a notification of a statutory right the Working Group supports this requirement.
23.432(b)	Notify any non-swap dealer and non-major swap participant counterparty to a swap that is not subject to mandatory clearing that the counterparty may elect to require clearing and select the DCO.	As this is a notification of a statutory right the Working Group supports this requirement. The Working Group, however, recommends that the election of the non-Regulated Entity at the outset of the transaction should be binding unless both parties agree. Otherwise, the Regulated Entity might be required to transfer a swap from bilateral clearing to central clearing at an economically disadvantageous moment.
23.434	Have a reasonable basis to believe that any swap or trading strategy recommended to a counterparty is suitable for that counterparty through due diligence	Please see the comments of the Working Group at Section II.B.1. of this comment letter. This requirement should be removed from the Proposed Rule.
23.440(b)(1)	If acting as an advisor to a Special Entity, act in the best interests of the Special Entity.	This requirements should not apply if a special entity has an independent representative. Please see the comments of the Working Group at Section II.C.4. of this comment letter.
23.440(b)(2)	If acting as an advisor to a Special Entity, make reasonable efforts to obtain information necessary to make a reasonable determination that any swap or trading strategy recommended is in the best interests of the Special Entity.	Regulated Entities should be permitted to rely on representations made by special entities to satisfy this requirement. Please see the comments of the Working Group at Section II.C.4. of this comment letter.

Proposed Rule	Description of Requirement	Comment
23.450(b)	Have a reasonable basis to believe that a Special Entity has a representative that: (1) Has sufficient knowledge to evaluate the transaction; (2) Is not subject to a statutory disqualification; (3) Is independent of the swap dealer or major swap participant; (4) Acts in the best interests of the Special Entity; (5) Makes appropriate disclosures to the Special Entity; (6) Evaluates fair pricing and the appropriateness of the swap; and (7) In the case of a municipality, is subject to restrictions on certain political contributions.	Regulated Entities should be permitted to rely on representations made by special entities to satisfy this requirement. Please see the comments of the Working Group at Section II.C.4. of this comment letter.
23.450(c)(3)	Disclose any compensation paid by swap dealer or major swap participant to the independent representative.	If the compensation is provided in connection with the swap, disclosure is warranted. How other compensation should not be disclosed unless material. Please see the comments of the Working Group at Section II.C.4. of this comment letter.
23.450(e)	If a representative of a Special Entity is not qualified, make a written record of the basis for such determination and submit such determination to its Chief Compliance Officer for review.	The Commission should not require Regulated Entities to evaluate qualifications of advisors to a special entity. The Commission might establish a registration program for such advisors. The special entity should be allowed to represent that it has adequate representation, and the Regulated Entity should be allowed to rely on such representation.

Proposed Rule	Description of Requirement	Comment
23.450(f)	Before the initiation of a swap, disclose to a Special Entity the capacity in which it is acting and, if applicable, the material differences between capacities in which it is acting in connection with the swap and any other financial transaction or service.	The Working Group supports this requirement.
23.451(b)	Cannot offer to enter into or enter into a swap with a municipal entity within two years after making a political contribution or after an associated person makes a political contribution to an official of such municipal entity.	It is unclear how Regulated Entities will monitor this. Perhaps the rule should be written in a more targeted fashion where an entity cannot provide political contributions with the intent to solicit swaps business. Again, offer should be defined in a manner that is consistent with its traditional legal definition.
155.7	If a swap is available for trading on a DCM or SEF, prior to execution, (1) Disclose to the customer the DCMs and SEFs on which the swap is available and the DCMs and SEFs on which the registrant has trading privileges; (2) Execute the order on terms that have a reasonable relationship to the best terms available; and (3) Use reasonable diligence to ascertain the best terms available.	If transactions are available on a DCM or a SEF, then a Registered Entity's obligations should be limited to directing the counterparty to trading on such platform. The Regulated Entity should not owe a duty of best execution as this concept does not exist where trading is forced to be on a platform and the FCM determines the pricing. This requirement, as drafted, applies to all "customers." This requirement should, at a minimum, not apply to transactions between Regulated Entities as in such circumstance it is both unnecessary and costly.