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By Commission Website

August 8, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: RIN 3038-AD53: Adaptation of Regulations to Incorporate Swaps, 76 Fed.Reg. 33066 (June 7, 2011)

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the proposed amendments to its rules intended to conform them to the regulatory regime established in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the implementing rules that the Commission has proposed or promulgated thereunder. FIA generally supports the proposed amendments to the extent that they are "accommodating" or "ministerial" in nature. However, FIA cannot support the proposed substantive amendments to Commission Rule 1.35(a) and Rule 1.31.

These latter amendments are not "essential to the implementation" of the Dodd-Frank Act[2] and run counter to the guiding principles set out in President Obama's January 18, 2011 Executive

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[1] FIA is the leading trade organization for the futures, options and OTC cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world's largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearing organizations, our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions.

FIA's core constituency consists of futures commission merchants ("FCMs"), and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA's regular members, which act as the majority clearing members of the U.S. exchanges, handle more than 90 percent of the customer funds held for trading on U.S. futures exchanges.

[2] 76 Fed.Reg. 33066, 33067 (June 7, 2011).

Order 13563, Improving Regulation and Regulatory Review, which the Commission indicates it has voluntarily undertaken to implement. As the Commission notes, the Executive Order instructs agencies to "consider the costs and benefits of their regulations and choose the least burdensome path [and] attempt to harmonize regulations to reduce costs and promote certainty for business and the public."[3]

The proposed amendment to Rule 1.35 would require FCMs, introducing brokers and members of designated contract markets ("DCMs") and swap execution facilities ("SEFs") to create and maintain records of certain oral communications. As explained in detail below, the nature and scope of the obligations that would be imposed on Commission registrants and non-registrant members of DCMs and SEFs under the proposed amendment is unclear and, in one case, simply impossible to meet. Moreover, the Commission has substantially underestimated the potential costs that Commission registrants would incur in complying with the recording requirement.

FIA appreciates the Commission's desire to have access to records of relevant communications, both oral and written, regarding derivatives transactions within the Commission's jurisdiction. However, for the reasons explained below, we believe it would be more appropriate for the Commission to withdraw the proposed amendment and, following consideration of the issues identified herein, to publish for comment a revised amendment that is consistent with (i) the stated purpose of proposed Commission Rule 23.202(a)(1),[4] and (ii) the retention requirements of the United Kingdom Financial Services Authority ("FSA"), the Hong Kong Securities and Futures Commission and the French Autorité des Marches Financiers.[5] In connection with such revised amendment, we also urge the Commission to clarify the extent to which Commission registrants and non-registrant members of DCMs and SEFs may rely on the records created and maintained by trading platforms.[6]

As noted, FIA also opposes the proposed amendment to Rule 1.31, which would require Commission registrants to maintain paper records in their original form for a period of at least five years. The Commission has provided no support for such a dramatic reversal of policy. In

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[3] 76 Fed.Reg. 38328 (June 30, 2011).

[4] 75 Fed.Reg. 76666 (December 9, 2010).

[5] Each agency requires that recordings generally be maintained for a six-month period. We note that, although the Commission has emphasized that certain foreign regulatory authorities have adopted similar recording requirements, the Commission has ignored the fact that the Securities and Exchange Commission has not proposed such a recording requirement. Yet, section 712(a) of the Dodd-Frank Act specifically instructs the Commission "[b]efore commencing any rulemaking or issuing an order regarding swaps . . . [to] consult and coordinate to the extent possible with the Securities and Exchange Commission . . . for the purposes of assuring regulatory consistency and comparability, to the extent possible." The National Futures Association and the Financial Industry Regulatory Authority impose recording requirements only in those limited circumstances in which, based on objective criteria, the agency believes sales practice abuses may occur.

[6] As explained below, we also recommend that action on the proposed rule be deferred pending consideration by the Commission's Technology Advisory Committee.

Further, the Commission has failed to provide any meaningful estimate of the potential costs that Commission registrants would incur in complying with the proposed record retention requirement.

Commission Rule 1.35(a)

The scope of the proposed requirement to record all oral communications is unclear. The Commission has proposed to amend Rule 1.35(a) to require FCMs, introducing brokers, and non-registrant members of DCMs and SEFs to maintain records of "all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the execution of transactions in a commodity interest or cash commodity, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device or other digital or electronic media." At the outset, we note that many commercial firms that are producers, processors and merchants in agricultural products and other commodities, such as energy and precious metals, are members of DCMs (and will likely be members of SEFs). These entities will be subject to the proposed recording requirements with respect to their proprietary transactions and will incur the significant costs described below. These costs will be passed on to their cash market customers.[7]

Substantively, the language of the proposed amendment is very broad and would appear to require the recording of all telephone calls, including calls made on mobile telephones, involving sales or trading personnel even if the call does not lead to a customer order. After all, a customer may decide to enter an order at any time, even if that was not the original purpose of the call. Moreover, "communications . . . ***concerning*** . . the execution of transactions" may include communications involving an FCM's back office, which would expand further the proposed recording requirement.

Notwithstanding the apparent broad scope of the proposed recording requirement, the Federal Register release accompanying the proposed rule indicates that the rule is intended to capture a more limited class of oral communications. In several places throughout the release, the Commission states that the provisions of the proposed amendment to Rule 1.35(a) are designed to "harmonize" Rule 1.35(a) with the recordkeeping requirements proposed for swap dealers and major swap participants, thereby "increasing consistency" across regulatory regimes.[8] The Federal Register release then quotes the provisions of proposed Rule 23.202(a)(1), which

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[7] Swap dealers and major swap participants may also be members of DCMs and SEFs and, therefore, will be subject to the requirements of Rule 1.35(a) as well as the requirements of proposed Rule 23.202(a).

[8] 76 Fed.Reg. 33066, 33072 (June 7, 2011). Elsewhere, the Commission states that the amendments to Rule 1.35(a) are being proposed for "regulatory parity."

imposes on swap dealers and major swap participants essentially the same requirements as set out in proposed Rule 1.35(a).[9]

In the Federal Register release accompanying proposed Rule 23.202(a)(1), however, the Commission more narrowly defines the scope of the recording requirement:

> This rule would require swap dealers and major swap participants to maintain recordings of telephone calls and other communications created in the normal course of its business, ***but would not establish an affirmative new requirement to create recordings of all telephone conversations if the complete audit trail requirement can be met through other means, such as electronic messaging or trading.*** 75 Fed.Reg 76666, 76668. [Emphasis supplied.]

It appears, therefore, that the proposed recording requirement for swap dealers and major swap participants is not as inclusive as its terms would suggest. Its focus is on records that create a "complete audit trail,"[10] not "sales."[11] Moreover, the Commission states that telephone recordings will not be required if the audit trail requirement can be met by other means.

We respectfully submit that the separate Federal Register releases accompanying proposed Rule 23.202(a)(1) and Rule 1.35(a) set conflicting standards that must be resolved if the Commission is to achieve "regulatory parity." In this regard, we believe the standard set out in the Federal Register with respect to proposed Rule 23.202(a)(1), *i.e.*, the recording of oral conversations is not required "if the complete audit trail requirement can be met through other

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[9] Specifically, proposed Rule 23.202(a)(1) requires swap dealers and major swap participants to "make and keep pre-execution trade information, including, at a minimum, records of all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the execution of a swap, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device or other digital or electronic media." 75 Fed.Reg. 76666 (December 9, 2010).

[10] Rule 1.35 does not use the term "audit trail." However, in the Commission's proposed rules on core principles for designated contract markets, the Commission has proposed that a DCM's audit trail must include "original source documents," which are defined to include

> unalterable, sequentially identified records on which trade execution information is originally recorded, whether recorded manually or electronically. Records for customer orders (whether filled, unfilled or cancelled, each of which shall be retained or electronically captured) must reflect the terms of the order, an account identifier that relates back to the account(s) owner(s), and the time of order entry. For open-outcry trades, the time of report of execution of the order shall also be captured. Proposed Rule 38.552(a). 75 Fed.Reg. 80572, 80618 (December 22, 2010).

[11] We note that, to the extent customers are introduced to an FCM, it is likely that relevant sales communications will be made by introducing brokers that generally will not have the resources to incur the significant costs to implement the proposed recording requirement, as discussed below.

means, such as electronic messaging," is the more practical and reasonable standard.[12] We ask the Commission to revise proposed Rule 1.35(a) to state this standard more clearly.

The requirement that records of each transaction "be maintained as a separate electronic file identifiable by transaction and counterparty" sets an impossible standard. The proposed amendment to Rule 1.35(a) also provides that "[e]ach transaction record shall be maintained as a separate electronic file identifiable by transaction record and counterparty." Although the rule provides that such records include all documents on which members of DCMs and SEFs originally record trade information, the Commission does not further define the scope of the records that are required to be maintained "as a separate electronic file" or state when such files must be created.[13] If the proposed amendment requires such files to include, for example, "all written and oral communications . . . that lead to the execution of transactions in a commodity interest," we submit that the technology to collate such disparate records does not currently exist.[14] Moreover, the operational and financial burden of collating manually such information with respect to every transaction, which information could include communications over several days or more, would be overwhelming. Simply stated, the Commission's proposed requirement is impossible to achieve on any level.

The standard of liability to which Commission registrants may be held is unclear. Given the breadth of the proposed rule, the standard of liability to which Commission registrants may be held is uncertain. It will be difficult, if not impossible for registrants to assure that all telephone conversations are recorded and that all relevant conversations with respect to a particular transaction are identified when a request is made.

If the Commission elects to proceed with the proposed amendment, therefore, we encourage the Commission to adopt formally the principles-based approach favored by the United Kingdom FSA, which requires firms to take "reasonable steps" to: (i) record relevant telephone conversations sent or received on equipment provided by the firm or sanctioned by the firm; and (ii) prevent an employee from making, sending or receiving conversations on privately-owned equipment which the firm is unable to record.[15] In particular, we note that FSA has stated that, in principle, a firm could be found to have taken "reasonable steps" to prevent relevant conversations from taking place on mobile telephones, if the firm: (i) prohibits the use

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[12] If the Commission elects, instead, to require swap dealers and major swap participants to record all telephone conversations, we suggest these potential registrants have not received adequate notice of the scope of proposed Rule 23.202(a)(1).

[13] It is also not clear whether the requirement to create electronic files of these documents conflicts with the proposed amendment to Rule 1.31, which will require registrants to maintain copies of paper records in their original form.

[14] As discussed below, FIA is aware of two companies that offer so-called "word spotting" technologies that may allow firms to search electronic records for specific words. However, we understand that this technology is expensive and not foolproof.

[15] FSA Conduct of Business Sourcebook, 11.8.

of mobile telephones provided by the firm to make or receive relevant conversations; (ii) restricts the use of mobile telephones to make or receive relevant conversations outside the office (when coupled with a recording solution for such telephones that may be used to record relevant conversations in the office); or (iii) permits the use of mobile telephones that are not recorded only in "exceptional circumstances."[16]

The Commission has underestimated the costs of implementing a recording requirement.[17] The Commission has asserted, without providing any support therefore, that the costs of implementing the proposed recording requirement would be "minimal," and "estimates that the cost of procuring systems to record these oral communications will be $55,000 for an average large entity that does not already have such systems in place, and estimates procurement costs of $10,000 for each small entity that does not already have such systems in place."[18] This is because

> the information and data required to be recorded is information and data a prudent [Commission registrant] would already maintain during the ordinary course of its business. Moreover, most [Commission registrants] have adequate existing resources, technology systems, and recordkeeping structures that are capable of adjusting to the new regulatory framework without material diversion of resources away from commercial operations.[19]

We strongly disagree. The Commission has provided no basis for its statement that a "prudent" registrant would already maintain records of oral communications or that most registrants "have adequate existing resources, technology systems, and recordkeeping structures that are capable of adjusting to the new regulatory framework without material diversion of resources away from commercial operations."[20]

Certainly, not all FCMs currently record telephone conversations. To the extent that they do record relevant conversations, (i) such conversations are frequently limited to dedicated order desks, and (ii) records of such conversations are maintained for no more than a period of days or weeks. Records of conversations are maintained solely to resolve any disputes that may

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[16] FSA Policy Statement 10/17, Taping of mobile phones: Feedback on CP10/7 and final rules, November 2010, pp. 12-13.

[17] Although we encourage the Commission to confirm that Commission registrants are required to record only those conversations necessary for a complete audit trail, the following discussion necessarily assumes that the requirement is broader.

[18] 76 Fed.Reg. 33066, 33077 (June 7, 2011). The Federal Register release provides no support for the Commission's cost analyses.

[19] Id, p. 33081.

[20] As the Commission is well aware from its review of the FSA's taping rules, recordings are not made in the ordinary course of business in the UK.

arise over the terms of a transaction. If there are such issues, they arise shortly after the customer has received confirmation of the trade and are quickly resolved.

Moreover, cost estimates that we have received from several of our member firms far exceed the $55,000 cost estimated by the Commission for "the average large entity." One member recently spent an estimated $600,000 to upgrade and maintain less than 100 land line telephones. Another mid-size member firm has determined that the cost of the necessary system to record all land-line telephone conversations is in excess of $300,000. Annual operating costs add an additional $600,000 annually for another firm. The proposed rules, of course, do not apply only to large entities. The requirement to record all oral communications would extend to small and mid-sized FCMs, introducing brokers and all members of DCMs and SEFs.

More troubling, the Commission's estimate does not include the cost of recording mobile telephones. For one large firm, the cost of implementing a recording requirement in accordance with the FSA's mobile taping requirement exceeded $2.5 million. Another large firm estimated that its annual operating costs would increase approximately $1.0 million. Estimated operating costs for other firms begin at approximately $160,000.

We further understand that a mobile telephone recording requirement would require the firm to provide a firm-owned mobile telephone to each employee whose conversations are required to be recorded. Although some firms may provide firm-owned mobile telephones, that is not the industry norm.

In addition, the Commission's estimate does not include the costs of maintaining "each transaction record . . . as a separate electronic file identifiable by transaction record and counterparty" and their subsequent retrieval and production. As explained above, we are not aware that the technology exists today to collate such disparate records. We understand that two software providers, NICE Actimize and Nexidia, offer so-called "word spotting" programs that may facilitate the search for conversations. However, we have been advised that licensing fee alone for such programs may cost $500,000**.** We also understand that, as a result of differences in tone and dialect, such programs are not foolproof and may identify less than 50 percent of potentially relevant conversations.

Finally, the Commission cannot ignore the potential civil litigation costs that this recording and retention requirement may impose on Commission registrants. As discussed above, the technology to search records of oral communications with the ease apparently contemplated by the proposed amendment simply does not exist. A requirement to search for recordings of all potentially relevant oral communications over a five year (or longer) period in response to a

discovery request, would impose an overwhelming operational and financial burden on a Commission registrant.[21]

Adoption of the recording requirement should be referred to the Technology Advisory Committee. The significant costs described above are in addition to the already substantial costs that firms will incur to modify their existing technology to meet the requirements demanded under the Dodd-Frank Act. Moreover, the technology necessary to comply with the proposed rule is uncertain at best, and it is likely that any hardware and software purchased to comply with the proposed rule will soon be outdated. In these circumstances, we believe the better course is to defer action on the proposed rule and ask the Commission's Technology Advisory Committee for its analysis of the existing technology, how effective it is, as well as its true cost.[22]

The Commission should clarify the extent to which persons affected by the proposed amendment may rely on the records created and maintained by trading platforms. In discussing its proposed amendments to Rule 1.31, the Commission states:

> to the extent that a registrant's transactional activity is retained on a platform operated by or additionally is captured by a regulated entity, trading mechanism, clearinghouse or another regulated entity . . . that is required to maintain these records in the same form, the registrant may rely on the retention requirements of the other registrant in order to comply with the proposed requirements of regulation 1.31.

FIA welcomes the Commission's statement that registrants may rely on other registrants to create and maintain records required to be maintained under Rule 1.31, and we encourage the Commission to amend Rule 1.31 accordingly. For purposes of complying with Rule 1.35(a), we interpret the Commission's statement to mean that, to the extent a DCM or SEF records the relevant conversations of orders transmitted for execution by telephone, a Commission registrant that transmits such orders may rely on the DCM or SEF and is not required to record such conversations and maintain such records separately. We urge the Commission to confirm that Commission registrants and non-registrant members of DCMs and SEFs may rely on such records for purposes of complying with the proposed amendment.

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[21] We note that the potential civil litigation costs in the UK can be expected to be substantially less. First, as previously noted, the FSA rule provides that recordings must be maintained for only a six-month period, rather than the minimum five years the Commission has proposed. Second, litigation is less frequent in the UK, in part, perhaps as a result of the "loser pays" rule, which requires the losing party in litigation to pay legal fees.

[22] The proposed recording requirement is not required under the Dodd-Frank Act.

Commission Rule 1.31(a)

FIA strongly opposes the proposed amendment to Rule 1.31(a), which would require Commission registrants to maintain "[a]ll books and records required to be kept by the Act or by these regulations . . . in their original form (for paper records) or native file format (for electronic records) for a period of five years from the date thereof and shall be readily accessible during the first 2 years of the 5-year period." Many firms may transfer electronic records upon creation to other forms of electronic media currently permitted by Rule 1.31(b), such as "non-rewritable, non-erasable" disks. In addition, "records of any swap or related cash or forward transaction shall be kept until the termination, maturity, expiration, transfer, assignment, or novation date of the transaction and for a period of five years after such date."[23]

The proposal marks a dramatic reversal of the Commission's policy that has been in effect since at least 1999, when the Commission amended Rule 1.31 to harmonize its recordkeeping rules with those then in effect at the Securities and Exchange Commission ("SEC"). The Commission adopted the 1999 amendments in recognition of the fact that "a significant number of Commission registrants [ ] are subject to the recordkeeping requirements of the Securities and Exchange Commission."[24] The 1999 amendments were designed to achieve the Commission's goals of "maximizing the cost-reduction and time-saving arising from technological developments in the area of electronic storage media and maintaining the type of safeguards that ensure the reliability of the recordkeeping process."[25] As explained below, we believe the Commission has provided no justification to support such a radical shift in policy.

First, the Commission has not indicated that compliance with the current rules has had an adverse effect on the Commission's investigations or surveillance activities. Moreover, we have consulted with experienced litigation counsel, who have advised us that Rule 34 of the Federal Rules of Civil Procedure does not require registrants to maintain records in their original form. In this regard, Fed. R. Civ. P. 34(b)(2)(E)(i) states that "[a] party must produce documents as they are kept in the usual course of business or must organize and label them to correspond to the categories in the request." Records maintained in accordance with current Rule 1.31 are records "as they are kept in the usual course of business."

Further, Fed. R. Civ. P. 34(b)(2)(E)(i) provides, in relevant part, that "a party must produce [electronically stored information] in a form or forms in which it is ordinarily maintained or in a reasonably useable form or forms." Again, records maintained in accordance with current Rule 1.31 constitute records "in a form or forms in which [they are] ordinarily maintained."

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[23] 76 Fed.Reg. 33066, 33077 (June 7, 2011).

[24] 64 Fed.Reg. 28735 (May 27, 1999). Rule 1.31(d) requires registrants to retain "in hard-copy for the required time period . . . [t]rading cards, documents on which trade information is originally recorded in writing, written orders required to be kept pursuant to Sec. 1.35(a), (a-1), (a-2) and (d)."

[25] Id.

In addition, Fed. R. Civ. P. 34(b)(2)(E)(iii) confirms that "a party need not produce the same electronically stored information in more than one form." Finally, 2006 Notes of Advisory Committee to Fed. R. Civ. P. 34 observes that "discovery of electronically stored information stands on equal footing with discovery of paper documents."

The Commission also states, without support, that it has determined that for Commission registrants, costs to institute recordkeeping systems to retain swap records for the life of the swap . . . and for five years after that date would be far outweighed by the benefits to the financial system as a whole." Further, the Commission "is not imposing any cost that a prudent [registrant] would not already incur in maintaining records for swap transactions. A prudent registrant would retain a swap record for the life of the swap to ensure that its rights under the contract are protected and its obligations are fulfilled."[26] We urge the Commission to withdraw this proposed amendment.

Conclusion

FIA appreciates the opportunity to submit these comments on the proposed amendments to Rule 1.35(a) and Rule 1.31(a). If the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIA's Executive Vice President and General Counsel at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner

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[26] 76 Fed.Reg. 33066, 33080 (June 7, 2011).