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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: *Rulemaking under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter to the Commodity Futures Trading Commission (the "Commission") to offer certain observations regarding the approach by which the Commission might implement regulations under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[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 regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

Because the Commission has not finalized the regulatory definition of the terms such as "swap dealer," "major swap participant" and "swap," members of the Working Group have commented on proposed rulemakings applicable to swap dealers and major swap participants and offer their thoughts contained herein on requirements imposed on "swap dealers" and "major swap participants." While members of the Working Group have never considered themselves, or been viewed by others as swap dealers or major swap participants, they are concerned with the

[1] This letter sets out general observations about the Commission's rulemaking process to date. The Working Group intends to submit a separate letter on the topic of sequencing the final rules and their implementation.

breadth and vagueness of the proposed rules and, thus, have commented on proposed rules imposing obligations on swap dealers and major swap participants.

I. COMMENTS OF THE WORKING GROUP.

Title VII of the Dodd-Frank Act places a substantial burden on the Commission. The Commission is tasked with constructing a new regulatory regime for swap markets based on the contours set forth in the Dodd-Frank Act. It is charged with completing this monumental task in less than a year with limited resources. The Commission must balance the timing requirements set forth by Congress with the need to construct rules that (1) accomplish the goals of the Dodd-Frank Act, (2) are enforceable by the Commission and (3) cause the least disruption in, and impose the lowest possible costs on swap markets.[2] The Working Group respectfully submits this letter to assist the Commission in satisfying these three goals.

A. MARKET ANALYSIS.

As a threshold matter, when proposing a rule, the Commission should conduct a careful analysis of the markets and market participants to which the rule will apply. Without a comprehensive understanding of the relevant market and its participants, the Commission will be unable to ensure that such proposed rule will meet the three goals set forth above. Further, analysis of the relevant market and its participants is necessary to satisfy the Commission's cost benefit obligations under Section 15(a) of the CEA. Such analysis is warranted particularly for swap markets that traditionally have not been regulated pervasively by the Commission, such as the energy swap markets.

The current approach taken by the Commission to the regulation of swap markets does not appear to have the benefit of such careful market analysis. For example, as Chairman Gensler has stated repeatedly, over $277 trillion in notional amount of domestic swaps are held by 25 bank holding companies.[3] Said another way, those 25 bank holding companies are party to

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[2] Satisfying these three goals would not only fulfill the Commission's obligation under Section 15(a) of the Commodity Exchange Act ("CEA") to consider and evaluate the costs and benefits of a proposed rule, but it would also adhere to the intent of President Obama's Executive Order on Improving Regulation and Regulatory Review. Exec. Order No. 13563, 76 Fed. Reg. 3821 (January 18, 2011) (the "Executive Order"). The Working Group acknowledges, that as an independent agency, the Commission is not subject to the Executive Order. However, the Working Group encourages the Commission to adhere to President Obama's intent.

[3] *See, Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 112th Cong. (Feb. 10, 2011) (statement of Hon. Gary Gensler, Chairman, CFTC). Chairman Gensler stated that, based on OCC estimates, the largest 25 bank holding companies held $277 trillion in notional amount of swaps and that the domestic swap market was approximately seven times larger than the $40 trillion futures market. Based on those figures, the 25 largest bank holding companies would hold 99% of the domestic swap market. *See also, Chairman Gensler's Budget Transmission Letter* (Feb. 14, 2011). Chairman Gensler stated that, based on OCC estimates, the largest 25 bank holding companies held $277 trillion in notional amount of swaps and that some estimates placed the size of the U.S. swap market at "as big as $300 trillion." Based on those figures, the 25 largest bank holding companies would hold 91% of the domestic swap market.

91-99% of domestic swaps. Despite these compelling statistics, the proposed definition of "swap dealer" appears to be based on the premise that the universe of swap dealers extends far beyond this group of financial institutions.[4] Drafting the definition of "swap dealer" in a manner that captures entities far beyond these 25 bank holding companies will have serious implications for swap markets. As noted above, in crafting rules, the Commission must take into account the costs of regulation. In this instance, the Commission must weigh (a) the costs of extending the comprehensive regulation imposed on swap dealers to entities beyond the 25 bank holding companies against (b) the potential benefits of this additional regulation. If the Commission extends the definition of "swap dealer" beyond such bank holding companies, it will impose substantial additional costs on consumers and the overall swap markets, while providing little or no benefit to the economy. Further, extending the designation of swap dealers beyond these core bank holding companies will not further the underlying intent of the Dodd-Frank Act.

B. THE COMMISSION SHOULD CONTINUE ITS PRINCIPLES-BASED APPROACH.

1. THE DODD-FRANK ACT GENERALLY ALLOWS THE COMMISSION TO ADOPT PRINCIPLES-BASED REGULATIONS.

The Commission has an established history of effective oversight through a principles-based approach to regulation. The Working Group believes that the Commission should remain squarely within this tradition. This tradition results in clear statements of the goals and requirements of regulation and is based upon the market participants' deep experience and knowledge of the swap markets to create efficient compliance solutions. It also reduces the burden on the Commission to craft and monitor compliance with granular criteria.

While the Dodd-Frank Act is prescriptive in many of the requirements that it imposes,[5] many of the rules proposed by the Commission have been prescriptive when the Dodd-Frank Act allows the Commission ample latitude to craft rules consistent with a principles-based approach. For example, Section 731 of the Dodd-Frank Act requires the Commission to set basic duties of, and business conduct standards for, swap dealers and major swap participants, including disclosure of material risks associated with swaps and having processes in place to ensure compliance with position limits. However, the rules proposed by the Commission to implement such duties and business conduct standards go well beyond setting a general compliance, risk management, and disclosure framework for swap dealers and major swap participants. The Proposed Rule on Duties of Swap Dealers and Major Swap Participants would codify a set of detailed aspirational "best practices," arguably appropriate only as guidance for financial entities, as legal requirements for all swap dealers and major swap participants. The Proposed Rule on Business Conduct Standards for Swap Dealer and Major Swap Participants with Counterparties

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4 *See*, Gary Gensler, Chairman, CFTC, *Remarks Before ISDA Regional Conference* (Sept. 16, 2010). Chairman Gensler stated "initial estimates are that there could be in excess of 200 entities that will seek to register as swap dealers."

5 *See, for example,* the requirement in Section 731 of the Dodd-Frank Act for swap dealers and major swap participants to provide daily marks to counterparties on uncleared swaps.

would impose a suitability standard on swap dealers and major swap participants and also seeks to codify a set of detailed aspirational "best practices" intended as guidance for financial entities as legal requirements for all swap dealers and major swap participants.[6]

In these two rulemakings, among others, the Commission has taken an unnecessary prescriptive approach. This approach will not result in market participants taking the proper approach to compliance, i.e., developing an organic "culture of compliance" within the company to constantly improve compliance as markets evolve and react to conditions. A prescriptive approach limits the judgment of entities and their personnel to essentially binary decisions, and, thus, leads to robotic compliance practices that seek only to assure compliance with the letter of the Commission's regulations and not the intent. Under such prescriptive approach, market participants might know what they can and cannot do but will not fully understand the policy behind the rules.

2. OVERLY PRESCRIPTIVE RULES WILL LIMIT PARTICIPATION IN SWAP MARKETS.

Adopting prescriptive rules for all market participants based on aspirational "best practices" for financial entities will limit competition in swap markets. Markets function best when there is a large and diverse group of participants. This is particularly true in the energy swap markets, where many large commercial energy firms are active traders. This activity brings liquidity to the markets, and it also helps disperse counterparty credit risk. As drafted, many of the proposed rules might not be workable for non-financial swap market participants and, even if they prove workable, they would likely impose substantial costs on such market participants.

A prescriptive approach to rulemaking might lead to a perverse result of promoting the further concentration of market activity and risk in certain swap markets to institutions that are "too big to fail." The consequence of being a swap dealer or a major swap participant for a non-financial entity, such as a commercial energy firm, is that it will be regulated as a financial entity. Accordingly, depending on the scope and compliance burden imposed under the final regulations, it is possible that non-financial entities will decrease or discontinue their participation in swap markets.

Only entities that can structure their businesses to meet the prescriptive requirements included in many of the Commission's proposed rules will have the ability to be central players in markets. The burdens of regulatory compliance as a swap dealer or major swap participant effectively will become a substantial barrier to entry to those non-financial entities looking to become active, sophisticated traders in swap markets. Non-financial entities that are currently active market participants will have to reevaluate their activity in the swap markets. Some may

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[6] *See* Notice of Proposed Rulemaking on Business Conduct Standards for Swap Dealer and Major Swap Participants with Counterparties 75 Fed Reg. 81,519 (Dec. 28, 2010), notes 47, 50, 52. The "best practices" upon which the Commission relies on in certain circumstances are the work of the Counterparty Risk Management Policy Group, which was comprised almost entirely of representatives from the largest banks.

continue as major market participants. Others may not. In such cases, the relative role of financial firms in the operation of the swaps market will increase and, as other entities leave the market, liquidity will likely decrease and volatility will increase.

This concern is especially relevant in swap markets that currently rely on non-dealer market participants for a substantial amount of transaction volume. In energy swap markets, many parties trade directly without the involvement of a swap dealer or other intermediary. An overly broad definition of "swap dealer" or rules that force all energy swaps to be done through swap dealers or other intermediaries likely will harm an otherwise mature and efficient market. Swaps between commercial energy firms where neither party plays the role of a dealer bring cost savings to the market and energy consumers, valuable liquidity to the market and help disperse credit risk among a wide number of market participants that are generally outside the core of the U.S. financial system. Without certainty that they will not be regulated like financial entities, commercial energy firms will be reluctant to enter into swaps with each other. The end result will be a market dominated by financial firms that are "too big to fail," a loss of liquidity, a possible increase in consumer energy prices and a loss of market expertise.

C. ELECTIVE RULE MAKINGS.

As noted above, by requiring the Commission to issue numerous rulemakings in a short period of time, the Dodd-Frank Act tasks the Commission with a substantial undertaking. Given these mandatory obligations, the Working Group advises the Commission to postpone the consideration of any proposed rules not explicitly required by the Dodd-Frank Act ("Elective Rulemakings") until all of the required rulemakings have been completed, and more importantly, until the effects of the required rulemakings on swap markets are known.[7]

Delaying the consideration of the Elective Rulemakings would have multiple advantages. *First*, delaying these rulemakings will allow the Commission and market participants to dedicate their limited resources to only those undertakings required by Congress. *Second*, by waiting until the regulatory paradigm set forth by Title VII of the Dodd-Frank Act is in place, the Commission can determine if the Elective Rulemakings are in fact necessary. *Third*, if the Commission finds that the Elective Rulemakings are necessary, the delay will enable the Commission to focus on the Elective Rulemakings. Delay and subsequent consideration will ensure that the Elective Rulemakings further the intent of the Dodd-Frank Act, will work in swap markets, and will accomplish the desired result without imposing undue burdens on the Commission and swap market participants. In this light, the Working Group respectfully requests that the Commission postpone all Elective Rulemakings until the entire mandatory Dodd-Frank Act regulatory paradigm is in place.

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[7] Elective Rulemakings include, but are not limited to, proposed rules on portfolio compression, portfolio reconciliation, the suitability standard for non-swap dealer and non-major swap participant counterparties and the provision of scenario analysis.

D. WORKING GROUP RECOMMENDATIONS.

In light of the difficulties that the Commission faces in creating rules that (1) accomplish the goals of the Dodd-Frank Act, (2) are workable for the Commission and market participants and (3) accomplish these two goals while limiting the negative impacts on swap markets, the Working Group has the following three suggestions.

First, the Working Group suggests that the Commission limit the scope of the definition of "swap dealer" in a manner that captures only those 25 bank holding companies that hold over 90% of the notional value of domestic swaps.[8] Doing so will accomplish the intent of the Dodd-Frank Act in that it will capture the overwhelming majority of the U.S. swap market and will do so in a manner that limits the costs to market participants. Adopting such a definition will allow the Commission to focus its limited resources on a small number of market participants and will allow traders who are not thought of by the market as swap dealers to remain active market participants. Setting a definition of swap dealer that captures the remaining minimal percentage of the market will impose substantial marginal costs on the Commission and on the many market participants that will be captured. Therefore, to do so, the Commission should determine that there is a compelling benefit to the market that outweighs the additional costs.

Second, where possible, the Commission should retain its traditional principles-based approach to regulation. The Dodd-Frank Act is prescriptive in some specific areas, but it generally does not limit the Commission's ability to write rules that provide discretion to market participants to design and implement compliance measures. Such adaptability is necessary to allow a diverse community of active traders to remain in swap markets so that such markets remain liquid and well functioning. Permissive rules will allow market participants to put in place compliance and risk management infrastructure that is most efficient for their individual circumstances. Issuing permissive rules will also allow the Commission to easily adapt such rules to changing market conditions. Said differently, prescriptive rules will likely be too rigid to adapt to changing market conditions, and it is probable that the Commission will have to reissue such rules to account for such changes. Finally, if the Commission issues permissive rules, it will allow market participants to approach compliance from a holistic perspective. Market participants will be able to construct compliance and risk management programs that encourage self-governing and self-reporting and create a culture of compliance rather than the "check-the-box" approach that is the logical outgrowth of prescriptive rules.

If the Commission elects to retain its traditional principles-based approach, the Working Group respectfully submits that the Commission develop a formal policy statement with respect to compliance under the rules it proposes under the Dodd-Frank Act. The statement should

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[8] The Working Group is not suggesting that the definition of "swap dealer" be constructed to capture these 25 bank holding companies because they are large bank holding companies. The definition should focus on the role played in the market by potential "swap dealers" and should be calibrated to capture these 25 bank holding companies because they are party to a vast majority of domestic swaps. The Commission, of course, has the authority to expand the definition if it is necessary with regards to the post-Dodd-Frank Act market structure.

identify the policy objectives for the overall regulatory effort, the proper design of regulations to support those policy objectives and the factors by which the Commission will determine if its proposed regulations adhere to Congress' intent. This statement would be the "blueprint" for effective regulation of swap dealers and major swap participants. Adopting a policy statement will send a clear message to market participants of the Commission's policy goals and expectations, which will facilitate regulatory certainty as well as uniform and orderly enforcement of the existing and new rules and regulations adopted by the Commission.[9]

Third, the Working Group respectfully suggests that the Commission prioritize drafting sound and functional regulations over promulgating rules within a certain time period. Rulemaking should be a deliberate, methodical and iterative process. If the Commission, in its attempt to satisfy Congressionally mandated deadlines, issues rules that leave significant legal uncertainty, are unworkable or impose substantial unnecessary costs on swap markets, then it is likely that the Commission will have to revisit a number of rulemakings. If this is the case, not only would the Commission have to expend additional resources to do so, but swap markets will be confronted with an extended period of legal uncertainty.

Thankfully, Congress provided the Commission with two tools with which it can take the time necessary to draft regulations that (1) accomplish the goals of the Dodd-Frank Act, (2) are enforceable by the Commission and (3) satisfy these latter two goals while causing the least disruption in and imposing the lowest possible costs on swap markets, without departing significantly from the timing requirements set forth in Title VII of the Dodd-Frank Act.

Section 754 of the Dodd-Frank Act provides "the provisions of this subtitle shall take effect on the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after the publication of the final rule or regulation implementing such provisions of this subtitle." Section 754 would allow the Commission to delay the effective date of any final rule promulgated under Title VII of the Dodd-Frank Act until the Commission determines the market is ready to comply. In addition, Section 723 of the Dodd-Frank Act grants the Commission the authority to allow market participants to remain subject to current Section 2(h) of the CEA for up to a year after the Dodd-Frank Act becomes effective.[10] The Working Group respectfully submits that by using the

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[9] There is a good amount of academic writing supporting the Working Group's suggestion for an integrated, principles-based regulatory paradigm. *See*, John S. Moot: *Compliance Programs, Penalty Mitigation and the FERC*, 29 ENERGY LAW JOURNAL 547 (2008); Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71 (2002); Kimberly D. Krawiec, *Corporate Decisionmaking: Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. L. REV. 571 (2005); and Jennifer Arlen and Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U.L. REV. 687 (1997).

[10] If the Commission elects to use the 2(h) extension in Section 723 to help phase in Title VII of the Dodd-Frank Act's compliance requirements, it is possible that the implementation dates for certain rules will be extended beyond the maximum one year 2(h) extension period. In such an event, the Working Group suggests that the Commission use its existing statutory authority to address any gaps in the regulatory treatment of swaps and swap market participants.

authority granted to it under Sections 754 or 723 of the Dodd-Frank Act, the Commission can take the time necessary to construct sound rules without violating Congress' required time frame.

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.

Respectfully submitted,

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