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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: *Interim Final Rule For Reporting Pre-enactment Swap Transactions*

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 "Interim Final Rule for the Reporting of Pre-enactment Swap Transactions" issued by the Commodity Futures Trading Commission ("CFTC") pursuant to Title VII, Section 729 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") and published in the *Federal Register* on October 14, 2010.[1]

Section 729 of the Act requires the CFTC to adopt, within 90 days of enactment of the Act, an interim final rule for the reporting of Swap transactions entered into before July 21, 2010 whose terms had not expired as of that date ("Pre-enactment Swaps"). Pursuant to this mandate, on October 5, 2010, the CFTC issued the *Interim Final Rule* requiring specified counterparties to Pre-enactment Swaps to report certain information related to such transactions to (i) a registered swap data repository ("SDR"), or (ii) to the CFTC by the compliance date to be established in reporting rules required under new Section 2(h)(5) of the Commodity Exchange Act ("CEA"), or within 60 days after an SDR becomes registered under new CEA Section 21, whichever occurs first.[2]

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[1] *See Interim Final Rule for Reporting Pre-enactment Swap Transactions*, 75 Fed. Reg. 63,080 (Oct. 14, 2010) ("*Interim Final Rule*").

[2] The *Interim Final Rule* was published in the *Federal Register* on October 14, 2010.

II. EXECUTIVE SUMMARY.

Title VII of the Act grants the CFTC and the Securities and Exchange Commission ("SEC") jurisdiction to oversee and regulate the over-the-counter ("OTC") derivatives markets.[3] Congress imposed such oversight and regulation to, among other things, "mitigate cost and risks to taxpayers and the financial system."[4] The instruments over which the Commissions have jurisdiction pursuant to the Act are "Swaps."

A broad and inclusive definition of "Swap" is set forth in new CEA Section 1a(47). This definition captures a substantial portion of derivatives transacted in OTC markets, including many energy-based derivatives. Section 712(d) of the Act expressly requires the CFTC and SEC to further define several key definitions contained in Title VII, including Swap, through a series of joint rulemakings. Further, Section 721(c) of the Act specifically requires the CFTC to further define, among other things, the definition of Swap specifically for purposes of including transactions and entities structured to evade the requirements of Title VII of the Act. Each rulemaking required by Section 712(d) and 721(c) of the Act must be completed by no later than 360 days after enactment of the Act.

The *Interim Final Rule* adopts new Section 44.02 of the CFTC regulations, which sets forth the specific reporting obligations of identified counterparties to Pre-enactment Swaps.[5] In addition, new Section 44.02 contains an Interpretive Note advising that certain counterparties that may be required to report Pre-enactment Swaps to an SDR or the CFTC will need to preserve information pertaining to these transactions.

Section III.A., below, suggests that final transaction confirmations, related master agreements and any amendments or modifications thereto are sufficient to fulfill the recordkeeping requirements of new Section 44.02(a) of the CFTC's regulations. Collectively, these documents identify all of the key commercial terms of a transaction and provide the information necessary for the CFTC to evaluate a transaction and otherwise perform its statutory obligation to oversee the Swaps market. Such an outcome would eliminate much uncertainty and is consistent with the CFTC's representation that the *Interim Final Rule* "does not require any counterparty to a pre-enactment unexpired swap to create or retain new records with respect to transactions that occurred in the past," and that it requires retention only "to the extent and in such form as they presently exist."[6]

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[3] The CFTC and SEC are collectively referred to herein as the "Commissions."

[4] S. Rep. No. 111-176, at 92 (2010).

[5] 17 C.F.R. § 44.02. Recognizing that existing CEA Section 2(h) will remain in effect until July 15, 2011, it is not clear, in light of this exemptive provision, whether the CFTC has the authority to require recordkeeping with respect to Pre-enactment Swaps.

[6] *Interim Final Rule* at 63,083.

Section III.B. addresses concerns that the non-discretionary mandate imposed by Congress in Section 729 to issue the *Interim Final Rule* in advance of a final rule further defining the term Swap creates legal and regulatory uncertainty regarding the universe of Swap transactions that are subject to the reporting and recordkeeping requirements of new Section 44.02(a). The Working Group respectfully requests that the CFTC clarify that market participants should rely only on applicable provisions of the CEA, CFTC regulations, and related guidance in effect on the day before the date of the Act's enactment for purposes of identifying transactions subject to the reporting and recordkeeping requirements of new Section 44.02(a) of the CFTC's regulations as Pre-enactment Swaps.

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

The Working Group appreciates the CFTC's efforts in issuing the *Interim Final Rule*. The Working Group recognizes the practical, legal, and regulatory complexities faced by the CFTC that are created by the non-discretionary language of Section 729 of the Act,[7] and welcomes the opportunity to submit comments in this proceeding. The Working Group looks forward to working with the CFTC as it develops a final rule addressing the reporting and recordkeeping requirements applicable to Pre-enactment Swaps.

A. RECORDKEEPING REQUIREMENTS SHOULD BE LIMITED TO TRADE DATA CURRENTLY RETAINED IN THE ORDINARY COURSE OF BUSINESS.

1. Records Kept in the Ordinary Course of Business.

The Working Group appreciates that the *Interim Final Rule* makes clear that it requires retention only "to the extent and in such form as they presently exist."[8] Despite the caveat in the *Interim Final Rule* that parties are not required to create or retain new records with respect to past swap transactions, the Interpretative Note, as applied to bilateral transactions in OTC markets, covers data that is not currently kept by market participants in the normal course of business, particularly by commercial firms and other entities that are not registered with the CFTC.

For example, as a matter of standard industry practice, commercial firms and other non-registrants do not retain information relating to the "time of execution of the transaction." Transaction confirmations for Swaps specify a "trade date" or "effective date" rather than "time of execution" to serve as a point of reference for the origination of each trade.

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[7] Specifically, Section 729 requires the CFTC to issue the *Interim Final Rule* prior to: (i) the general effective date of Title VII of the Act; (ii) the review and approval of any pending SDR registrations by the CFTC; (iii) the implementation of infrastructure necessary to handle the volume of Pre-enactment Swap data that could be reported directly to the CFTC itself; and (iv) the issuance of final regulations further defining key terms adopted in Title VII that are implicated by the *Interim Final Rule*, *i.e.*, Swap, Swap Dealer and Major Swap Participant.

[8] *Interim Final Rule* at 63,083.

The imposition of new requirements mandating that counterparties to Pre-enactment Swaps identify and retain the "time of execution" information, if available, would impose a significant and costly burden on market participants.[9] While information exchanged between counterparties, brokers, exchanges, and other intermediaries may include certain time stamps, market participants generally view this information as ancillary in nature and do not seek to identify a specific "time of execution" for any particular trade or capture such time stamps in their systems of record. Given that "time of execution" data is not retained in the normal course of business and is not always available, it is unlikely that the counterparties to a Pre-enactment Swap would have a consistent view of the actual time of execution for a transaction (if they have the information at all).

2. <u>Information "Relating To" Swap Transactions Should Not Include Data that is Not Normally Covered by Existing Record Retention Policies</u>.

The Interpretive Note to new Section 44.02(a) of the CFTC Regulations requires that counterparties separately identify and retain information "relating to" the terms of a Swap transaction. The term "relating to" is ambiguous and creates uncertainty regarding what information must be retained. In this light, the Working Group requests that the CFTC clarify that neither the *Interim Final Rule* nor the recordkeeping requirements addressed in the Interpretative Note are intended to create an expectation or otherwise require that parties to Pre-enactment Swaps create or retain data not normally covered by its existing record retention policies and practices.

Specifically, the Working Group suggests that final transaction confirmations, related master agreements, and any amendments or modifications thereto are sufficient to fulfill the requirements of Section 44.02(a). Collectively, these documents identify all of the key commercial terms of a transaction and provide the information necessary for the CFTC to evaluate a transaction and otherwise perform its statutory obligation to oversee the Swaps market. Such an outcome would eliminate much uncertainty and is consistent with the CFTC's representation that the *Interim Final Rule* "does not require any counterparty to a pre-enactment unexpired swap to create or retain new records with respect to transactions that occurred in the past," and that it requires retention only "to the extent and in such form as they presently exist."[10]

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[9] Generally speaking, "time of execution" information is not typically available given the nature of these off-exchange, individually negotiated transactions.

[10] *Interim Final Rule* at 63,083.

3. Recordkeeping Requirements in New Section 44.02 of the CFTC Regulations Should Apply Exclusively to Pre-enactment Swaps.

The Working Group appreciates that the *Interim Final Rule* makes clear that it "does not require any counterparty to a pre-enactment unexpired swap to create or retain new records with respect to transactions that occurred in the past," and that it requires retention only "to the extent and in such form as they presently exist."[11] The Working Group is concerned that the Interpretative Note to Section 44.02(a) creates, perhaps inadvertently, the expectation that market participants must retain trade data for transactions other than Pre-enactment Swaps, *i.e.*, Swaps entered into after the date of enactment of the Act.

Therefore, it would be helpful for the CFTC to clarify that the recordkeeping requirements imposed by new Section 44.02(a) are not expected to apply to Swaps executed by market participants on a post-enactment basis.

B. REQUIRED ISSUANCE OF THE INTERIM FINAL RULE IN ADVANCE OF REGULATIONS FURTHER DEFINING THE TERM "SWAP" CREATES LEGAL AND REGULATORY UNCERTAINTY AND INCREASES COMPLIANCE RISK.

The Working Group is concerned that the non-discretionary mandate imposed by Congress in Section 729 to issue the *Interim Final Rule* in advance of a final rule further defining the term Swap creates legal and regulatory uncertainty regarding the universe of Swap transactions that are subject to the reporting and recordkeeping requirements of new Section 44.02(a) of the CFTC regulations.[12] Until such time that final rules further defining the term Swap, as adopted in new CEA Section 1a(47), become effective, the Working Group requests that the CFTC issue guidance that market participants may rely upon to help identify existing transactions that are subject to the reporting and recordkeeping requirements of new Section 44.02(a).

Without clear guidance regarding the scope and application of the *Interim Final Rule*, participants in certain OTC derivatives markets, notably energy markets, must make good faith determinations as to whether certain transactions are reportable as Pre-enactment Swaps.[13] In the absence of such guidance or, alternatively, the creation of a safe harbor for good faith attempts to comply with the requirements of new Section 44.02(a), the uncertainty created by Congress through the non-discretionary language of Section 729 unnecessarily

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[11] *Id.*

[12] On September 20, 2010, the Working Group submitted comments in response to the Advance Notice of Proposed Rulemaking ("ANOPR") issued by the Commissions addressing further definition of the term Swap set forth in new CEA Section 1a(47). *See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, 75 Fed. Reg. 51,429 (Aug. 20, 2010).

[13] The Working Group recognizes the definition of "swap agreement" set forth in Section 35.1(b)(1) of the CFTC's regulations, 17 C.F.R. § 35.1(b)(1). This definition focuses primarily on swap agreements covering excluded and other financial commodities. By its terms, it does not cover the plethora of swap agreements transacted in energy markets.

exposes participants in energy markets, among others, to increased non-compliance risk for failing to either (i) properly identify and report Pre-enactment Swaps, or (ii) retain records for such transactions, as required by new Section 44.02(a).

1. The Existing Provisions of the CEA and CFTC Regulatory Requirements Should Apply for Purposes of Identifying Pre-enactment Swaps Subject to the Interim Final Rule.

As noted in Section II, above, although the *Interim Final Rule* became effective immediately upon issuance, the statutory definition of Swap set forth in new CEA Section 1a(47) does not become effective until 360 days from the date of enactment of the Act, *i.e.*, July 15, 2011. Section 712(d) of the Act requires the Commissions to undertake a joint rulemaking specifically for the purpose of further defining the term Swap. The issuance of such a final rule is not required until 360 days from the Act's date of enactment.

Given the pendency of this joint rulemaking and the Congressionally stated need for further definition of the term Swap, the Working Group respectfully requests that the CFTC clarify that market participants should rely only on applicable provisions of the CEA, CFTC regulations, and related guidance in effect on the day before the date of the Act's enactment for purposes of identifying transactions subject to the reporting and recordkeeping requirements of new Section 44.02 of the CFTC's regulations as Pre-enactment Swaps.

2. Existing CFTC Guidance Interpreting the Forward Contract Exclusion Should Continue to Apply.

The CFTC and Congress have previously recognized both the importance and unique characteristics of certain forwards and options transactions, particularly as these transactions relate to energy commodities.[14] Such energy transactions have generally been excluded from regulation pursuant to various interpretations of the well-established forward contract exclusion in CEA Section 1a(19).[15] The *Interim Final Rule*, however, is silent regarding whether forward contracts are outside of the scope of the recordkeeping and reporting requirements set forth in new Section 44.02(a).

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[14] *See* Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188-92 (Sept. 25, 1990), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925. Energy markets are unique in that they are inextricably intertwined with a physical market structure which provides the capability for market participants to make and take delivery of a transaction's underlying commodity. ANOPR Comments at 3-4. Various forms of transactions are routinely executed in physical energy markets, including physical delivery forwards and physical delivery options on energy commodities. *Id.* These transactions are critical for energy companies and consumers of energy commodities to make or take physical delivery of energy commodities and to manage various commodity risks. *Id.*

[15] *See* CEA Section 1a(19), 7 U.S.C. § 1a(19) and 17 C.F.R. § 32.4, respectively.

Given the transitional regulatory environment in which the *Interim Final Rule* has been issued, this silence creates uncertainty and unnecessarily heightens non-compliance risks faced by market participants making good faith attempts to comply with new Section 44.02(a). Accordingly, the Working Group requests that the CFTC clarify that: (1) existing guidance interpreting the forward contract exclusion in the CEA continues to apply; and (2) certain transactions taking place in physical markets, *i.e.*, pre-enactment, unexpired physical delivery forwards and physical delivery options on energy commodities, are not Pre-enactment Swaps and, therefore, are not subject to the reporting and recordkeeping requirements in new Section 44.02(a) of the CFTC's regulations.[16]

a. Physical Delivery Forwards.

The CFTC and courts have applied the forward contract exclusion under CEA Section 1a(19) to "private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity."[17] In energy markets, transactions such as these involve two parties seeking to reduce the risks and costs associated with transacting in the underlying physical commodity exposure. These transactions ensure the efficient delivery of energy commodities to companies that require them to conduct their core business.[18] Given these fundamental characteristics, physical delivery forwards of energy commodities do not present any basis for treating them as Pre-enactment Swaps subject to new Section 44.02. Furthermore, the treatment of physical delivery forwards that financially settle as Pre-enactment Swaps would not be consistent with the well-established exemption for forward contracts referencing energy commodities.[19]

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[16] Physical delivery transactions in the energy markets, whether forward transactions or options to deliver a physical commodity, by structure and design, are distinct from OTC derivatives transactions in securities, interest rates or other financial markets.

[17] *See* Statutory Interpretation Concerning Forward Transactions, *supra* note 14, at 39,190.

[18] By way of example, physical delivery forward transactions in power markets, including those that are "booked out," are essential to cost-effective delivery scheduling, but their regulation as futures or Swaps would substantially limit their utility. A power producer may enter into a year-long contract with a counterparty to provide a certain amount of power over the duration of the contract. However, demand variability may lead the power producer to purchase power from that counterparty during the term of their contract. Instead of the inefficient outcome of both parties delivering power on coincidental delivery dates, the delivery obligations for the two transactions are netted, yielding the delivery of power by one party instead of both parties. If there are price differences between the two trades, then they are settled between the parties in a similar manner with one party paying the difference between the two transactions to the other party.

[19] Prior to the Commodity Futures Modernization Act of 2000, the CFTC, pursuant to a 1993 order for exemptive relief, created a limited exemption from the CEA for certain forward contracts referencing energy commodities (the "Energy Forward Exemption"). The exemption applied to contracts for the purchase and sale of "crude oil, condensates, natural gas, natural gas liquids, or their derivatives which are used primarily as an energy source." Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21286 (Apr. 20, 1993).

Therefore, in accordance with the long-standing CFTC guidance, contracts meeting the CEA's forward contract exclusion and the Energy Forward Exemption should not be subject to the reporting and recordkeeping requirements of new Section 44.02.

b. Physical Delivery Options for Energy Commodities.

Many physical delivery forwards executed in energy markets contain elements of options or actual options within the contract, including options on the quantity to be delivered, price or delivery point. Such physical delivery forwards should be treated as single contracts and not as separate contracts or options.[20] Such treatment is consistent with both Supreme Court precedent treating "contract[s] as a whole, not individual portions piece-by-piece"[21] and CFTC precedent "evaluating the complete transaction when considering forward contracts that contain elements of options."[22] Accordingly, because physical energy delivery options, like physical delivery forwards, are entered into with the intent that such option contracts will physically settle, they should be treated as a single integrated contract and not as Pre-enactment Swaps.[23]

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[20] As noted in the Working Group's ANOPR Comments, market participants, such as commercial energy firms, frequently enter into physical delivery forwards that contain elements of options or options. ANOPR Comments at 8-9. For example, in a day-ahead call option, an electricity provider will enter into a contract for a specific amount of energy with an embedded option to purchase additional energy in the event that demand exceeds expectations. Such contracts are essential to the efficient delivery of energy. Another example is commercial energy firms that sometimes include a "trigger price" option in physical delivery natural gas contracts, whereby a counterparty may elect to exercise a "trigger price" option to purchase natural gas under the contract at a fixed price as opposed to an index price.

[21] *See In re Cargill, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 28,425, n.47, *citing Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 59 (1995) (quoting Restatement (Second) of Contracts § 202(2) (1979)).

[22] *See 1985 Interpretative Statement*, ¶ 22,718 at 31,029-31 (the Commission's General Counsel finds minimum price contacts to be forward and spot contracts even though they each contained the element of a "cash settled put option"); *CFTC Interpretative Letter No. 96-23*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,646 at 43,697-98 (CFTC Mar. 14, 1996) (Commission's Division of Economic Analysis considering contract "in its entirety," regarded "producer option contract" as a forward contract, although it contained provisions whereby the elevator buys an exchange-traded call option for the benefit of the producer); *CFTC Interpretative Letter No. 98-13*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,264 at 46,152-53 (CFTC Dec. 3, 1997) (Division of Economic Analysis viewed contract that establishes a minimum and maximum price and "includes characteristics of an option" to be a forward contract "based upon the nature of the instrument as a whole.").

[23] Physical delivery options and physical delivery forwards are analogous for purposes of applying the physical delivery exclusions in the CEA. They are both entered into to mitigate the price and supply risks associated with a core business in non-financial commodities. The material difference between a forward and an option is that, in an option contract, one party (the option holder) is not obligated to exercise its right. This difference is not sufficient to distinguish such options from forwards for purposes of treating them as Pre-enactment Swaps subject to the requirements of new Section 44.02. Simply put, at their very core, physical delivery forwards and physical delivery options involve the sale of a physical commodity. Moreover, each transaction relates to, and is bounded by, the physical markets for energy commodities.

c. Embedded Options in Physical Delivery Forwards.

Further, a physical delivery forward with an embedded option should be viewed as a single transaction option for the reasons discussed in Section III.B.2.b, above.[24] The primary purpose of the parties to execute such a contract is to enter into a transaction that creates an enforceable delivery obligation for energy on a certain date. The inclusion of the option to purchase additional energy provides an additional risk mitigation tool to the transaction. It does not change the characterization of the contract from a physical delivery forward to a financial option. Accordingly, like other physical delivery forwards and physical delivery options executed in energy markets, physical delivery forwards with embedded options should not be treated as Pre-enactment Swaps.

C. THE CFTC SHOULD ISSUE COMPLIANCE GUIDANCE FOR THE INTERIM FINAL RULE OR CREATE A SAFE HARBOR FOR GOOD FAITH COMPLIANCE EFFORTS.

The requirement to issue the *Interim Final Rule* in advance of final rules issued pursuant to Sections 712(d) and 721(c) of the Act further defining the term Swap, together with the need for CFTC guidance discussed herein, creates legal and regulatory uncertainty regarding the scope and applicability of the recordkeeping requirements set forth in new Section 44.02(a). The Working Group respectfully requests that the CFTC amend the *Interim Final Rule*, or through a stand-alone issuance, publish the requested guidance to ensure effective compliance with these requirements.

As the CFTC makes the transition to new regulation under Title VII of the Act, the dedication of limited agency resources on the development of such guidance will help market participants more effectively comply with the new reporting and recordkeeping requirements adopted by the *Interim Final Rule*. In the absence of such guidance, market participants making demonstrative, good faith efforts to comply with new Section 44.02(a) of the CFTC's regulations should be granted safe harbor protection from possible enforcement action for failing to (i) properly identify and report Pre-enactment Swaps, or (ii) retain records for such transactions, as required by new Section 44.02(a) of the CFTC's regulations.

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[24] *See In re Cargill, Inc.*, n.47 (citing *1985 Interpretative Statement*, at 31,029-31).

IV. CONCLUSION.

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. The Working Group (i) supports tailored regulation that brings transparency and stability to the energy Swap markets in the United States, and (ii) appreciates the balance the CFTC must strike between effective regulation and not hindering the Swap markets for energy commodities. Accordingly, the Working Group respectfully requests that the CFTC consider its comments to the *Interim Final Rule* urging:

1. the issuance of guidance designed to facilitate effective compliance with the requirements of new Section 44.02 of the CFTC's regulations;

2. the continued application of the CEA and CFTC regulations, guidance and precedent, including the CFTC's interpretations of the forward contract exclusion (as in effect the day before the date of enactment of the Act) for purposes of identifying transactions that must be reported as Pre-enactment Swaps; and

3. in the absence of requested guidance, the creation of safe harbor protection for market participants making demonstrable good faith efforts to comply with requirements of new Section 44.02(a) of the CFTC's regulations.

If you have any questions, or if we may be of further assistance, please contact the undersigned directly.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.
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