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

VIA ELECTRONIC MAIL

Re: *Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants*

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 (the "Commission" or "CFTC")'s request for comment concerning the Commission's Notice of Proposed Rulemaking on *Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements of Swap Dealers and Major Swap Participants"* (the "Proposed Rule").[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.

I. COMMENTS OF THE WORKING GROUP.

A. ELECTIVE RULEMAKINGS.

Section 4s(i)(2) of the Commodity Exchange Act (the "CEA"), as added by Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), mandates that the Commission promulgate documentation standards for swap dealers and major swap

[1] 75 Fed Reg. 81,519 (Dec. 28, 2010).

participants. Those documentation standards are required to "relate to timely and accurate confirmation, processing, netting documentation and valuation of all swaps."[2] Consistent with Congressional intent, proposed rules on documentation standards should address the acknowledgement, valuation and confirmation of trades. However, CEA Section 4s(i)(2) does not require the Commission to issue proposed rules on portfolio reconciliation and portfolio compression. The Working Group, as discussed below, believes the final rules issued under the Proposed Rule should not include requirements for portfolio reconciliation and portfolio compression.

Alternatively, given the multitude of rulemakings the Commission is required to undertake pursuant to the Act and the corresponding number of obligations those rulemakings place on market participants, the Commission should (a) delay promulgating rules on portfolio reconciliation and portfolio compression until after it has finalized all rules required to be issued under the Act and can fully analyze the potential effect of portfolio reconciliation and portfolio compression rules on the swap markets,[3] or (b) if the Commission elects to move forward with portfolio reconciliation and portfolio compression rules, adopt a general framework that provides market participants with an extended period of time to design and implement appropriate portfolio reconciliation and portfolio compression practices.

As in all circumstances where the Commission elects to promulgate rules not explicitly required under Title VII of the Act, the Commission should articulate the public policy benefit it attributes to the proposed rule. The Commission also should present analysis that demonstrates that the value of such public policy benefit exceeds the costs that would be imposed on (a) market participants and (b) the Commission itself. Such analysis would ensure the Commission satisfies its obligation under Section 15(a) of the CEA to consider and evaluate the costs and benefits of any proposed rule.

B. COMMENTS ON THE PROPOSED CONFIRMATION RULE.

1. PROCESS REQUIREMENTS.

While the Working Group acknowledges there might be value in standardizing the confirmation process, including the period of time for confirmation of certain swaps, the suggested process set forth in the Proposed Rule does not reflect current practice in the over-the-

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2 CEA Section 4s(i)(1).

3 The Commission might ultimately promulgate rules on portfolio reconciliation and portfolio compression in the future under its cited authority in CEA Section 8a.

counter ("OTC") swap markets. This is particularly true for swaps that are not executed or processed electronically.

Currently, a vast majority of market participants in energy swap markets, pursuant to certain changes to the ISDA Master Agreement, agree that one party sends an acknowledgement (which is commonly referred to as a "confirmation") to its counterparty and the counterparty is deemed to have accepted the acknowledgement if it fails to execute the acknowledgement or object to it within three business days. As such, there may be no confirmation that is actually signed by both parties. Nonetheless, such a process has worked well in the OTC swap markets and serves to protect counterparties from the risks associated with "open" confirmations. The practice is also cost efficient in that a swap dealer does not have to expend time and resources ensuring a physical confirmation is received from its counterparties and it also relieves such counterparties from needlessly responding to a confirmation, the terms of which are acceptable. The Proposed Rule does not reflect or allow for this common practice in the OTC swap markets and appears to require some affirmative act by the receiving party to create a confirmation. The Working Group respectfully suggests that the Commission allow this efficient practice to continue under the Proposed Rule.

The short time period between execution and confirmation set forth in the Proposed Rule will make it difficult for market participants to enter into more complex swaps as they often involve the negotiation of both economic and legal terms. Often, parties will execute such a swap to take advantage of favorable economic conditions with the expectation of limited negotiation of non-economic terms after execution. In fact many master trading agreements contemplate this scenario. Section 9(e)(ii) of the 2002 ISDA Master Agreement states:

> "The parties intend that they are legally bound by the terms of each Transaction from the moment they agree to those terms (whether orally or otherwise). A Confirmation will be entered into as soon as practicable and may be executed and delivered…or be created by an exchange of telexes, by an exchange of electronic messages…, or by an exchange of e-mails."

This paradigm was established as the default method for entering into a swap because it is the most efficient method for entering into complex agreements, the execution of which is often sensitive to market conditions.

Under the Proposed Rule, all terms of swaps effectively must be negotiated prior to execution of a swap. This will inherently grant the counterparty that is least sensitive to timing a substantial advantage in negotiations. For complex swaps that require the negotiation of multiple terms, the Proposed Rule would force a counterparty sensitive to the timing of the swap to accept (a) some slippage in economic terms, or (b) reduced negotiating leverage to execute a swap within its desired time frame.

2. NON-REGULATED ENTITIES MIGHT NOT HAVE THE RESOURCES NECESSARY TO COMPLY WITH THE PROPOSED CONFIRMATION REQUIREMENTS.

The Commission appropriately recognizes that swaps entered into by swap dealers and major swap participants (together, "Regulated Entities") with non-Regulated Entity counterparties will require longer confirmation periods.[4] However, non-Regulated Entities generally have not allocated to the confirmation process the resources necessary to meet the stringent confirmation timing requirements effectively imposed on non-Regulated Entities under the Proposed Rule because there is no business reason to justify that allocation of resources.

The Proposed Rule requires Regulated Entities to have processes in place that are "reasonably designed to ensure that" swaps are confirmed with non-Regulated Entities not later than the business day following execution.[5] Confirmation would require both the delivery of an acknowledgement to the non-Regulated Entity counterparty and receipt of a manual, electronic or other legally equivalent signature on or with respect to such acknowledgement. Non-Regulated Entities might not have devoted the resources necessary to review and confirm a trade acknowledgement in this mandated time frame. This is particularly true if a swap involves complex terms, such as a unique distribution of obligations and risks. The timing requirements in the Proposed Rule would likely place a substantial burden on both Regulated Entities and non-Regulated Entities. Non-Regulated Entities will need to expend the resources necessary to review and confirm trades on an expedited basis, and Regulated Entities will need to incur the additional costs associated with sending acknowledgements and any attempts to ensure that their counterparties respond in accordance with the Proposed Rule.

More importantly, what benefit would accrue to non-Regulated Entities and the swap markets if Regulated Entities must require their non-Regulated Entity counterparties to countersign an acknowledgement no later than the day after execution? The Commission does not articulate the benefits, if any, that indirectly imposing these timing requirements on non-Regulated Entities would yield. Any benefit would have to be substantial in order to offset the expenditure of resources that will be required for most non-Regulated Entities to review an acknowledgement, reconcile any discrepancies and countersign the acknowledgement in that

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4 Proposed CFTC Rule 23.501(a)(3).

5 *Id*.

time period.[6] Accordingly, the Working Group requests that the Commission give careful study to the costs that will be imposed on swap markets and non-Regulated Entities if, under the Proposed Rule, Regulated Entities are required to confirm swaps with non-Regulated Entities no later than the day after execution.

3. Clarity Is Needed on Implications of Failure to Adhere to the Proposed Confirmation Rule.

The Proposed Rule only regulates the Regulated Entity portion of a transaction with counterparties that are non-Regulated Entities. To provide market participants with a degree of legal certainty, the Commission should clearly indicate the regulatory and legal consequences of one or more parties to a swap failing to meet the timing requirements for acknowledgement and confirmation. The Proposed Rule provides that "each swap dealer … shall establish, maintain and enforce … policies … reasonably designed to ensure … that it executes a confirmation … not later than the next business day…."[7] However, an individual firm is only able to ensure compliance with the timing requirements to which it is subject. For example, under the Proposed Rule, a swap dealer, when entering into a swap with a non-Regulated Entity, would only be able to ensure compliance with the timing requirements for the acknowledgement and not the confirmation. A Regulated Entity should not be responsible for ensuring its Non-Regulated Entity counterparty adheres to the time frame imposed by the Proposed Rule, and a swap, which might have taken weeks to negotiate, should not be invalidated for the failure to meet the Proposed Rule's timing requirements.

4. Application of Confirmation Timing to Lifecycle Events.

The Proposed Rule's confirmation timing requirements apply not only to the execution of a swap, but also to other lifecycle events.[8] The Commission identifies two categories of events as constituting "life cycle events": (i) events that affect the material terms of the swap (*e.g.*, novation, modification.); and (ii) events that pertain to the exposure that the swap references (*e.g.*, underlying market disruption). The Commission requests comment as to whether certain

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[6] The Working Group believes that it will be very difficult, if not impossible, for Regulated Entities to meet all of the timing requirements in the Proposed Rule without establishing and operating an internal automated confirmation infrastructure. As discussed in Section B.6 herein, the costs associated with the such infrastructure would likely be significant, potentially in excess of a million of dollars per year for each firm.

[7] Proposed CFTC Rule 23.501(a)(3).

[8] Proposed CFTC Rule 23.500(m).

lifecycle events should be carved out of the rule and whether confirmations for certain lifecycle events should be allowed an extended compliance period.[9]

The Working Group generally supports requiring confirmations when counterparties change the material economic or legal terms of a swap. However, counterparties should be permitted to confirm such events within a reasonable period of time.

With respect to lifecycle events related to the underlying exposure of a swap, the Working Group believes that such events should not be subject to a confirmation requirement. Most of this class of lifecycle events are a function of events external to the negotiated terms of a swap. The documentation requirements associated with such lifecycle events are generally addressed in master trading agreements or the applicable confirmation. Accordingly, there is no need for confirmation timing requirements in these circumstances.

5. RECORDKEEPING REQUIREMENTS ARE UNNECESSARY.

The Working Group requests that the Commission analyze the recordkeeping obligations under the Proposed Rule to eliminate any redundant or otherwise unnecessary requirements. For example, the Proposed Rule requires Regulated Entities, in a swap between Regulated Entities, to retain a record of when a swap is executed and when a confirmation is executed.[10] The Proposed Rule also requires a Regulated Entity to keep a record of the length of time between those events. This is an unnecessary requirement that could impose substantial programming and record retention costs on market participants. Under Section 4s(g) of the CEA, Regulated Entities are only required to "maintain a complete audit trail for conducting comprehensive and accurate trade reconstructions." That could easily be done by only requiring time stamps on individual documents, from which the length of time between the execution of the relevant documents can easily be determined, if necessary.

In addition, the Proposed Rule can be read to require the same form of recordkeeping for confirmations associated with lifecycle events other than entry into a swap. For many lifecycle events time stamps would not make sense. For example, in the case of a novation, execution and confirmation are generally not separate events. The Working Group requests that the Commission clarify how or if the recordkeeping requirements in proposed CFTC Rule 23.501(b) apply to lifecycle events other entry into a swap.

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[9] *Proposed Rule* at 81,523.

[10] Proposed CFTC Rule 23.501(b).

6. CLARIFICATION OF "PROCESSED ELECTRONICALLY."

The Commission requests comment as to whether further definition of the term "processed electronically" is needed.[11] The Working Group respectfully requests that the Commission clarify what is meant by "processed electronically." Does the term mean processed on an electronic matching platform? Or would confirming a swap via email suffice? Such clarification is necessary for market participants to understand their obligations under the Proposed Rule. In the event that the Commission elects to further define the term "processed electronically," the Working Group requests that it do so through a separate rulemaking process that provides market participants with the opportunity to provide comments.

The Commission also asks whether all swap transactions should be processed electronically.[12] If "processed electronically" is the use of an electronic matching platform, then all transactions should not be required to be "processed electronically." Confirmation platforms will likely not be able to capture all trade terms in customized transactions given the variety of possible terms, and given that parties have unique needs, they must have the ability to customize trades. Under current technology, customized trades can only happen with written acknowledgements and confirmations.

If the Commission is considering requiring all swaps or certain types or categories of swaps to be processed electronically, and if such phrase is read to mean the use of electronic matching platforms, then the Working Group requests that the Commission undertake a separate rulemaking to do so. That separate rulemaking should include a careful study and evaluation of the potential costs imposed by such a rule. The Working Group's members estimate that the developing proprietary systems to satisfy such a requirement could cost well in excess of $1 million annually per Regulated Entity.[13] This amount also is reflective of the potential cost of electing to satisfy such a proposed rule through the use of a third party's system, such as ICE's eConfirm, which as noted below in footnote 13, costs approximately $6 per trade.

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[11] *Proposed Rule* at 81,523.

[12] *Id.*

[13] The Intercontinental Exchange ("ICE") eConfirm service provides a standard upon which to estimate potential costs. Using the ICE fee of approximately $6.00 per trade as a basis, and assuming that a substantial portion of the fee is attributed to the costs to build and operate the confirmation infrastructure, the Working Group estimates that the cost to each Regulated Entity for system development, integration with other systems, and quality assurance and quality control, would be roughly $6.00 per swap transaction, and therefore well in excess of $1 million annually per Regulated Entity. However, the Working Group notes that as currently designed eConfirm would not satisfy the timing requirements of the proposed rule. Therefore, adjustments made to eConfirm to ensure compliance with the Proposed Rule might raise the per-transaction cost, and the Working Group's cost estimate.

The costs discussed above are just those required to comply with a requirement to process all swaps electronically. They do not reflect the opportunity costs associated with no longer being able to enter into bespoke swaps as many of such swaps cannot be processed electronically. That impact could be quite substantial and the Commission would have to determine the order of magnitude of such costs if it wishes to fully comprehend the implications of requiring all swaps to be processed electronically.

7. EXCHANGE EXECUTION AND CLEARING.

The Commission asks whether executing a swap on a designated contract market ("DCM") or swap execution facility ("SEF") or clearing a swap through a derivatives clearing organization ("DCO") should satisfy the Proposed Rule's confirmation requirement. The Working Group strongly believes that the use of a DCM, SEF or DCO should satisfy any requirements regarding the acknowledgement and confirmation of swaps. The Proposed Rules are designed to prevent the faulty documentation of swaps and execution on a DCO or SEF or clearing through a DCO should accomplish that goal.

C. PROPOSED PORTFOLIO RECONCILIATION RULE.

1. RECONCILIATION SHOULD BE DONE ON AN AS NEEDED BASIS.

In the collective experience of the Working Group, market participants already, in the absence of regulation, reconcile their swap portfolios on an as needed basis. What constitutes effective reconciliation practices is a function of both the characteristics of a firm and the nature of the swaps that firm trades. Proper reconciliation practices could be daily or weekly reconciliation for counterparties with a substantial number of swaps between them, it could be reconciliation upon the discovery of a dispute, or reconciliation (other than through periodic invoicing) could be unnecessary. This determination is best left up to counterparties, because as eligible contract participants, they have the sophistication necessary to make this determination independent of regulatory fiat.

In the experience of the Working Group members, market participants agree to engage in portfolio reconciliation exercises for the principal purpose of identifying any discrepancies in valuation. Thus, it is not currently industry practice to reconcile anything other than marks. The Proposed Rule suggests that reconciliation will also apply to material terms, which are defined as those terms required to be reported under the Commission's reporting rule (primary economic terms, confirmation terms, daily state data and daily valuation data).[14] The final rules should not require the reconciliation of such terms. A requirement to do so would impose substantial

[14] Proposed CFTC Rule 23.500(g).

costs on firms in the absence of any immediate need. If the confirmation process works as intended, there should be no need to double or triple check the trade terms (absent a valuation discrepancy with respect to a particular swap). Moreover, firms currently do not have electronic systems that reconcile trade terms, particularly for more complex and highly-customized swaps. Thus, firms will incur additional costs under the Proposed Rule to design, test and implement largely redundant systems.

Given that proper reconciliation practices are situation dependent, the Commission, should not impose universal requirements on all swap markets and swap market participants. If the Commission nonetheless insists upon imposing these requirements universally, the Working Group believes that the proposed reconciliation frequency thresholds are set too low. The Working Group respectfully requests that, if the Commission requires Regulated Entities to conduct portfolio reconciliation more frequently than "as needed," then the requirement should be that portfolio reconciliation be conducted quarterly with any counterparty with which a Regulated Entity has more than 100 swaps, and annually with all other counterparties. At the proposed levels for portfolio reconciliation, non-Regulated Entities would be obligated to reconcile swaps at a frequency that is unnecessary for proper risk management with many of their counterparties. In addition, a good number of those counterparties are end users and have not allocated the resources necessary to conduct portfolio reconciliation on such a frequent basis. This is particularly true to the extent the reconciliation exercises extend beyond comparing valuation of swaps.

2. VALUATION DISPUTES.

a. MARKET SOLUTIONS TO VALUATION DISPUTE RESOLUTION.

Swap market participants, under the direction of the International Swaps and Derivatives Association, Inc. ("ISDA"), are currently working to construct a uniform methodology for the resolution of valuation disputes and are doing so independent of any regulatory body. The Commission should support this effort, as the end result will likely be both robust and workable for market participants. The Commission should not impose a solution on the market by regulatory fiat as it is not required to do so under the Act. If the Commission chooses to adopt its own portfolio reconciliation requirements independent of ISDA it is possible that, given the complexity of the issue, the Commission's requirements will not be workable for many market participants.

The Working Group also notes that endemic valuation issues are not present in all swap markets, and, therefore the Commission should not adopt rules that might be necessary to cure problems in certain markets, but unnecessary and burdensome for other markets. In particular, endemic valuation issues are not present in swap markets with underlying physical markets. The presence of those underlying physical markets provides a clear, objective basis from which

parties determine the value of their swaps. That is not to say that there are not valuation disputes, but such disputes are bounded by prices in the physical markets.

The Working Group respectfully recommends that the Commission hold a technical conference to permit all industry participants to share their insights on some of the pragmatic and legal issues that arise when valuation disputes occur and to describe how valuation disputes are currently resolved in regulated swap markets.

b. VALUATION DISPUTES OCCUR ON A PORTFOLIO BASIS.

The Working Group respectfully requests that the Commission clarify that valuation disputes in the context of the Proposed Rule refers to valuation disputes on a portfolio and not swap-by-swap basis. Counterparties exchange valuation information on measure exposure on a portfolio basis. They do not analyze the valuation of individual swaps unless there is a material dispute as to the exposure between the parties. To do otherwise would be unnecessarily burdensome.

c. RESOLUTION OF VALUATION DISPUTES BETWEEN REGULATED ENTITIES.

The Proposed Rule's requirement for valuation disputes between Regulated Entities to be reconciled within one business day is not workable for market participants.[15] Valuation disputes can be complicated undertakings that can require complex calculations and involve multiple functional groups within a firm (*e.g.*, risk management and accounting). More importantly, valuation disputes can impact swaps other than the swap immediately at issue. If an entity uses an internal model or curve to value an illiquid or lightly-traded swap, and that swap is subject to a valuation dispute, that party might have to make modifications to its model to resolve the valuation dispute. It is likely that such model is also used to value other swaps, so in resolving the immediate valuation dispute the entity must make sure it does not create additional valuation disputes. The Proposed Rule's 10% buffer for valuation disputes alleviates this concern to some degree,[16] but it does not prevent the Proposed Rule's timing requirement from being unworkable when applied to valuation disputes that fall outside the buffer.

The Working Group respectfully requests that the Commission require that the valuation dispute resolution processes begin upon discovery of a dispute. However, given the potential

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15 Proposed CFTC Rule 23.502(a)(5).

16 *Id.*

complexity of valuation dispute resolution, counterparties should be permitted to resolve a dispute within a reasonable time period.

In addition, the 10% buffer for valuation is a relative measure, and, therefore, might not accurately reflect whether a valuation dispute is in fact material to the counterparties. It is likely that in certain circumstances it might be more cost efficient for counterparties to continue to exchange collateral rather than resolve a valuation dispute that exceeds the 10% buffer. Thus, the Working Group respectfully requests that the Commission amend the Proposed Rule to allow counterparties to elect to continue to exchange collateral in lieu of resolving a valuation dispute that exceeds the 10% buffer.

Finally, the Working Group respectfully requests that the Commission clarify the recordkeeping requirements imposed by proposed CFTC Rule 23.502(d). That rule appears to require that a Regulated Entity retain records pertaining to the resolution of any valuation dispute. However, the 10% buffer in proposed CFTC Rule 23.502(c)(4) allows counterparties to leave certain valuation disputes unresolved. The Working Group requests that the recordkeeping requirements in proposed CFTC Rule 23.502(d) only apply to those valuation disputes that are required to be resolved.

D. PROPOSED PORTFOLIO COMPRESSION RULE.

1. PORTFOLIO COMPRESSION REQUIREMENTS ARE NOT APPROPRIATE FOR ALL SWAP MARKETS.

Portfolio compression can provide substantial benefits to swap markets and portfolio compression exercise participants when conducted in markets with a large number of standardized contracts and among parties with a substantial number of redundant swaps between them. In such circumstances, a portfolio compression exercise can substantially reduce operational burdens, improve capital efficiency, reduce risk and provide regulators with a clearer view of the market. However, portfolio compression is a resource intensive undertaking and may be costly. If the proper market conditions do not exist, then the costs of portfolio compression will substantially outweigh any benefits.

At the urging of the Federal Reserve Bank of New York, major market participants in the credit default swaps market engaged in multiple rounds of portfolio compression.[17] The results were impressive. The notional amount of outstanding credit default swaps fell from a peak of almost $60 trillion in 2007 to just over $30 trillion in 2010, while gross market values at those

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[17] Darrell Duffie et.al, *Policy Perspectives on OTC Derivatives Market Infrastructure*, Federal Reserve Bank of New York Staff Report No. 424, March 2010, at 1.

two points in time were roughly equivalent.[18] This success was made possible by industry-driven standardization of credit default swaps and the high volume of redundant trades.[19] The ratio of the gross market value of the credit default swap market to its notional size increased from 1.45% in 2006 to 5.5% in 2010.[20]

However, the conditions that were present in the credit default swap market that made portfolio compression a valuable tool are not present in all other swaps markets. For example, in energy swap markets there is a low degree of standardization. This is partially because swaps are not just classified by type of underlying, but also by delivery location. In addition, the ratio of the gross market value of the "other commodity" swap market to its notional size was 17% as of the end of 2010.[21] In these markets, the level of standardization and redundant swaps necessary for portfolio compression to be beneficial is not present. Therefore, any mandatory portfolio compression exercise will impose substantial costs without any corresponding benefits.

With respect to the energy swap markets, the Working Group understands that there are few if any outside vendors with technology solutions that would facilitate multilateral portfolio compression exercises. In particular, we understand that TriOptima is considering offering such services with respect to energy related swaps. However, it is the understanding of the Working Group that it will be a considerable period of time before TriOptima would be able to conduct portfolio compression exercises in most energy swap markets and it is not apparent what the costs associated of such exercises will be. Accordingly, before market participants in the energy swaps markets can comply with any requirements for portfolio compression, a platform must be designed, tested and approved by the Commission.

2. BILATERAL OFFSETS SHOULD BE ENCOURAGED BUT NOT REQUIRED.

The Proposed Rule requires regulated entity counterparties to cancel bilateral offsetting swaps before the close of business on the business day following such swap's execution.[22] The

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18 Nicholas Vause, *Counterparty Risk and Contract Volumes in the Credit Swap Market*, BIS Quarterly Review, December 2010, at 59-61.

19 *Id.* at 62, 60.

20 The Working Group suggests that the ratio of gross market value to notional size is rough a estimation of the level of redundant trades in the market. Data retrieved from the Bank of International Settlements. Available at: http://www.bis.org/statistics/derstats.htm

21 Data retrieved from the Bank of International Settlements. Available at: http://www.bis.org/statistics/derstats.htm

22 Proposed CFTC Rule 23.503(a).

only swaps that will be subject to this requirement will be swaps that are too customized to be subject to mandatory clearing and such swaps are unlikely to completely offset one another. Accordingly, requiring regulated entities to run and monitor daily systems checks for completely offsetting uncleared swaps is unnecessarily burdensome.

In addition, there might be very good reasons to keep separate what appear to be off-setting long and short positions. For example, a single legal entity may have business operations that require functional separation for regulatory purposes that would be breached through a forced off-set. Accordingly, the Proposed Rule should require Regulated Entities to have policies and procedures in place mandating cancelation of offsetting swaps in appropriate circumstances, but should not require mandatory setoff in all circumstances.

However, if the Commission elects to retain a mandatory bilateral offset requirement for fully offsetting uncleared swaps, then the Working Group would suggest that such transactions be required to be terminated within one week of entry into the offsetting position. The current requirement to terminate such swaps by the end of the next business day is unnecessarily burdensome, given that most uncleared swaps will likely be too customized to be fully offset by another position.

3. ACCEPTABLE RISK MANAGEMENT LIMITATIONS.

The Proposed Rule, as it should, allows participants in portfolio compression exercises to exclude swaps from a portfolio compression exercise if "including the swap would be reasonably likely to significantly increase the risk exposure of the swap dealer or major swap participant" and to set "risk tolerances" for the exercise.[23] The Working Group respectfully requests, that if the Commission elects to move forward with a portfolio compression rule, that it grant market participants broad discretion when determining whether to exclude certain swaps from a portfolio compression exercise, including reasonable discretion to consider a broad array of potential risks, including regulatory and financial statement risk that might be firm-specific and less obvious to other market participants. Moreover, market participants should have some manner in which they can indicate a preference to preserve swaps with one counterparty over swaps with another counterparty. This ability to express preference allows firms an ability to manage their credit relationships.

In addition, the Commission should clarify that these exclusions can be used to ensure that only identical swaps, and not swaps that are substantially similar, can be compressed. The Working Group is concerned that its members, if subject to mandatory portfolio compression, would be required to compress swaps on the same commodity, but with different delivery

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[23] Proposed CFTC Rule 23.503(c)(3).

locations, even if the swaps have the same notional value and delivery date. Such swaps are entered into to hedge different risks and should be treated as such.

The Working Group also recommends that the Commission evaluate the portfolio compression requirements with its various reporting and record keeping requirements. Participation in a multilateral portfolio compression exercise might result in a firm incurring tremendous administrative obligations to record changes to its swap portfolio, and to report those changes to swap data repositories or the Commission, all on a swap-by-swap basis. In addition, the results of the portfolio compression exercise might affect a firm's accounting records, treasury arrangements and capital allocations.[24] The Commission, prior to issuing a final rule, if any, on portfolio compression, should account for these implications as potential costs- costs that are multiplied by the number of firms that are obligated to participate in the portfolio compression exercise.

E. OPEN COMMENT PERIOD.

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 proposed rules. The resulting comprehensive comments will allow the Commission to better understand how their proposed rules will impact Swap markets.

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.

[24] For example, forced compression of certain offsetting swaps could jeopardize cash flow hedging treatment under hedge accounting rules. That could cause gains or losses on swaps entered into as a hedge to be immediately recognized in earnings while the offsetting gains or losses on the positions being hedged are deferred.

Respectfully submitted,

/s/ David T. McIndoe

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