



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

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

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

March 8, 2011

FILE NO: 76142.2

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

VIA ELECTRONIC SUBMISSION

Re: *Core Principles and Other Requirements for Swap Execution Facilities*, RIN 3038-AD18

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the “Working Group”), Hunton & Williams LLP hereby submits these comments in response to the request for public comment set forth in the Commodity Futures Trading Commission’s (the “CFTC” or “Commission”) Notice of Proposed Rulemaking, *Core Principles and Other Requirements for Swap Execution Facilities* (the “Proposed Rule”), published in the *Federal Register* on January 7, 2011,¹ which provides new regulations for the registration and operation of Swap Execution Facilities (“SEF”) pursuant to new Sections 2(h)(8) and 5h of the Commodity Exchange Act (“CEA”), as established by Sections 723(a)(3) and 733, respectively, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”).²

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

¹ *Core Principles and Other Requirements for Swap Execution Facilities*, Notice of Proposed Rulemaking, 76 Fed. Reg. 1,214 (Jan. 7, 2011).

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

The Working Group appreciates the opportunity to submit the comments set forth herein and respectfully requests the Commission's consideration of these comments. The Working Group looks forward to working with the Commission to further define the scope and application of the regulations for a SEF prior to the effective date of Title VII of the Act.

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

A. GENERAL COMMENTS.

1. Voice Brokers Play an Integral Role in Energy Markets.

As a general matter, the Working Group believes that the CFTC needs to preserve the role of voice brokers in the energy swap markets. Voice brokers play a critical role in over-the-counter ("OTC") derivatives markets for energy commodities, functioning as key trading and execution platforms. Indeed, their role is particularly important in markets with less liquidity or "episodic liquidity" (*i.e.*, liquidity that comes and goes).

The following examples illustrate the integral role voice brokers play in swap markets:

- Commercial firms sometimes enter into a physical contract coupled with a swap. A voice broker is able to intermediate the negotiation of both sides of the transaction. However, if this transaction needed to be executed on an exchange-like platform, a counterparty could not be assured of getting the two legs at a certain price, and thus would be forced to take execution (or "slippage") risk that is unnecessary and costly.
- Given the variety of delivery locations in energy markets and the presence of long-dated trades, markets for certain instruments may be less liquid. In such markets, a voice broker can "shop" an order and solicit interest, thereby creating liquidity where it is most needed. This is also true in markets where there is episodic liquidity. As further detailed below, in these markets, voice brokers provide more accurate pricing information than quotes on an electronic platform.
- Having a voice broker intermediate in less liquid markets has the added advantage of a live market. Traders are certain that potential interested parties are engaged, rather than posting a bid or offer and "hoping" others are watching as the initial trader changes the components of its bid/offer (*i.e.*, price or quantity). In these less liquid markets, the pre-trade price information provided by a voice broker is more accurate than those posted on an electronic platform. In short, when using a voice broker there is immediate accurate feedback (liquidity) on both sides.
- Voice brokers serve as a third party check in the validation process of price and volatility. In this capacity, voice brokers help counterparties validate the mark-to-market value of their transactions. Without voice brokers, the energy industry would lose a key source of information routinely used to support FAS 157 (Fair Value Measurement) disclosures. The accurate price information provided by voice brokers, especially in less liquid markets, is a necessary component in calculating relative exposures to determine when

collateral must be delivered. Such exposure determinations will be key to the efficient operation of the margin and capital regimes that the CFTC must adopt under Section 731 of the Act.

2. The Commission Should Clarify the Scope and Application of “Permitted Transactions”.

Although the Proposed Rule states that one-to-one voice services for the execution or trading of swaps do not comply with the statutory definition of a SEF, particularly the “multiple participant to multiple participant” requirement, the Commission interprets the statutory language “by any means of interstate commerce” to permit execution methods that may include voice communications for block trades, swaps not subject to clearing, and bespoke or illiquid swaps.³ Accordingly, under the Proposed Rule, “permitted transactions,” which include illiquid swaps, may be executed by a voice-based system on a registered SEF subject to the Commission’s approval. Specifically, proposed CFTC Rules 37.9(a)(1)(v) and 37.9(c) provide:

§ 37.9 Permitted execution methods.

(v) *Permitted Transactions* means transactions that meet any of these requirements:

- (A) Are block trades;
- (B) Are not swaps subject to the Act’s clearing and execution requirements, or
- (C) Are illiquid or bespoke swaps.

...

(c) *Permitted Transactions*. (1) Permitted Transactions may be executed by an Order Book, Request for Quote System, a Voice-Based System,⁴ or any such other system for trading as may be permitted by the Commission.

As discussed in Part II.A.1, above, the Working Group believes voice brokers play an integral role in energy markets. Due to the variety of delivery locations and long-dated trades in energy markets, standardized swaps may often be traded in markets characterized by episodic liquidity. For example, a standardized Henry Hub contract requiring execution on a SEF may be liquid one month out, but may be, in contrast, substantially illiquid several months out. Under these circumstances, a voice broker can “shop” an order and solicit interest, assisting liquidity where it is most needed. Additionally, as noted in Part II.A.1, above, a voice broker can provide more accurate pricing information than quotes on an electronic platform. In sum, voice-based systems play a key role in facilitating the trading of standardized swaps in illiquid markets.

³ See Proposed Rule at 1221.

⁴ Proposed CFTC Rule 37.9(a)(1)(iii) states: “*Voice-Based System* means a trading system or platform in which a market participant executes or trades a Permitted Transaction using a telephonic line or other voice-based service.”

In this light, the Working Group supports the Commission's proposal permitting the use of voice-based systems under proposed CFTC Rule 37.9 for certain "permitted transactions." The Working Group, however, seeks guidance on the scope and application of the definition of "permitted transactions." In particular, the Working Group seeks clarification on how the Commission will identify which instruments are deemed to be illiquid. The Working Group respectfully requests, for example, that the analysis not be whether "natural gas" is liquid or illiquid, but whether instruments pricing a particular location are liquid or illiquid, whether a particular delivery month is liquid or illiquid, and whether there are periods of time when an otherwise liquid instrument is illiquid due to a paucity of bids and/or offers. To address the issue on the broader "market" scale would result in prohibiting the use of voice-based systems for instruments, which may generally be illiquid or experience episodic illiquidity—the specific subset of the broader market in which the benefits of the voice-based systems are needed most.⁵

3. The Commission Should Clarify and Define Particular Terms Used in the Proposed Rule.

Throughout the Proposed Rule, the Commission uses undefined terms such as "trader(s)," "member(s)," "market participant(s)," and "person(s)," which appear to be used interchangeably. The Working Group respectfully requests that the Commission define these terms and give specific meaning to each in order to provide clarity regarding the intent, scope, and application of the Proposed Rule and the regulations set forth thereunder. To do otherwise would compel entities regulated by the Commission to interpret such terms as they see fit, which could result in many conflicting or inconsistent interpretations.

B. SPECIFIC COMMENTS ON PARTICULAR PROPOSED CFTC RULES.

1. Proposed CFTC Rule 37.6(b).

Proposed CFTC Rule 37.6(b) provides:

§ 37.6 Enforceability.

(b) A transaction entered into on or pursuant to the rules of a registered swap execution facility shall include written documentation that memorializes all of the terms of the transaction and legally supersedes any previous agreement. The confirmation of all terms of the transaction shall take place at the same time as execution.

⁵ The Working Group understands that the liquidity (and illiquidity) of a swap is a major factor in determining whether that particular swap will be subject to the Act's mandatory clearing (and consequently, execution) requirements. However, the precise process for determining which swaps must be cleared pursuant to the Act is still the subject of the Commission's ongoing rulemaking proceeding, *Process for Review of Swaps for Mandatory Clearing*, 75 Fed. Reg. 67,277 (Nov. 2, 2010), and thus the Working Group is compelled to submit the comments set forth herein.

While the Commission states that proposed CFTC Rule 37.6 is intended to provide legal certainty to swap market participants, the Working Group submits that subsection (b) is unclear in two respects. First, the proposed rule requires written documentation that memorializes the terms of a transaction and allows such documentation to supersede any previous agreement between counterparties. This language does not appear to allow for the operation of master trading agreements between parties who execute on a SEF. As such, the Working Group requests the Commission to clarify the scope and application of this provision. Second, the proposed rule requires “[t]he confirmation of all terms of the transaction [to] take place at the same time as execution.” However, the Working Group submits that such requirement is impossible, as confirmation and execution are two distinct steps within the swap transaction process—execution occurring before confirmation.⁶

2. Proposed CFTC Rule 37.702.

Proposed CFTC Rule 37.702 provides:

§ 37.702 General financial integrity.

A swap execution facility must provide for the financial integrity of its transactions:

...

(c) For transactions not cleared by a derivatives clearing organization, by requiring members to demonstrate that they:

- (1) Have entered into credit arrangement documentation for the transaction;
- (2) Have the ability to exchange collateral; and
- (3) Meet any credit filters that may be adopted by the swap execution facility.

In short, the Working Group believes that proposed CFTC Rule 37.702(c) should be narrower in scope. While new CEA Section 5h(f)(7) indeed requires a SEF to ensure the financial integrity of swaps entered into on or through the SEF, the Working Group submits that, with respect to uncleared swaps, a SEF fulfills its obligation under this statutory provision simply by ensuring counterparties have entered into bilateral credit support arrangements, such as master trading agreements. With such arrangements in place, there is no need for a SEF to impose additional credit filters or requirements on parties to a swap transaction. Accordingly, any final rule adopted by the Commission in this proceeding should permit counterparties executing uncleared swaps on an SEF to establish their own credit terms through a bilateral agreement and not subject them to any further credit requirements.

⁶ See *Real-Time Public Reporting of Swap Transaction Data*, 75 Fed. Reg. 76,140 (Dec. 7, 2010) (stating that “affirmation and execution *always occur prior* to the confirmation of a swap”) (emphasis added).

III. 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 OTC 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 its proposed rules will impact swap markets.

IV. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the energy swap markets in the United States. The Working Group appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding.

The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.

R. Michael Sweeney, Jr.

Mark W. Menezes

David T. McIndoe

*Counsel for the
Working Group of Commercial Energy Firms*