Kyle B. Isakower
Vice President
Regulatory and Economic Policy

1220 L Street, NW
Washington, DC 20005-4070
Telephone (202) 682-8314
Fax (202) 682-8408
Email isakowerk@api.org
www.api.org

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Submitted Electronically

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

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," RIN 3038-AD06, RIN 3235-AK65, SEC File No. S7-39-10

Dear Mr. Stawick and Ms. Murphy:

The American Petroleum Institute ("API") appreciates the opportunity to submit these comments in response to the notice of proposed rulemaking ("NOPR") issued by the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC" and, together with the CFTC, the "Commissions") concerning the further definition of "swap dealer" under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010). The proposed rules are set forth in 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 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pts. 1 & 240).

API is a national trade association representing more than 450 oil and natural gas companies. API's members transact in physical and financial, exchange-traded, and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers. Associated with the hedging of physical exposures, API members enter into swap transactions to offset credit risks and to facilitate physical transactions. API members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry. As such, many API members are naturally positioned to be both buyers and sellers of various commodities. Accordingly, they may create custom products to hedge particular commodity exposures or to speculate.

I. Introduction

API further supports Dodd-Frank's goal of reducing systemic risk and enhancing operational standards in the swaps markets on which API members rely. API is concerned, however, that the Commissions' proposed definition of "swap dealer" may sweep more broadly than market participants -- or Congress -- understand the term. As proposed, the definitions potentially ensnare thousands of firms across a wide range of industries. Furthermore, the proposed definitional rules require companies to determine their status based on vague indicia of dealing activity, carry severe penalties for failure to register, and impose significant regulatory burdens related to all swap activity, not just the activity that triggers the swap dealer registration. It is critical that the Commissions define swap dealer as precisely as possible while still fulfilling the purposes of Dodd-Frank.

API is particularly concerned that an excessively broad definition of "swap dealer," not tailored to the purposes of Dodd-Frank, would impose undue regulatory, legal, and financial burdens on commercial end users, including API's members, and ultimately raise costs, including energy costs, for American consumers. API therefore urges the Commissions to consider the following recommendations:

- The CFTC should clarify that it will distinguish between swap dealers and swap traders based on factors similar to those used to distinguish between dealers and traders under the Securities Exchange Act of 1934.

- The CFTC should refine the *de minimis* exception, so that it applies only after an entity is determined clearly to be engaged in dealing activity as contemplated by Dodd-Frank. Only for those market participants clearly engaged in the type of activity Dodd-Frank seeks to regulate as dealing should the *de minimis* exception even be relevant.

- The proposed *de minimis* thresholds are too low. The *de minimis* exception rule would better serve Dodd-Frank's purposes if it identified customer dealing activity relative to the overall swaps market.

- The CFTC should start by regulating true dealers. Before imposing additional regulatory burdens on other entities, the CFTC should consider meaningful cost estimates and only identify dealing where the regulatory benefits clearly outweigh the costs of regulation.

- The final rule should make clear that the Commissions will not consider swaps among affiliates for purposes of identifying whether an entity is a swap dealer.

II. The CFTC Should Clarify that the Proposed Definition of Swap Dealer Will Distinguish Between Swap Dealers and Swap Traders

API is concerned that the proposed regulations further defining swap dealer are overly broad and require additional clarity. API further believes that, to fulfill Dodd-Frank's purpose, a more useful definition would differentiate between entities that enter into swap transactions for hedging or speculative purposes and those that are true dealers. Specifically, the CFTC should clarify that it will distinguish between dealers and traders based on interpretive principles similar to those that have developed under the Securities Exchange Act of 1934.

Relying on principles developed in the securities context is consistent with both the statutory language and the complex and varied market structure for swaps. By choosing similar language to define swap dealers as it used to define securities dealers in the Exchange Act, Congress signaled its intent that the two statutes be interpreted similarly.[2] This intent is consistent with Dodd-Frank's instruction that "the Commodity Futures Trading Commission shall consult and coordinate to the extent possible with the Securities and Exchange Commission

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[2] *See* 15 U.S.C. § 78c(a)(5)(A) ("The term 'dealer' means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."); *see also, e.g.*, *Smith v. City of Jackson*, 544 U.S. 228, 233 (2005) ("[W]e begin with the premise that when Congress uses the same language in two statutes having similar purposes . . . it is appropriate to presume that Congress intended that text to have the same meaning in both statutes."); *Morisette v. United States*, 342 U.S. 246, 263 (1952) ("[W]here Congress borrows terms of art in which are accumulated the legal tradition and meaning of centuries of practice, it presumably knows and adopts the cluster of ideas that were attached to each borrowed word in the body of learning from which it was taken and the meaning its use will convey to the judicial mind unless otherwise instructed.").

and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible."[3]

Dodd-Frank further states that the definition of 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 a part of a regular business."[4] The CFTC should clarify that, when read together with new Section 1a(49)(A)(iii) of the Commodity Exchange Act ("CEA"), this exception means that entities entering into swaps for hedging or speculative purposes -- but not as a part of a "regular business" of dealing -- should not be regulated as swap dealers.

In the context of the Exchange Act, the SEC and commentators have understood the concept of "business" to distinguish between a dealer, on the one hand, and a trader, on the other, even though the trader also "buys and sells for his or her own account with some frequency."[5] This distinction reviews the functional role of each in the market. Specifically, dealers have the following characteristics:

- A dealer tries to obtain a regular clientele and is apt to transact a substantial part of its business directly with investors, rather than with other dealers or exchange members;
- A dealer ordinarily holds itself out as one engaged in buying and selling securities at a regular place of business; and
- A dealer's business is characterized by regular turnover, while a trader's transactions are generally more irregular in volume and time.[6]

By contrast, traders generally do not handle other people's money or securities, and ordinarily do not furnish related services such as:

- Quoting the market;
- Rendering incidental investment advice;
- Extending or arranging for the extension of credit; and

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[3] Dodd-Frank § 712(a)(1).

[4] *Id.* § 721(a)(21) (CEA § 1a(49)(A)(C)).

[5] Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 814-15 (5th ed. 2004).

[6] *See id.* at 815.

- Lending securities to customers.[7]

The dealer-trader distinction applies similarly in the context of certain tax laws, where the key difference is whether the dealer serves, and is compensated for serving, an intermediary function.[8]

API recognizes that some securities-specific principles do not directly apply to the swaps market and its participants. For example, swap dealers may not have "inventory" in the way securities market participants understand that term.[9] Further, as the Commissions have recognized, swaps do not involve the purchase and sale of tangible or intangible property, but instead are notional contracts requiring the performance of agreed terms.[10] Thus, by nature of the ongoing relationship between parties, swaps may appear more frequently to involve the extension of credit. This should not necessarily render swap participants dealers based on the securities analysis. These differences do not, however, render the dealer-trader distinction inapposite.

API believes that the central principle that dealers serve primarily an intermediary function, and traders do not, applies equally to the swaps markets and should inform the CFTC's determination of which entities must register as swap dealers. Recognizing that the swaps market is highly varied as to participants and transactions, API proposes a few general principles

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[7] *See id.*

[8] *See Bielfeldt v. Comm'r of Internal Revenue*, 231 F.3d 1035, 1037 (7th Cir. 2000) (Posner, J.) ("The standard distinction between a dealer and a trader is that the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely, fluctuations in the market value of the securities or other assets that he transacts in. This is not to deny that a trader, whether he is a speculator, a hedger, or an arbitrageur, serves the financial system by tending through his activities to bring prices closer to underlying values, by supplying liquidity, and by satisfying different preferences with regard to risk; he is not a parasite, as the communists believed. But he is not paid for these services. His income from trading depends on changes in the market value of his securities between the time he acquired them and the time he sells them." (citations omitted)); *accord Marrin v. Comm'r of Internal Revenue*, 147 F.3d 147, 151 (2d Cir. 1998) ("A dealer is a person who purchases the securities or commodities with the expectation of realizing a profit not because of a rise in value . . . but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or markup represents remuneration for their labors as a middle man bringing together buyer and seller. . . . In contrast to dealers, traders are sellers of securities or commodities who depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. A trader performs no merchandising functions nor any other service which warrants compensation by a price mark-up." (quoting *United States v. Wood*, 943 F.2d 1048, 1051-52 (9th Cir. 1991) (internal quotation marks omitted))).

[9] *See* NOPR, 75 Fed. Reg. at 80,177.

[10] *See id.* at 80,176.

based on the functional distinctions used in the securities context. Specifically, the CFTC should consider that:

- Dealers often perform an intermediary role bringing together two sides to a trade;

- Dealers provide quotes to, and profit from engaging in swaps with, customers, while traders use swaps for underlying hedging, investment, or liquidity objectives driven by their businesses;

- Dealers attempt to keep a flat book remaining neutral to price movements with respect to swaps or their underlying commodities, while traders enter into swaps to hedge exposure to underlying positions associated with their business;

- Dealers respond to customer-initiated orders, while traders seek to enter into a particular position based on their business risks; and

- Dealers provide related services such as credit and investment advice, while traders do not.

Consistent with these proposed considerations, API believes that the swap dealer analysis should focus on the entities entering into swaps, and their reasons for doing so, not on the unique attributes of the products they use. As in the securities context, a swap dealer serves, and is compensated for serving, an intermediary function. It is therefore critical that the CFTC look to the purpose of swap transactions as part of the dealer analysis, so that large traders that enter into swaps, by contrast, for the purpose of hedging or mitigating commercial risk are not inadvertently considered swap dealers -- even to the extent they occasionally accommodate demand for swaps or have a significant number of non-dealer counterparties.

Some API members are large enough that they regularly engage in swaps activity but do so to manage portfolio and enterprise risks associated with commercial energy assets and obligations. At first glance, these companies' swaps activity may appear to fit the proposed definition of swap dealer. But these commercial firms differ from traditional swap dealers because their swaps activity is driven by the resources and risks of their underlying commodities business. With respect to API member firms, the securities law distinction between dealers and traders can be very useful in distilling which entities warrant regulation as swap dealers and which firms do not.

API therefore disagrees that unique features of swaps render irrelevant the factors used in the dealer-trader analysis. To be sure, as the NOPR states, "the parties [to a swap] are negotiating the terms of a contract, they are not negotiating the price at which they will transfer

ownership."[11] One consequence of this arm's length negotiation is that sophisticated commercial entities on both sides of a custom, bilateral swap seek to hedge or mitigate commercial risk or gain exposure to particular commodities, but not to profit from serving as a financial intermediary. Accordingly, one might expect to identify fewer dealers in the swaps markets than in the securities markets.

This is not a reason, however, to expand the concept of a "dealer" well beyond the Exchange Act understanding that Congress referenced in Dodd-Frank. To the contrary, if large traders pose systemic risk, Congress intended them to be regulated as major swap participants. Other than for major swap participants posing risk to the financial system, Congress did not intend to subject entities that enter into swaps for hedging or speculative purposes, but do not deal swaps, to registration, capital and margin, and business conduct regulation.

III. The General and *De Minimis* Exceptions Should Have Meaningful Scope and Application

Because the proposed definition of swap dealer is expansive, API urges the CFTC to adopt meaningful interpretations of the general and *de minimis* exceptions to the swap dealer definition. Exceptions with meaningful scope would provide clarity to commercial end users and ensure that additional, unnecessary regulation does not attach to beneficial hedging and speculative activity.

First, before analyzing the *de minimis* exception, the CFTC should give meaning to the general exception in new Section 1a(49)(C) of the CEA. In this regard, API believes that commercial end users that enter into swaps "but not as a part of a regular business" should be excluded from the swap dealer definition without reference to the *de minimis* exception. This is particularly important because the CFTC has proposed to define swap dealer broadly, and the *de minimis* exception narrowly, based on factors -- including aggregate effective notional exposure, number of counterparties, and number of swaps -- that do not easily differentiate dealers, which must be regulated, from large traders, which should not necessarily be regulated as dealers.

As noted above, API believes that the definition of swap dealer should not capture traders engaged in a large amount of swap activity for hedging or speculative purposes. As proposed, however, the definition of swap dealer encompasses traders that serve no intermediation function. Thus, the proposed definition prematurely shifts the analysis from which entities qualify as swap dealers to which entities qualify for either exception to the definition. The further definition of swap dealer should be precise enough to exclude businesses engaged in swaps to hedge or mitigate risk; it should not force those businesses to rely on the *de*

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[11] NOPR, 75 Fed. Reg. at 80,177.

minimis exception as the only means to escape the swap dealer label. API's proposed dealer-trader analysis would solve this problem by including within the definition of swap dealer only those firms appropriately regulated as dealers. The *de minimis* exception would then serve its distinct purpose of exempting from regulation those entities engaged in true swap dealer activity, but only at a level so small that additional regulatory burdens outweigh additional regulatory benefits.

Second, API agrees that "the '*de minimis*' exemption should be interpreted to address amounts of dealing activity that are sufficiently small that they do not warrant registration to address concerns implicated by the regulations governing swap dealers."[12] Under this standard, the proposed *de minimis* thresholds for aggregate effective notional amount, number of swaps, and number of counterparties are too low. Many companies that engage in limited amounts of swap dealing not raising systemic risk or customer protection concerns would nevertheless fall outside the proposed *de minimis* exception and be regulated as dealers under the proposed rule. These entities would therefore be forced either to register with the CFTC and incur significant new regulatory costs or to stop engaging in beneficial commercial activity. Both outcomes would, in turn, decrease liquidity, increase market volatility, divert capital from beneficial projects, and ultimately raise prices for consumers. Rather than setting these proposed low thresholds for the *de minimis* exception, API urges the CFTC to implement the exception in a manner that achieves Dodd-Frank's objectives without imposing unnecessary costs on beneficial commercial activity.

Because Dodd-Frank is primarily concerned with addressing systemic risk, the CFTC should focus the *de minimis* exception on those entities that engage in a relatively small amount of customer-facing swap transactions. For these entities, additional regulation as a swap dealer adds additional cost without any corresponding reduction of systemic risk. Specifically, API suggests that the CFTC define the *de minimis* exception by reference to an entity's dealing activity, as defined in Section II above, as a percentage of the notional value of the overall swaps market. Although this refined *de minimis* exception would enable the CFTC to identify which entities must be regulated as dealers to address systemic risk, it would not impose unjustified costs on market participants whose customer activity represents a relatively small piece of the market and is therefore less likely to create a systemic event. API further believes that such an approach would not raise the customer protection concerns that appear to motivate the CFTC's proposed thresholds for number of swaps and number of counterparties. Because API members enter into swaps with other sophisticated entities that qualify as eligible contract participants, there would be minimal benefit, but substantial cost, to swap dealer regulation.

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[12] *Id.* at 80,179.

IV. The Cost of New Regulatory Burdens Outweighs the Benefits of Regulating Commercial End Users as Swap Dealers

Section 15(a) of the CEA requires the CFTC to "consider the costs and benefits of the action of the Commission." API commends the CFTC for recognizing that the proposed definition will require entities to review their swap activities to determine whether they must register as swap dealers. API urges the CFTC to engage with market participants as it endeavors to estimate the costs of the proposed rules.

API appreciates the CFTC's sensitivity to the fact that its "qualitative" definition of swap dealer, which may result in "multiple interpretations . . . by market participants," will cause additional expense.[13] API believes that the cost of regulatory uncertainty stems not just from the CFTC's use of qualitative factors for identifying dealing, but also from the agency's effort to reach beyond true swap dealers. If the CFTC truly seeks to "efficiently achieve the purposes underlying Title VII of the Dodd-Frank Act -- to reduce risk and to enhance operational standards and fair dealing in the swap markets,"[14] then it should focus its efforts on those entities whose dealing activities inject risk into the market and who benefit from market power disparities with customers. For these true swap dealers, registration, business conduct, and capital and margin requirements are entirely appropriate to fulfill Dodd-Frank's purposes. For other market participants engaged in swaps activity only to maximize the efficiency of their primary commercial business, the new regulatory requirements do not yield the same risk reduction and fair dealing benefits.

API therefore proposes that, as with the proposed rule on position limits, the CFTC should identify swap dealers in two phases. *First*, rather than attempting to capture many additional entities that engage in a limited amount of swap dealing in connection with hedging or mitigating their commercial risk, the CFTC should start by defining and regulating traditional swap dealers. Applying requirements to those true dealers Dodd-Frank intends to regulate will yield the greatest benefits to the market. *Then*, the CFTC should engage in a rigorous analysis of the costs and benefits of regulating other entities that engage in limited swap dealing in connection with hedging or mitigating commercial risk. For these market participants, the CFTC should only expand the definition of swap dealer where it is clear that the benefits will outweigh the significant costs imposed by the designation.

The proposed *de minimis* exception rule also imposes unwarranted costs. The NOPR states that "[t]he proposal regarding the *de minimis* exemption . . . would impose lower

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[13] *Id.* at 80,204.

[14] *Id.* at 80,177.

costs because of the precise, quantitative nature of the proposed exemption."[15] By setting such low *de minimis* thresholds, however, the CFTC has imposed compliance costs on commercial end users whose limited dealing activity raises no systemic risk or customer protection concerns. These entities will be required to institute new monitoring and compliance programs to make sure their swap activity continues to fall below the *de minimis* thresholds. Higher and more tailored thresholds would give commercial end users greater comfort and decrease the burden of complying with CFTC regulation.

API commends the CFTC for recognizing that "[t]he proposed regulations further defining swap dealer and major swap participant are significant because any entity determined to be a swap dealer or major swap participant would be subject to registration, margin, capital, and business conduct requirements."[16] These substantive regulations will impose still greater costs on commercial end users required to register as swap dealers. An unmeasured, regulate-them-all approach that subjects entities engaging in limited swap activity to capital, margin, and business conduct requirements may drive those entities away from the market, potentially decreasing liquidity and increasing volatility. Indeed, the smallest swap dealers that are least able to bear new regulatory costs will be the first to drop out of the market. This will likely result in fewer potential counterparties and a short-term strain on liquidity. In the longer term, a reduction in the number of market participants could serve to concentrate systemic risk among traditional swap dealers.

Ultimately, the potential for additional regulation of commercial firms will add unnecessary compliance costs that will divert capital from beneficial projects and commercial investments. For example, new regulatory costs may cause energy companies to forego important exploration and resource development, and would ultimately result in higher energy prices for consumers. Particularly with respect to commercial end users of swaps, API urges the CFTC to include these considerations in its required cost-benefit analysis.

V. Inter-affiliate Swaps Should Not Be Considered in Identifying Swap Dealers

API urges the Commissions to clarify that they will not consider swaps among wholly owned or controlled affiliates for purposes of identifying whether an entity is a swap dealer. API agrees with the Commissions' suggestion that "[i]n determining whether a particular legal person is a swap dealer or security-based swap dealer, . . . it would be appropriate for the person to consider the economic reality of any swaps and security-based swaps it enters into with affiliates (*i.e.*, legal persons under common control with the person at issue), including whether those swaps and security-based swaps simply represent an allocation of risk within a corporate

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[15] *Id.* at 80,204.

[16] *Id.* at 80,203.

group."[17] API further agrees that "[s]waps and security-based swaps between persons under common control may not involve the interaction with unaffiliated persons that we believe is a hallmark of the elements of the definitions that refer to holding oneself out as a dealer or being commonly known as a dealer."[18] While API generally supports these statements, we urge the Commissions to make clear that only swap transactions with unrelated entities will be considered in determining swap dealer designation.

Congress did not intend for the swap dealer definition to capture companies that enter into swaps to allocate risk among affiliates. The Senate debates make this clear. There, Senator Collins stated, "I want to make clear that it is not Congress' intention to capture as swap dealers end users that primarily enter into swaps to manage their business risks, including risks among affiliates."[19] Senator Dodd confirmed this understanding and further clarified that "the bill is clear that an end user does not become a swap dealer by virtue of using an affiliate to hedge its own commercial risk."[20]

Consistent with congressional intent, the Commissions should state clearly in the final rule that swaps used to allocate risk among affiliates will not render an entity a swap dealer.

VI. Conclusion

For the reasons described in these comments, API urges the Commissions to clarify that market participants will not be considered swap dealers subject to costly new capital, margin, and business conduct requirements. In the case of API members, these regulatory burdens would result in higher energy costs for consumers with no benefit to the financial system. The Commissions should therefore clarify that they will distinguish between swap dealers and swap traders based on principles similar to those used in securities law; expand the scope of the general and *de minimis* exceptions to the swap dealer definition; and engage in a meaningful cost-benefit analysis before imposing new regulatory and compliance burdens on commercial end users.

API appreciates the opportunity to provide these comments. We would be pleased to provide additional information regarding our views on the proposed rule, and would welcome the opportunity to work with the Commissions. Please contact me or Brian Knapp at (202) 682-8172 if you have any questions.

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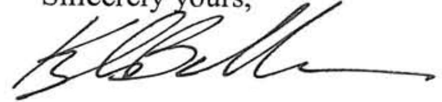
[17] *Id.* at 80,183.

[18] *Id.*

[19] 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (statement of Sen. Collins).

[20] *Id.* (statement of Sen. Dodd).

Sincerely yours,



Kyle B. Isakower
Vice President
Regulatory and Economic Policy
American Petroleum Institute

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner