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June 3, 2011

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

**VIA ELECTRONIC SUBMISSION**

Re: *Definition of "Swap Dealer" - Supplemental Comments*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP submits the following supplemental comments regarding the definition of "swap dealer." These comments are filed pursuant to the recent action of the Commodity Futures Trading Commission (the "CFTC" or the "Commission"), *Reopening and Extension of Comment Periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*,[1] pursuant to which the CFTC has opened the comment periods for multiple proposed rulemakings under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act").[2]

The Commission and the Securities and Exchange Commission ("SEC") issued the Joint Notice of Proposed Rulemaking, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"* ("Proposed Rule")[3] that, among other things, further defined the term "Swap Dealer." In February, the Working Group submitted comments to the CFTC regarding the definition of "Swap Dealer" (the "February Comment Letter").[4]

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1 Reopening and Extension of Comment Periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 25,274 (May 4, 2011).

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

3 Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (Dec. 21, 2010).

4 http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27902&SearchText=menezes. See other comments of the Working Group regarding the definition of "swap dealer" at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26228&SearchText=

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 customers, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. As such and following discussions with the Commission and its staff, the Working Group offers refinements to its February Comment Letter.[5]

## I. GENERAL DISCUSSION.

### A. THE FIRST GOAL OF THE COMMISSION SHOULD BE AN APPROPRIATE DEFINITION OF "SWAP DEALER."

Many commenters on the proposed definition of "Swap Dealer" have identified it as overly broad and potentially capturing far more market participants than Congress may have intended. The Working Group is one such commenter. We are particularly concerned that an overly broad definition of swap dealer will needlessly impair the operations of commercial firms, each with a primary business of producing, refining, marketing, transporting or selling physical energy commodities. In our view, solutions primarily designed to address problems in certain financial markets, if applied to commercial commodity markets where no systemic risk exists and that worked well throughout the financial crisis, will materially disrupt such markets. Further, an expansive application of the Swap Dealer definition will effectively reduce the number of parties that can be characterized as "end-users." Congress intended that commercial firms be categorized as end-users and be able to avail themselves of the end-user exception to mandatory clearing so they could use their capital productively (*e.g.*, for infrastructure projects and job creation).

We urge the Commission to further clarify the definition of "Swap Dealer" so it properly applies only to firms commonly viewed as swap dealers. Thus, while we support the Commission in crafting a well designed *de minimis* exception, we do not view this as a sufficient solution to the larger problem of an overly broad definition. The Commission needs to identify the activity that constitutes dealing in swaps before it measures how much of that activity warrants a firm being specifically regulated as a swap dealer.

### B. "FREQUENT TRADING" DOES NOT EQUAL "SWAP DEALING."

The frequency of trading that any firm may do should not be a criterion for evaluating whether that firm is a swap dealer. Over the past several months, there has been discussion as to whether computer-based, high-frequency traders should be regulated as swap dealers, even

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[5] The Working Group is submitting comments only to the CFTC at this time pursuant to its extension of the comment period. We recognize that the Proposed Rule was issued jointly by the CFTC and the SEC. Thus, to the extent applicable, our comments might be deemed made also to the SEC.

though they have no customers. The Working Group is not expressing a view on that question. The Working Group, however, strongly believes that a commercial firm should not be considered a swap dealer solely by virtue of the frequency of its trading. Instead, the proper indicia of a swap dealer should be making markets in swaps, engaging in a business to solicit customers to facilitate their customers' access to the bilateral swap markets or holding oneself out as a swap dealer, none of which are dependent upon the frequency of trading.

### C. Entering into Options that Call for Physical Delivery of Exempt Commodities Should Be Excluded from the Consideration of Whether a Commercial Firm is a Swap Dealer.

The Working Group believes that options on exempt commodities that require physical delivery in the event of exercise should be excluded from the definition of "Swap." However, to the extent that such options are not excluded, the Working Group urges the Commission to exclude such options from any determination as to whether a commercial firm is a swap dealer. Physically settling options for the delivery of exempt commodities are used in connection with the primary business of commercial energy firms including the ultimate delivery of energy commodities to consumers. Accordingly, such options should be characterized as commercial activity and afforded treatment as such.

## II. Proposed Language.

In the February Comment Letter, the Working Group set out proposed revisions to the definition of "swap dealer." In lieu of those changes, the Working Group submits revised recommended changes to proposed CFTC Rule 1.3(ppp). The revised language set forth below is more developed than the Working Group's recommendation in the February Comment Letter. To be certain, the changes proposed herein speak only to proposed language. The Working Group does not seek to amend the substantive discussion set forth in the February Comment Letter.

### A. Further Definitions

The swap markets, including both regulators and participants, have struggled to understand what activity constitutes market making for swaps and swap dealing under the Act. This is particularly true with respect to the energy swaps markets. The Working Group makes two suggestions to clarify the definition of "Swap Dealer."

#### 1. Market Making

The Working Group recommends that the CFTC clarify that, in certain instances, providing both "bid" and "ask" quotations does not constitute market making. In certain swap markets, particularly those tied to certain physical locations, only a few firms trade. This is

particularly true with respect to certain energy related swaps. We recommend the CFTC clarify that providing or eliciting two-sided pricing in these cases does not constitute market making.

2. Exceptions

The Working Group recommends that the CFTC identify certain categories of swaps transactions that do not constitute swap dealing activity. With these transactions removed, the CFTC will greatly simplify the analysis as to what constitutes swap dealing.[6]

Consistent with Congress' intent to not unduly burden hedging or risk mitigation through swap transactions, the Working Group suggests that all hedging activity by commercial firms be excluded from the consideration of what constitutes swap dealing.[7] More precisely, the hedging activity of a commercial firm should not be the basis on which that firm is deemed a swap dealer. Thus, while it is true a swap dealer may hedge, the activity of hedging through swaps is not indicative of being a swap dealer, particularly for commercial firms.

Looking at the other trading of swaps by a firm, the Working Group believes swap dealing constitutes those swap transactions done (a) in connection with market making or (b) in connection with some material marketing of a firm's ability and willingness to enter into swap transactions with swaps customers. We propose that the CFTC recognize that commercial firms that primarily transact in physical commodities, might offer counterparties "financial execution" in the form of swaps.[8]

B. *DE MINIMIS* EXCEPTION

The Working Group's view of the *de minimis* exception has evolved over the course of the rulemaking process. It has become quite clear that the objectives of the Act can be largely achieved by regulating as Swap Dealers, in the first instance, only the commonly known swap

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[6] The Working Group styled its proposed language changes as modifications to the terms "not as part of a regular business" as they appear in the general exception in proposed CFTC Rule 1.3(ppp)(2). However, the concepts behind the Working Group's proposed changes could also be applied to the words "as an ordinary course of business" in third prong of definition of "Swap Dealer" at proposed CFTC Rule 1.3(ppp)(1)(iii).

[7] The Working Group observes that limiting hedging activity beyond that found in CFTC Rule 1.3(z) (*bona fide* hedge) and proposed CFTC Rules 1.3(qqq) [definition of "major swap participant"] and 39.6 [end user exception] place legal uncertainty on those recognized hedging concepts. For example, finding a counterparty to enter into a necessary and otherwise *bona fide* hedge might require a firm to make multiple inquires with other firms. However that process of inquiry might mistakenly be characterized as solicitation activity and thus might be seen as swap dealing, undermining the characterization as a *bona fide* hedge.

[8] Moreover, if firms elect not to offer "financial execution" to avoid characterization as a swap dealer, then their counterparties might be left to trade for "financial execution" only with large financial institutions. The result is a concentration of swap trading with potentially serious liquidity and systemic adverse consequences.

dealers, which constitute the vast majority of swap transactions. In his testimony before the House Committee on Agriculture, Chairman Gensler noted that 25 bank holding companies in the United States are a party to $277 trillion notional in swaps, which constitutes over 90% of domestic swaps.[9] The minimal benefits of regulating the next 225 dealers to capture the next 10% of the business do not justify the costs—both the costs to the regulators and the costs to the regulated firms.

The Working Group recommends that the Commission consider, when setting the *de minimis* exception, the degree to which the swaps markets will change upon implementation of the Commission's final rules under the Act. The change will be dramatic. A significant percentage of the current bilateral swap market will move to clearing. Likely, the number of market participants that execute bilateral swaps will decrease, especially those who are intermediaries for other market participants and provide access to the bilateral swap markets. Accordingly, the Commission will regulate swap markets that are quite different from the historical markets against which the Commission is fashioning its regulatory standards. Not only will the Commission regulate in a different context, but it will have far more data about swap activity. The Commission, therefore, will be in a far better position to identify those entities that warrant regulation and set regulatory standards to capture only that set of identified firms.

The problem of over-reaching when setting regulatory standards and then retrenching when the dust settles is that the costs unnecessarily imposed are not recoverable. In addition, any depth in the market lost as parties change their swap trading activity may not return. By contrast, acting slowly and incrementally allows the Commission to broaden its reach when and if the need is demonstrated through the evolution of the swap markets towards new parties, platforms and structures.

The Commission should also consider that, in the context of the Act, limiting the universe of Swap Dealers to the top 25 does not mean that the balance of swap participants go unregulated. All of the reporting rules, the SEF/DCM trading requirement, mandatory clearing and position limit rules yield a far more transparent system than before the Act was enacted.

For all of these reasons, the Working Group supports the CFTC establishing a *de minimis* exception at a level where the incremental costs of regulating firms engaged in swap dealing activity exceeds any benefits. We recognize that this policy is easier to state, but harder to implement. This is particularly true as dealing in swaps has never been captured under a definition set by statute or regulation. So, there is no precedent or known data set on which the Commission can rely in determining the appropriate level.

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[9] *Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, House Committee on Agriculture, 112th Cong. (Feb. 10, 2011) (statement of Hon. Gary Gensler, Chairman, CFTC).

The Working Group proposes that firms with swap dealing activities with a notional amount less than $3.5 billion for each of two consecutive fiscal quarters should come within the *de minimis* exception. The Working Group arrived at $3.5 billion in the following manner: Of the bank holding companies reporting to the Federal Reserve, the 25th largest swap portfolio was approximately $17,544 billion.[10] (Of note, from this data, the bank holding companies reporting the ten largest swap portfolios hold approximately 99% of the swaps portfolios reported by the largest 50 bank holding companies.[11]) Multiplying the notional amount of the 25th largest swap portfolio by 20%, we arrived at approximately $3.5 billion. The Working Group's belief is that this level of swap dealing activity will capture the significant swap dealers regardless of how a swap market is defined.

The CFTC could use a different formulation of the *de minimis* exception and continue to support the policy of setting the *de minimis* level based on a cost-to-reward approach. For example, the Working Group believes that if swap dealing activity constitutes more than 15% of a firm's overall swap activity, that firm likely is a well recognized swap dealer in what ever swap markets it might trade. Either approach, each premised on a cost-to-reward determination, is likely to place all significant swap dealers within the CFTC's regulatory oversight.

Finally, the Working Group urges the CFTC to adopt a pragmatic approach that may be subject to reexamination at a later date. The swaps market is going to change dramatically under Title VII and the Commission's regulations thereunder. The CFTC would use its resources efficiently during this transition period by focusing on the regulation of the largest swap dealers. This approach would suggest a higher initial *de minimis* level. The CFTC might reserve the right to revisit the *de minimis* exception after a stated period of time, perhaps three years. After that period, the CFTC will likely have the data and experience, including insights about how the markets have changed, necessary to set the *de minimis* level appropriately.

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[10] Based upon publicly available data at the Federal Information Center that was reported in Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) (http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx), the Working Group estimates that the 25th largest swap portfolio was held by American Express Company, with an aggregate notional balance of approximately $17,544,000,000.00.

[11] The ten largest swap portfolios are held by JPMorgan Chase & Co.; Bank of America Corporation; Citigroup Inc.; Morgan Stanley; Goldman Sachs Group, Inc.; HSBC North America Holdings Inc.; Wells Fargo & Company; Bank of New York Mellon Corporation; Ally Financial Inc.; PNC Financial Services Group, Inc. The Working Group understands that the top 25 bank holding companies include affiliates that are dealers representing 90% of the derivatives markets. *See* Footnote 43 in February Comment Letter.

## III. REVISIONS TO PROPOSED RULE.

The Working Group recommends that Proposed CFTC Rule 1.3(ppp) be amended by (i) re-designating subclause (ppp)(5) as subclause (ppp)(6), (ii) deleting subclause (ppp)(4) in its entirety and replacing it with the following:

> (4) *De minimis exception*. A person shall not be deemed to be a swap dealer for any major category of swaps unless the aggregate delta adjusted notional amount of its swap customer transactions was in excess of [$3.5 billion][12] as of the last business day of each of two consecutive fiscal quarters.[13]
>
> (5) *Definitions*. For the purposes of this part:
>
> (i) "Makes a market in swaps" means in the business of providing two-sided pricing:
>
> (A) for a particular swap; or
>
> (B) pursuant to a contractual obligation;
>
> *provided* that, the phrase "makes a market in swaps" shall not be deemed to include providing two-sided pricing in a market or instrument of limited or episodic liquidity for the purpose of:
>
> (*1*) discovering a price for the swap or the underlying commodity; or
>
> *(2)* eliciting bids and offers for the swap from other market participants.
>
> (ii) "Not as part of a regular business" excludes from the scope of swap dealing activity swap transactions involving exempt or agricultural commodities that a producer, processor, transporter or commercial user of, or a merchant handling an exempt or agricultural commodity enters into:
>
> (A) for the purpose of hedging or mitigating commercial risk associated with its business as a producer, processor, transporter, commercial user, or merchant;
>
> (B) for any purpose other than to hedge or mitigate commercial risk, unless such transaction:

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[12] *See* Working Group comments at Part II.B of this letter regarding the appropriate policy rationale supporting a *de minimis* threshold level.

[13] The Working Group advocates that should a firm have a portfolio of swap customer transactions with an aggregate delta adjusted notional amount in excess of the level in the *de minimis* exception, that firm should be able to avail itself of the *de minimis* exception again if its portfolio of swap customer transactions have an aggregate delta adjusted notional amount that is below the level for the *de minimis* exception on each of the last business days for four consecutive fiscal quarters.

(*1*) is entered into in connection with market making activities; or

(*2*) is entered into as a swap customer transaction; or

(C) that are (1) ancillary or incident to that person's business as a producer, processor, transporter, or commercial user of, or a merchant handling an exempt or agricultural commodity and (2) entered into in connection with that person's business as such; *provided* that the other counterparty has a demonstrable ability, directly or through separate contractual arrangements, to make or take delivery of the underlying commodity.

(iii) A "swap customer transaction" means a transaction for which an identifiable group (*e.g.*, trading desk, functional business unit, stand-alone legal entity, as applicable) holds itself out as a dealer or solicits transactions for the purpose of accommodating or facilitating the counterparty's access to over-the-counter bilateral swap markets.

## IV. ECONOMIC ANALYSIS.

Good policy rests, in part, on economic analysis. The Working Group frequently has advocated that the Commission conduct thorough economic analysis to determine the possible consequences of its rulemakings, including with respect to key definitions like the definition of "swap dealer."

The Working Group requests that the Commission remain open for the submission of comments beyond June 3, 2011, particularly for the submission of economic analysis done by recognized economic consultants. The Working Group is considering providing such analysis to the CFTC and the SEC. However, it will need more time than provided under the extension for further comments on various rulemakings.

## V. CONCLUSION.

The Working Group supports tailored 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 prior to the adoption of any final rule implementing Title VII of the Act.

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/ David T. McIndoe*

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