

February 22, 2011

**Via Online Submission**

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

Re: COMMENTS OF THE COALITION OF PHYSICAL ENERGY COMPANIES - Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, RIN No. 3038-AD25.

Dear Mr. Stawick:

On December 22, 2010, the Commodity Futures Trading Commission ("CFTC" or the "Commission") issued a Notice of Proposed Rulemaking for the purpose of establishing "Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties."<sup>1</sup> In the NOPR, the Commission proposes specific requirements for interactions between Swap Dealers and Major Swap Participants and their non-regulated counterparties in order to implement a new section of the Commodity Exchange Act ("CEA"),<sup>2</sup> § 4s(h), that was added by § 731 of Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").<sup>3</sup> New § 4s(h) provides the CFTC with "both mandatory and discretionary rulemaking authority to impose business conduct requirements on swap dealers and major swap participants in their dealings with counterparties."<sup>4</sup>

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<sup>1</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80638 (December 22, 2010) (the "NOPR").

<sup>2</sup> Public Law No. 74-765, 49 Stat. 149 (1936).

<sup>3</sup> Public Law No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank").

<sup>4</sup> NOPR at 80639.

The Coalition of Physical Energy Companies ("COPE")<sup>5</sup> members are engaged in the physical energy businesses of producing, merchandizing, and/or processing natural gas, oil, and refined products at wholesale and retail. They regularly enter into swaps to hedge the commercial risk of their physical businesses. While COPE understands that Dodd-Frank requires that the Commission supervise Swap Dealers and Major Swap Participants (collectively, "Dealers"), COPE is concerned that aspects of the NOPR may increase Dealer costs (which will be passed on to end-users) and have a chilling effect on their Dealer counterparties' ability to engage in normal commerce as counterparties to physical energy end-users.

**The Commission Should Not Impose Standards of Conduct That Will Have a Chilling Effect on Commerce or Raise Costs to End-Users**

As proposed by the Commission, the NOPR treats COPE members' Dealer counterparties more like broker-dealers or securities issuers than counterparties in bilaterally negotiated, arms-length swaps transactions. COPE is concerned that the self contradictory role of acting both as an agent/advisor and counterparty pursuant to the proposed regulations will have a chilling effect on commerce and raise costs. Due to the pervasive disclosure requirements; best execution; institutional suitability requirements; and other broker/dealer type obligations, Dealers may need to turn over the commercial dialogue that they regularly have with their counterparties from sales desks to compliance departments in order to assure regulatory compliance. As implied by the NOPR, in an effort to act in compliance with the proposed regulations, Dealers may be forced to rely on "canned" risk disclosures, coupled with instructions to personnel to read from an approved script to avoid a violation.<sup>6</sup> Such compliance will have the effect of raising Dealer costs, as they will undoubtedly need to hire more compliance personnel to police disclosures and "watch what the desk is saying" while limiting the useful dialogue that occurs today.

A COPE member's typical interaction with its Dealer counterparties in the current regulatory environment is not one of victim and victimizer. COPE members are sophisticated market participants with swaps requirements large enough to cause Dealers to compete for their business. COPE's experience is, to paraphrase a current advertisement,

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<sup>5</sup> The members of the Coalition of Physical Energy Companies are: Apache Corporation; Competitive Power Ventures, Inc.; El Paso Corporation; Iberdrola Renewables, Inc.; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; Shell Energy North America (US), L.P.; and SouthStar Energy Services LLC.

<sup>6</sup> See, e.g., NOPR at 80643-80644 ("Appropriate disclosures should consider the effect of future economic factors and other material events that could cause the swap to experience . . . losses."); ("Swap dealers and major swap participants [are required] to disclose to their counterparties material information about the risks, characteristics, incentives and conflicts of interest regarding a swap."). COPE is concerned that such vague and generalized risk disclosure requirements would not only be of little value to sophisticated swaps market participants, but would also chill open communication between counterparties as Dealers become concerned about constant compliance with the letter of disclosure regulations in all commercial communications.

"when banks compete, you win." COPE members can attest to the fact that Dealer competition to transact with COPE members in the swaps markets is robust.

When COPE members execute swaps, eligible Dealer counterparties compete against each other to offer the best pricing. In general, Dealers are viewed as producers of a fungible product (a swap or other commodity derivative), rather than brokers acting on behalf of COPE members to identify well-priced third party products. Dealers are counterparties, not agents. The Commission regulations implementing new § 4s(h) of the CEA must not interfere with this competition or increase the cost of the product. As proposed, it appears to COPE that the regulations will do both. As the Commission itself acknowledges, "Congress granted the Commission broad discretionary authority to promulgate business conduct requirements, as appropriate in the public interest, for the protection of investors . . . ." <sup>7</sup> COPE requests that the Commission use its discretionary authority to offer protections to entities like COPE members in a manner that will not chill efficient commerce relating to members' abilities to efficiently hedge and mitigate the commercial risks of their physical businesses or that will drive up the cost of doing business.

The NOPR apparently seeks to establish a disclosure process that is the swaps equivalent of a regulated securities issuer putting out a prospectus or other offering document. <sup>8</sup> These disclosures would not result from market needs but, rather, from discretionary regulation. In this environment, Dealers will likely work hard to ensure that they have made required disclosures concerning their products to avoid CFTC enforcement risk and lawsuits from counterparties. COPE is concerned that the proposed disclosure process could very well turn into a scripted communication where a Dealer will effectively say to counterparties, "read this," or simply read from a canned compliance script, while conversations about market conditions or other matters affecting the swap would be limited because that would require a Dealer's compliance personnel to evaluate what, if any, further disclosures would be needed. Open communication between Dealers and counterparties would be frustrated, since all communications from the Dealer would require vetting to ensure that all required disclosures are being made on an ongoing basis and that the letter of the Commission's business conduct standards are being followed.

The over-the-counter ("OTC") swap market does not need a securities law overlay. Unlike public securities, which are issuer-specific and reflect the value of the offering firm, commodity swaps relate to underlying cash markets in which the notional product is fungible. The market, therefore, offers information and protection to the sophisticated counterparty that may not be available to an investor seeking to purchase securities.

COPE is not sure what value the Commission believes mandatory "canned" disclosures will have in the OTC swaps market. Market participants that would benefit from such disclosures are likely to be too unsophisticated to be in the market at all. On the other

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<sup>7</sup> *Id.* at 80639.

<sup>8</sup> *See id.* at 80643-80644.

hand, COPE believes that market participants with OTC swap market experience will receive no benefit. The same is true for the proposed requirement that Dealers inform counterparties of the terms and conditions of their bilaterally negotiated ISDA Agreements and confirmations.<sup>9</sup>

Similarly, COPE is unclear as to what the proposed Institutional Suitability requirements mean for its members.<sup>10</sup> It appears that Dealer counterparties will be required to evaluate COPE member businesses to determine if swaps are "suitable" for them. This requirement appears to be another potential litigation-producing provision under which commercially dissatisfied counterparties can assert that they entered into an "unsuitable swap." Other aspects of the NOPR, such as "best execution" requirements, that have their foundation in the broker/dealer world, will further complicate the current counterparty relationship. COPE is concerned that such requirements are likely to have the effect of raising costs to its members.

Finally, to the degree the NOPR is based upon FCM or IB roles in futures markets, it is similarly misguided. Those entities are brokers, not counterparties. The proposed rules should oversee a counterparty relationship.

COPE believes that the Commission should refocus these rules to the swaps market. The apparent wholesale adoption of a broker/dealer model will only increase costs to end-users and chill commerce.

### **The NOPR's Anti-Fraud, Fair Dealing and Transparency Requirements Should Be Revised to Comport With the OTC Swap Market**

COPE has no concerns about aspects of the NOPR prohibiting Dealers from manipulating markets, defrauding their counterparties, and requiring "fair dealing."<sup>11</sup> Further, COPE does not object to Dealers being required to disclose conflicts of interest. This seems to be embedded in the concept of "fair dealing." COPE also does not object to receiving scenario analysis or daily mark upon the non-regulated counterparty request of a Dealer as these elements may enhance transparency and may not be replicatable by physical energy end-users. COPE also does not object to its Dealer counterparties informing members of their option to clear.

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<sup>9</sup> *See id.* at 80645.

<sup>10</sup> *See id.* at 80647, 80659.

<sup>11</sup> *See id.* at 80642.

However, in implementing such provisions, the Commission cannot rely on securities or broker/dealer principles because, as stated above, swaps are not securities and Dealers are not brokers.<sup>12</sup>

### **Conclusion**

COPE appreciates that the Commission desires to provide enhanced protections to Dealers' counterparties in implementation of new § 4s(h) of the CEA. However, in doing so, the Commission must tailor its rules to the OTC swap market. The proposed rules should not increase end-user costs or chill commerce. They should enhance a robust swaps market with a free flowing dialogue between counterparties seeking to achieve mutually-agreed transactions in a dynamic market.

Respectfully,

/s/ David M. Perlman

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cc: COPE Members

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<sup>12</sup> See Comments of the Coalition of Physical Energy Companies to Commission NOPR – Prohibition of Market Manipulation, RIN No. 3038-AD27, submitted January 3, 2011.