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

Submitted via: www.regulations.gov

Re: "Definitions"
API comments to the Advance Notice of Proposed Rulemaking

Mr. Stawick,

API is a national trade association representing approximately 400 member companies involved in all aspects of the oil and natural gas industry. Our members actively trade various commodities and financial products and will be directly impacted by the definitions developed in a final rule. We appreciate the opportunity to comment on this notice.

I. REGULATION OF PRODUCTS

The Act provides for the comprehensive regulation of "Swaps" by the Commodity Futures Trading Commission ("Commission" or "CFTC").[1] The Act defines "Swap" to include a broad range of transactions, and also excludes certain transactions from the definition. One exclusion from the definition of "Swap" is "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[2] As energy providers that engage in a range of physical and financial transactions in energy markets, API's members are concerned that this physical delivery exclusion may be narrowly interpreted, the result of which would be the inclusion of numerous physical transactions, including forward contracts with the obligation for physical delivery and certain option contracts with the obligation for physical delivery, in the definition of "Swap."

[1] The Act also provides for the comprehensive regulation of "Security-Based Swaps" by the Securities and Exchange Commission. API's comments herein are focused solely on the regulation of derivatives markets by the CFTC.
[2] H.R. 4173 Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 721(a)(21)

A. Exclusion of Forward Contracts with the Obligation for Physical Delivery

API requests that the Commission clarify through regulations that forward contracts with the obligation for physical delivery are covered by the physical delivery exclusion and are not "Swaps." This clarification would be consistent with Congress's intended scope of the definition of Swap. In a letter dated June 30, 2010 from Senator Dodd, Chairman of the Committee on Banking, Housing, and Urban Affairs and Senator Lincoln, Chairman of the Committee on Agriculture, Nutrition, and Forestry to Representative Frank, Chairman of the Committee on Financial Services and Representative Peterson, Chairman of the Committee on Agriculture, Senators Dodd and Lincoln expressed their intent that the physical delivery exclusion be applied "consistent with the forward contract exclusion currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to 'book out' their physical delivery obligations under a forward contract."

In support of Congress's intent that the physical delivery exclusion applies to forward contracts, API suggests that the CFTC consider in applying the exclusion a variety of characteristics such as (i) contracts containing unique terms for place of delivery, or any other term that makes the contract not fungible with other contracts; (ii) whether the counterparty to such contract undertaking the obligation to deliver has the ability to do so; and (iii) delivery of the referenced commodity cannot be deferred indefinitely.

B. Exclusion of Certain Option Contracts with the Obligation for Physical Delivery

API requests that the Commission clarify through regulations that option contracts containing the obligation for physical delivery should also be exempt from the definition of a "Swap." API requests that the CFTC utilize the same type of criteria for determining intention to physically deliver for such option contracts as it uses for certain swap contracts.

II. REGULATION OF MARKET PARTICIPANTS

A. General Policy Comments

Section 721(a) of the Act amends the Commodity Exchange Act (CEA) to add the defined terms of "Swap Dealer," and "Major Swap Participant" in new CEA Sections 1a(49) and 1a(33). In addition, the Act envisions a third category of market participants, which can be broadly defined to include certain persons that are not "Swap Dealers" or "Major Swap Participants."[3] This

[3] The CEA also regulates other types of persons, including "Futures Commission Merchants," "Floor Brokers," and "Floor Traders."

third category can be referred to as "Non-Financial Entities,"[4] and generally includes, but may not be limited to, persons that are commonly referred to and acting in their capacity as "energy providers," "end users," and "traders."[5] API's members generally are "energy providers," in that they own tangible assets and transact in derivatives primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers.

As envisioned by Congress and demonstrated in the Act, the categories of market participants known as "Swap Dealers", "Major Swap Participants", and "Non-Financial Entities" are intended to be mutually exclusive. For a specific category of swaps, a person cannot be a "Major Swap Participant" if that person is a "Swap Dealer".[6] Likewise, a person cannot be a "Non-Financial Entity" if that person is either a "Swap Dealer" or a 'Major Swap Participant".[7] While recognizing that an entity could be classified as a "Swap Dealer" or "Major Swap Participant," for one category of swaps and not for others, the Commission should be faithful to the intent of Congress to maintain the mutual exclusivity between these categories of market participants within a specific category of swaps.

B. Definition of "Swap Dealer"

1. General Characteristics of a "Swap Dealer"

The Act broadly defines "Swap Dealer" to include any person that engages in one of four specific activities. Three of those four specific activities can generally be described as involving intermediation activities to facilitate trading activities on behalf of a "Swap Dealer"'s counterparties.[8]

2. Scope of "Swap Dealer" Designation

The Act states that "a person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities."[9] Further, the CEA broadly defines "person" to include

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[4] The term "Non-Financial Entity" is not defined in the Act. However, Section 723(a)(2) of the Act, which, *inter alia*, amends Section 2(h) of the CEA, defines the term "Financial Entity" to include any person that is either a Swap Dealer or a Major Swap Participant.

[5] The distinctions within this third category of market participants are not intended to be mutually exclusive.

[6] H.R. 4173 Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 721(a)(16)

[7] H.R. 4173 Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 723(a)(3)

[8] These specific activities include (1) holding itself out as a dealer in swaps, (2) makes a market in swaps, and (3) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. H.R. 4173 Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 721(a)(21)

[9] Ibid

"individuals, associations, partnerships, corporations, and trusts."[10] API is concerned that these two provisions, when combined, could result in a level of granularity that makes it administratively and operationally impossible for a market participant to comply with the requirements applicable to Swap Dealers if that market participant is designated a "Swap Dealer" for any part of its business. For example, if the Commission makes a determination to designate certain market participants that transact in crude oil as "Swap Dealers" on the basis of different types of crude oil, a market participant that trades ten different types of crude oil could find itself designated as a swap dealer for three types of crude oil but not for the remaining seven types of crude oil. Conversely, API also is concerned that the Commission could take the opposite position and determine that a legal entity is a "Swap Dealer" if any of the transactions conducted by that legal entity, regardless of product type, rise to the level of swap dealing. For example, assume that a market participant ("Company A") transacts in natural gas swaps and swaps involving ten types of crude oil, and that the Commission determines that Company's transactions in three types of crude oil rise to the level of swap dealing, but Company A's transaction in the remaining seven types of crude oil and its transaction in natural gas do not rise to the level of swap dealing. Applying a legal entity basis to determining "Swap Dealer" designation, the Commission would determine that Company A is a "Swap Dealer" and regulate all of its transactions as swap dealing transactions.

API suggests that the Commission take a middle-of-the-road approach with respect to the scope of the "Swap Dealer" designation. Specifically, API recommends that the Commission adopt the following categories (the "swaps categories") as the basis for determining "Swap Dealer" status in energy markets:

- Coal;
- Crude Oil;
- Electricity;
- Ethanol;
- Freight;
- Natural Gas;
- Petrochemicals; and
- Refined Products.[11]

Using this approach, a person could be a "Swap Dealer" for one or more of the swaps categories, but, as noted above, a person could not be both a "Swap Dealer" and a "Major Swap Participant" or a "Non-Financial Entity" for a single swaps category.

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[10] 17 CFR§1.3(u)

[11] Each of these categories corresponds to CME Group's subgroup designation for energy-related products that can be cleared through CME ClearPort.

3. Interpretation of New CEA Section 1a(49)(iii)

On its face, the third prong of the Act's definition of "Swap Dealer" appears to be much broader than the other three activities that are deemed to be activities performed by "Swap Dealers". This third prong states that a person is a "Swap Dealer" if that person "regularly enters into swaps with counterparties as an ordinary course of business for its own account."[12] API is concerned that the Commission might be inclined to interpret this prong of the "Swap Dealer" definition in a manner that essentially sweeps in any person, with respect to one or more of the swaps categories, that enters into swaps as part of its normal course of business, regardless of the purpose for which that person enters into those "Swaps." However, such an interpretation is not consistent with the concept of "Swap Dealers" generally acting in an intermediation capacity. Also, such an interpretation is inconsistent with Congress's intent to establish mutual exclusivity between the "Swap Dealer" and "Non-Financial Entity" categories of market participants and could result in a scenario where an overly expansive interpretation of one section of the Act negates the purpose for another section of the Act. API respectfully suggests that the Commission should interpret the third prong of the "Swap Dealer" definition, including each of the key terms within that definition, to include a requirement that a person be acting in an intermediation capacity before that person could be a "Swap Dealer" for one or more of the swaps categories solely on the basis of the third prong.

4. Scope of the General Exception

New CEA Section 1a(49)(C) states that "the term swap dealer does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as part of a regular business." API suggests that this general exception is consistent with the overall interpretation of the definition of "Swap Dealer" being limited to those entities that engage in swap transactions in an intermediary capacity and not to entities that engage in derivatives transactions for proprietary purposes, including hedging or mitigating commercial risks associated with their core business.

5. Scope of the De Minimis Exception

The Act requires the Commission to exempt from designation as a "Swap Dealer" any entity that "engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers."[13]

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[12] H.R. 4173 Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 721(a)(21)
[13] Ibid.

a. Definition of "Customer"

Neither the Act nor the CEA defines "customer." For purposes of swap transactions subject to regulation under Title VII, any person that is an "Eligible Contract Participant" or an "Eligible Commercial Entity" should be deemed not to be a customer of another person unless those two parties expressly agree otherwise. This is consistent with the CEA's recognition of the sophistication of ECPs and ECEs.

b. Two-Part Test for "De Minimis"

A "Swap Dealer"'s transactions with its customers should be deemed de minimis if those transactions pass a two-part test. First, the "Swap Dealer"'s transactions with its customers must be small, either from a notional or volumetric basis, relative to all swaps transactions conducted by all market participants within the applicable swaps category. Second, the "Swap Dealer"'s transactions with its customers must be small, either from a notional or volumetric basis, relative to all transactions conducted by that "Swap Dealer" within the applicable swaps category.

C. Definition of "Major Swap Participant"

Similar to the definition of "Swap Dealer", the Act sets forth separate characteristics that are indicative of whether a person is a "Major Swap Participant." In each case, the Act bases the determination for whether a person is a "Major Swap Participant" on the impact of that person's swap positions on the U.S. financial system, and not solely on the size of that person's swaps positions.

1. New CEA Section 1a(33)(A)(i)

a. Limited Applicability to Companies that Create Systemic Risk

One test for whether a person is a "Major Swap Participant" is in new CEA Section 1a(33)(A)(i).[14] Under that test, a person is a Major Swap Participant if that person "maintains a substantial position in swaps for any of the major swap categories as determined by the Commission." Certain positions, including those held for hedging or mitigating commercial risk, are excluded from this test.[15] "Substantial Position" is defined to be the threshold that is "prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States."[16]

[14] H.R. 4173 Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 721(a)(16)
[15] Ibid.
[16] Ibid.

API suggests that the intent of Congress, as evidenced in the definition of Substantial Position, is to limit the test in new CEA Section 1a(33)(A)(i)[17] to those persons that are systemically risky. API further notes the strong similarity between the definition of "Substantial Position" and the goals of Title I of the Act, which include:

- To identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; and
- To respond to emerging threats to the stability of the United States financial system.[18]

Given this strong correlation between new CEA Section 1a(33)(A)(i)[19] and Title I of the Act, API requests that the Commission clarify that a person can be a "Major Swap Participant" under this first prong of the "Major Swap Participant" definition only if that person is also a Bank Holding Company or a Nonbank Financial Company, as defined in Title I of the Act.

b. Test for "Substantial Position"

For the determination of a "Substantial Position," hedging swaps and swaps entered into for the mitigation of commercial risk must be excluded.

With respect to "commercial risk," API suggests that the Commission define "commercial risk" to include each of the following:

- Market risk;
- Credit risk;
- Operational and operating risk;
- Liquidity risk;
- Financial statement risk; and
- Any other risk that underlies, or could underlie, the transaction.

In addition to the exclusion of hedging swaps and swaps to mitigate commercial risk, the Commission should clarify that cleared swaps and swaps that are collateralized should, by definition, be excluded from test to determine whether a position is substantial.

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[17] Ibid.
[18] These are two of the three goals expressed as the duties of the Financial Stability Oversight Council. The third goal, which relates to market intervention to protect investors, is unrelated.
[19] H.R. 4173 Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 721(a)(16)

Additionally, the Commission should clarify that transactions between affiliated entities should be excluded from such a test.

Each of these transactions has mitigating factors that reduces the risk that these transactions will have a negative impact on the U.S. financial system. The exclusion of these transactions would be in addition to the exclusion expressly stated in the statute for positions held for hedging or mitigating commercial risk.

2. New CEA Section 1a(33)(A)(ii)

The second test for whether a person is a Major Swap Participant is in new CEA Section 1a(33)(A)(ii).[20] Under that test, a person is a Major Swap Participant if that person "whose outstanding swaps create substantial counterparty exposure that [such position] could have [a] serious adverse effect on the financial stability of the United States banking system.

API suggests that a person satisfies this test, if such person: (a) holds swap positions that are uncleared and non-collateralized, and (b) such uncleared non-collateralized swap position creates associated counterparty exposure of the magnitude that it if the entity succumbs, that the US banking system would be seriously adversely effected.

API suggests a swap position is considered non-collateralized if the collateral is of low quality. The Commission should draw upon the language commonly used in the ISDA agreement to establish standards that differentiate high quality collateral and low quality collateral. Cash or Letters of Credit issued by qualifying institutions, should be deemed high quality collateral.

API and our member companies appreciate the opportunity to comment on this Advance Notice of Proposed Rulemaking and welcome the prospect of working with the CFTC as regulations are developed. Please contact me at 202-682-8192 if you have any questions about these comments.

Sincerely,

Patrick Kelly
Policy Advisor
API

[20] Ibid.