HUNTON & WILLIAMS LLP
2200 PENNSYLVANIA AVENUE , N.W.
WASHINGTON, D.C. 20037

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

MARK W. MENEZES
R. MICHAEL SWEENEY, JR.
DAVID T. MCINDOE

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

VIA ELECTRONIC MAIL

Re: *Proposed Rule on Adaptation of Regulations to Incorporate Swaps,* RIN 3038-AD53

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits these comments to the "Notice of Proposed Rulemaking on Adaptation of Regulations to Incorporate Swaps" ("*Proposed Rule*") issued by the Commodity Futures Trading Commission ("CFTC" or the "Commission") and published in the *Federal Register* on June 7, 2011 in order to conform the many new rulemakings promulgated pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") to the Commission's existing regulations.[1]

II. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

The Working Group acknowledges the complicated necessity of making conforming amendments to the Commission's existing regulations in order to reflect the numerous changes required by the Act. The Working Group appreciates the Commission's diligence in attempting to provide conformity among its proposed rulemakings, over 45 of which have been issued since the date of enactment of the Act. However, the Working Group submits that it is premature to implement conforming amendments at the beginning of the final rulemaking process. The final rules that have yet to be written may very well impact how the conforming amendments should be drafted and implemented in order to accomplish the objectives of the final rules and avoid unintended consequences. Further, the Working Group seeks clarification regarding the issues described below.

[1] *See* Adaptation of Regulations to Incorporate Swaps, *Notice of Proposed Rulemaking*, 76 Fed. Reg. 33,066 (June 7, 2011).

A. THE ELECTRONIC COMMUNICATIONS RECORDING AMENDMENT TO REGULATION 1.35 SHOULD NOT EXTEND TO MEMBERS OF DCMS AND SEFS THAT DO NOT HANDLE CUSTOMER ORDERS.

The *Proposed Rule* makes a substantive amendment to regulation 1.35 that would impose electronic communications recording obligations on members of swap execution facilities ("SEFs") or designated contract markets ("DCMs"), including those that do not handle customer orders.[2] The concept of "membership" in a SEF is, for the most part, still an unknown, but the *Proposed Rule* suggests that it includes parties that merely trade on SEFs. The Working Group respectfully submits that this costly and administratively burdensome new obligation should not be imposed so broadly. As the Commission is well aware, the concept of "membership" in a contract market (now DCM) has evolved greatly since the original language of regulation 1.35 was drafted. In drafting the *Proposed Rule* as it has, the Commission is casting an extremely broad net, impacting the non-derivative portions of a vast array of physical market participants in exempt and agricultural commodities that have obtained "memberships" in DCMs or will obtain "memberships" in SEFs simply to get access to trading systems (or sometimes to get access at a reduced cost). These entities, which are neither futures commission merchants ("FCMs") nor swap dealers, are in fact "end-users" and should not be subject to the same burdens as those entities that interact with customers.[3]

The Working Group submits that the requirements of regulation 1.35 have never been intended to place recordkeeping burdens on end-users. While it is true that "off-the-floor" members with trading privileges on a contract market (who actually are more properly characterized as customers seeking lower "member rates" on the contract market) were subject to maintaining records that they otherwise prepared in connection with their cash commodity business, the Commission has not previously imposed any direct record *creation* obligations on "members of contract markets" that were not FCMs, IBs, or present on a trading floor. The record *creation* requirements principally applied to market participants that interact with customers and/or the Commission's ability to reconstruct the audit trail for trades that involved

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[2] The *Proposed Rule* would extend the requirements of regulation 1.35 to members of SEFs or DCMs, requiring them to make and keep 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. Each transaction record shall be maintained as a separate electronic file identifiable by transaction and counterparty. Among such records each member of a designated contract market or swap execution facility must retain and produce for inspection are all documents on which trade information is originally recorded, whether or not such documents must be prepared pursuant to the rules or regulations of either the Commission, the designated contract market or the swap execution facility." *Proposed Rule* at 33,091. Emphasis added.

[3] The Working Group characterizes "end-users" as those market participants which would fall under the definition of "non-financial entity," as defined in the Commission's proposed rules on margin requirements for uncleared swaps. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, *Notice of Proposed Rulemaking*, 76 Fed. Reg. 23,744 (April 28, 2011) ("'Non-financial entity' means a counterparty that is not a swap dealer, a major swap participant, or a financial entity.")

customer orders.[4] Consistent with that practice, the Working Group respectfully requests that the Commission not impose record *creation* duties on end-users that do not interact with customers in this instance.

The Commission has also failed to take into account the broad array of market users that do not handle customer orders who will be exposed to Commission recordkeeping requirements for the first time and to whom the burden of new electronic communications record creation requirements will be exceptionally onerous. This group includes the many entities that will become members of SEFs. Of course no one, including the Commission, has a clear picture as to how the creation and evolution of SEFs will unfold, but it appears clear that the Intercontinental Exchange ("ICE") that currently operates as an exempt commercial market will become a SEF.

It is our understanding that over 1000 entities have the ability to transact on ICE. Under the Commission's proposal, many of these entities will be required, for the first time, to maintain records pursuant to Commission rules, and to the extent they already make such records, they now will be required to retain them in a particular form, for certain time periods, and be subject to inspection, all pursuant to the Commission's rules. All of them would be required, again for the first time, to record all of their electronic communications relating to transactions in physical commodities and derivatives and manage those recordings in accordance with all of the Commission's mandates. Likewise, the Commission's proposal would impact the full scope of business of many of the approximately 70 entities that have trading privileges on the Nodal Exchange. To the extent there are other SEFs on which commercial entities seek to trade exempt or agricultural commodities, they would be similarly impacted.[5] Many of these commercial entities are small; many of them are likely unaware of the Commission's proposal and its potential impact on them.[6]

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[4] *See* 17 C.F.R. § 1.35(a-1)(1), (2) and (4), 1.35(a-2)(1) and (2), 1.35(b), and 1.35(e).

[5] For example, if financial transmission rights and other products traded on independent systems operator ("ISO") markets are deemed "Swaps," ISOs would presumably become SEFs. Thus, they and their members would be caught up in the onerous requirements of the *Proposed Rule*. Many of these entities have never been subject to CFTC oversight and likely are unaware they will be impacted by the requirements of the *Proposed Rule*. These entities include municipal utilities and rural electric cooperatives. Further, the *Proposed Rule* creates a scenario in which, if ISOs are required by the Commission to register as SEFs, members of ISOs (such as municipal utilities and rural electric cooperatives) that strictly deal in physical transactions and not Swaps would still be subject to the electronic communications recording requirements.

[6] Indeed, the Working Group questions the inclusion of any changes that could be deemed "substantive" within a proposed rule that is intended to make conforming amendments to existing regulations. If such changes are viewed by the Commission itself as substantive, the Commission should issue them separately so that the public can provide appropriate comment. Including substantive amendments among a litany of other changes to regulations creates unwarranted difficulty with respect to the public's ability to provide informed and effective comment.

Further, in the *Proposed Rule*, the Commission states that each of the conforming amendments fall within one of three categories: substantive, accommodating, or ministerial (*Proposed Rule* at 33,067). However, in its description of such changes, the Commission stops short of indicating the particular classification of each amendment. These classifications would have been more helpful had the Commission specified which category each amendment fell within. In the current *Proposed Rule*, it is difficult to subjectively determine which changes are substantive and necessary of public comment.

The Working Group respectfully submits that this is a substantial and unwarranted cost and burden being imposed by the Commission on end-users that are neither swap dealers nor FCMs and do not handle customer orders. Congress has been extremely diligent in protecting end-users from the unintended consequences of financial market reform. The Working Group respectfully requests that the Commission consider that important policy and limit the electronic communications recording requirement to those that handle customer orders.

1. <u>The Language in the Proposed Electronic Communications Recording Requirement is Unnecessarily Broad</u>.

The language in the proposed amendment to regulation 1.35 is extremely broad, particularly in that it would require the retention of all electronic communications "concerning" information that leads to the execution of a transaction in a cash commodity or commodity interest.[7] The Working Group is concerned that the use of the term "concerning" could be interpreted to apply not only to electronic communications among personnel on a trade floor, but also to communications among middle office personnel clarifying terms of a transaction, attorneys negotiating master trading agreements, and/or other employees discussing terms that relate to a transaction, but are not directly related to the execution of the transaction. If this is the case, the costs of implementing recordkeeping systems to comply with the *Proposed Rule* (as discussed below) could increase exponentially.

Further, the amendment to regulation 1.35 is particularly onerous as it would require the recording of electronic communications made on cell phones or other mobile devices. The Working Group submits that this requirement is extremely burdensome on its own and for the reasons stated above regarding the applicability of the recording requirement to personnel other than traders. Additionally, the Working Group views such a requirement as overreaching in light of the fact that many market participants already ban the use of cell phones and mobile devices on the trading floor or for trading purposes generally. Again, imposing such a requirement would be extraordinarily costly with little or no benefit.[8]

2. <u>Costs Associated With Record Retention</u>.

With respect to the Commission's request for comment on potential costs and benefits of requiring the retention of electronic communications, the Working Group directs the Commission to the Working Group's previous comments on other proposed rules relating to

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[7] *Proposed Rule* at 33,091.

[8] Indeed, several firms have provided estimates of the costs associated with recording electronic communications made via cell phones in light of the United Kingdom Financial Services Authority's new rules requiring such records. *See* "Britain to Tape Traders' Cell Phones to Fight Fraud," *New York Times*, November 11, 2010. ("One unidentified investment bank estimated that the cost of recording all Blackberry phones could reach £2.6 million ($4.2 million) each year, according to the [Financial Services Authority] policy statement.")

recordkeeping requirements.[9] In particular, requiring records of electronic communications to be kept in their native format and tied to individual transactions is not technologically feasible and will be extraordinarily costly if required to be implemented. Document creation and indexing requirements are not sensible from a cost-benefit perspective when applied to swap dealers, let alone end-users. As stated in the Working Group's comments on the Commission's proposed rule on "Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants:"

> From an IT standpoint, the Working Group is unaware of existing technology, other than through a manual process, that would allow records of telephone conversations, instant messages, voice recordings, e-mails, and other electronic communications to be maintained in an individual file that would be identifiable and searchable by transaction and counterparty. Even if such technology exists, the Working Group does not believe that it would be possible to identify much, if any, of the pre-execution data specified by the Commission as being applicable to any specific trade because traders and other commercial employees typically engage in ongoing dialogue with any number of counterparties over an extended period of time and do not necessarily initiate communications with counterparties specific to any single trade or prospective trade. It would be extremely difficult and time consuming – if not impossible – to manually review each and every communication, electronic or otherwise, of a specific trader to determine which specific pre-execution conversations or documents ultimately led to the execution of a particular swap and, consequently, to assign each particular communication to a segregated, unified file for that particular swap transaction.
>
> To reiterate, putting aside the impossibility of identifying all of the communications that might relate to an individual transaction, the Working Group is currently unaware of <u>any</u> existing IT system that could provide segregated, unified files containing all swap transaction information, including pre-transaction and post-transaction data, identifiable and searchable by transaction and counterparty. Even if such a system could be acquired or developed, the Working Group believes that it would be prohibitively costly to do so.[10]

The CFTC cost estimates are significantly lower than the Working Group's preliminary estimates of costs that will be incurred in order to implement the electronic communications recording requirements. These are unprecedented document *creation* and *indexing* requirements with no clear technological solution available. The only process the Working Group has identified to meet the indexing requirements for all financial and physical transactions would be an expansive manual process requiring multiple analysts and technical support staff to log and index all communications by traders, transactional lawyers, credit personnel, and physical

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[9] *See* Comments of the Working Group of Commercial Energy Firms, *Swap Data Recordkeeping and Reporting Requirements*, at 12-13 (Feb. 7, 2011), *Real-Time Public Reporting of Swap Transaction Data*, at 16 (Feb. 7, 2011), and *Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants*, at 6 and 9-11 (Feb. 7, 2011).

[10] *Id.* (Comments of the Working Group of Commercial Energy Firms, *Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants*, at 6).

commodity sales persons. The Working Group estimates that one analyst likely will be required to manage the document creation and indexing for each handful of business personnel. Even a small or modest-sized end-user commodity business could require as many as 3-5 analysts and 1-2 additional technical support personnel to support transactions in its swaps and underlying physical business. Therefore, based on the Commission's estimate of wage costs for full-time employees and the Working Group's estimates of technology costs, the Working Group estimates that the total cost to a commodity business is likely to be in excess of $1 million dollars annually, just to meet the creation and indexing obligations.[11] Any benefits of requiring the broad range of commercial businesses and hedgers to record all communications relating to transactions not only on SEFs but in all aspects of their underlying cash business in no way justify the significant costs to these market participants that conduct no customer facing business in swaps and pose minimal systemic concerns.

The Commission should further evaluate the actual costs, availability of technology, and the ability of market participants to deploy the technology required to comply with the requirements of regulation 1.35 before requiring compliance with such requirements. For example, it does not appear that the Commission has taken into consideration the number and types of affected parties and the costs associated with applying the record creation and recordkeeping burdens of regulation 1.35 across such a large number of end-users in the exempt and agricultural commodities. In evaluating such costs the CFTC should have considered the costs associated with an end-user having to decide between paying an FCM or swap dealer to transact for it on a SEF[12] and the implementation of the record creation and recordkeeping requirements of regulation 1.35. These requirements, if applied to end-users, would be as or more onerous than those that swap dealers are required to comply with under the Commission's recordkeeping proposals.[13]

The Working Group Submits that the burdens on end-users far outweigh any benefit to the market or to the Commission in requiring these parties to comply with the requirements of regulation 1.35 or cease being a member of the SEF and transacting through an FCM or a swap dealer. Furthermore, to the extent any class of market participant is subject to the electronic communications recording requirement, the Commission should allow these market participants the choice to tie electronic communications records to a specific transaction at the time the records pertaining to such transaction are requested by the Commission. This option would

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[11] Indeed, several preliminary internal estimates by Working Group members regarding compliance with the telephone conversation recording requirement alone are many multiples of the Commission's estimate, and for some members of the Working Group such estimates are upwards of $1,000,000.

[12] Transacting through an FCM or a swap dealer is not likely to be an acceptable alternative to the end-users who currently transact on ICE or the Nodal Exchange who would have to give up the ability to transact directly on the platform and possibly miss executing transactions at the best pricing due to delays in transmitting orders through an intermediary.

[13] *See* Swap Data Recordkeeping and Reporting Requirements, *Notice of Proposed Rulemaking*, 75 Fed. Reg. 76,574 (Dec. 8, 2010), Real-Time Public Reporting of Swap Transaction Data, *Notice of Proposed Rulemaking*, 75 Fed. Reg. 76,140 (Dec. 7, 2010), and Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, *Notice of Proposed Rulemaking*, 75 Fed. Reg. 76,666 (Dec. 9, 2010).

present a less-costly, more-tailored approach as opposed to requiring that all records be maintained on a transaction-by-transaction basis. It is not justifiable from a cost-benefit standpoint to expend the resources necessary to tie all recorded communications to individual transactions in real-time when a majority of such records likely will not be subject to examination by the Commission.[14]

III. CONCLUSION.

Simply put, the Working Group does not believe that the record creation and indexing duty reflected in the *Proposed Rule's* electronic communications recording requirement should be imposed on members of DCMs or SEFs that are not FCMs, IBs or swap dealers. The costs that will be incurred by such market participants are far too large to justify any benefit that may arise from recording the expansive list of electronic communications specified in the *Proposed Rule*.

The Working Group further believes that the proposal reflects a substantive change and an unintended consequence that implicates a vast array of market participants that may be unaware of its impact and, accordingly, should be issued separately for comment, and not embedded in an extensive set of "conforming" amendments.

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets in the United States. The Working Group appreciates this opportunity to provide comment on the *Proposed Rule* and offers its advice and experience to assist the Commissions in implementing the Act.

Respectfully submitted,

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

Counsel for the Working Group of
Commercial Energy Firms

[14] The Working Group also reiterates its previous comments that the indexing of pre-execution records on a transaction-by-transaction basis is technologically unfeasible.