

April 4, 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 –  
**Commodity Options and Agricultural Swaps**, RIN No. 3038-AD21

Dear Mr. Stawick:

By Federal Register Notice dated February 3, 2011, the Commodity Futures Trading Commission ("CFTC" or "the Commission") issued a notice of proposed rulemaking concerning Commodity Options and Agricultural Swaps ("Options NOPR" or "NOPR").<sup>1</sup> In the Options NOPR, the Commission makes the notable finding that "Commodity Options are Swaps."<sup>2</sup> Based upon this finding, the Commission proposes a set of regulations entitled "Regulation of Commodity Option Transactions."<sup>3</sup>

The Coalition Of Physical Energy Companies ("COPE")<sup>4</sup> hereby provides comments on the Options NOPR. The members of COPE are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale. COPE members utilize swaps and futures to hedge the commercial risk of their physical businesses. COPE believes that, contrary to the view expressed in the NOPR, commodity options are not swaps.

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<sup>1</sup> Commodity Options and Agricultural Swaps, 76 Fed. Reg. 6095 (Feb. 3, 2011).

<sup>2</sup> NOPR at 6097.

<sup>3</sup> *Id.* at 6108 (proposed § 32).

<sup>4</sup> The members of the Coalition of Physical Energy Companies are: Apache Corporation; 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.

## I. THE PROPOSED REGULATIONS WOULD DEFINE SWAP TOO BROADLY

As noted by the Commission, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")<sup>5</sup> establishes a regulatory regime for the previously unregulated Over-the-Counter ("OTC") swaps market.<sup>6</sup> Among the responsibilities placed upon the Commission by Dodd-Frank is to propose and implement regulations further defining the term "swap."<sup>7</sup> In August 2010, the Commission issued an Advanced Notice of Proposed Rulemaking which sought input on this definition together with other "key definitions."<sup>8</sup> In December 2010, the Commission issued a proposed rule covering all of the key definitions other than that of "swap."<sup>9</sup>

Notwithstanding the fact that the Commission has not proposed a definition of the term "swap," the instant NOPR asserts that a commodity option (other than an option on a future ) is a swap.<sup>10</sup> COPE disagrees with the Commission's finding and requests that the Commission suspend action on the Options NOPR until it proposes a definition of swap. This NOPR is clearly putting the cart before the horse.

Assuming the Commission intends to move forward with the NOPR, COPE provides the following comments. As defined by the Commission, an option is:

**Option:** A contract that gives the buyer the right, but not the obligation, to buy or sell a specified quantity of a commodity or other instrument at a specific price within a specified period of time, regardless of the market price of that instrument.<sup>11</sup>

Thus, in the energy industry, an option would be the right to require the physical delivery of a commodity such as electricity or natural gas at a specified delivery point, at a specified time, and at a specified price.<sup>12</sup> These transactions can take the form of put and call options, tolling

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<sup>5</sup> Public Law No. 111-203, 124 Stat. 1376 (2010).

<sup>6</sup> Dodd-Frank § 701

<sup>7</sup> *Id.* at § 721(c) (as codified at 15 U.S.C § 8321).

<sup>8</sup> Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51429 (Aug. 20, 2010).

<sup>9</sup> Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174 (Dec. 21, 2010).

<sup>10</sup> NOPR at 6097-98.

<sup>11</sup> *CFTC Glossary, A Guide to the Language of the Futures Industry*, 41 (visited Mar. 25, 2011), <http://www.cftc.gov/ucm/groups/public/@educationcenter/documents/file/cftcglossary.pdf>. ("CTFC Glossary").

<sup>12</sup> *See*, Edison Electric Institute, *Master Power Purchase and Sales Agreement* (Apr. 25, 2000) at 9, in which "Option" is defined as "the right but not the obligation to purchase or sell a Product as specified in a Transaction" and "Product" is defined as "electric capacity, energy or other product(s) related thereto as specified in a Transaction by reference to a Product listed in Schedule P hereto or as otherwise specified by the Parties in the Transaction." Further, the agreement contemplates that all

agreements, purchased power agreements with demand charges, or other structures. These agreements are often subject to oversight by regulators such as the Federal Energy Regulatory Commission ("FERC").

As understood by COPE, Dodd-Frank specifically excluded physically settled transactions from the definition of "swap." The above-mentioned option transactions are all intended to be physically settled and should not be considered swaps. Section 721 of Dodd-Frank states:

EXCLUSIONS.—The term 'swap' does not include— [...] (ii) any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.<sup>13</sup>

The Commission should refrain from expanding the statutory definition of swap. As understood by COPE, swaps are financially settling agreements.

In addition to being excluded from the definition of "swap" by Dodd-Frank, a physically settled option cannot be cleared as generally required by Dodd-Frank. In a cleared transaction, a trader's counterparty is the clearinghouse. Clearinghouses do not have the capability to make or take delivery as needed for a physical option. Given that physical options typically have a daily strike and require significant coordination between buyer and seller, it would be logistically impossible for a clearinghouse to somehow stand in the middle of a trade and direct traffic. Of course, issues of delivery failure or other logistical problems would necessarily entangle a clearinghouse in litigation involving a physical seller and buyer in the delivery chain.

Moreover, as noted above, many physical options are jurisdictional to physical energy regulators such as FERC. If physical options are swaps, clearinghouses will need to become FERC-regulated public utilities.

Thus, for the foregoing reasons, the Commission must limit its jurisdiction with respect to the definition of "swap" in accordance with the intent of Congress that transactions intended to be physically settled are not swaps.

The Commission has also defined a "swaption" as follows:

Swaption: An option to enter into a swap—i.e., the right, but not the obligation, to enter into a specified type of swap at a specified future date.<sup>14</sup>

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transaction are made pursuant to a FERC-jurisdictional tariff. *See, Master Power Purchase and Sales Agreement* at Cover Sheet.

<sup>13</sup> Dodd-Frank § 721(a)(21) (as codified at 7 U.S.C. § 1(a)(47)(B)).

<sup>14</sup> CFTC Glossary at 53.

Unlike a commodity option, a commodity swaption is not intended to settle physically. It, like a swap, is intended to settle financially. Simply put, a commodity option is not a swap, while a commodity swaption is a swap.

## **II. THE PROPOSED ANTI-FRAUD REGULATION IS REDUNDANT AND SHOULD REQUIRE THE ELEMENT OF INTENT**

The Options NOPR includes a provision relating to "fraud in connection with commodity option transactions."<sup>15</sup> COPE believes that this provision should be deleted from any final rule or, at a minimum, modified to require intent.

As stated above, COPE requests that the Commission find that, unlike swaptions, commodity options are not swaps. In the event the Commission disagrees, it should eliminate its proposed anti-fraud provision, Section 32.9, from the final rule or modify it to include the element of intent. If the Commission determines commodity options are swaps, it already has a proposed rule to address fraud.<sup>16</sup> That proposed rule will more than cover the conduct to be addressed by Section 32.9, and these redundant provisions for "different flavors of swaps" will only create confusion.

If the Commission nonetheless moves forward to include Section 32.9, it must modify it to require intent. As proposed Section 32.9 states (with emphasis added):

It shall be unlawful for any person directly or indirectly:

(a) To cheat or defraud or attempt to cheat or defraud any other person;

*(b) To make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof; or*

(c) To deceive or attempt to deceive any other person by any means whatsoever; in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction.

Proposed Section 32.9 (b) would sanction the making of a false report or statement regardless of intent. However, it is obvious from the proposal that the Commission intended to only sanction fraud, which requires intent. As such, COPE requests that the Commission modify Section 32.9 (b) to only cover statements that are *knowingly false* and *are made with the intent to defraud*. Any other "strict liability" standard would be inappropriate and inconsistent with the behavior the Commission intends to sanction and prevent.

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<sup>15</sup> See NOPR at 6102; *see also* proposed § 32.9.

<sup>16</sup> See Prohibition of Market Manipulation, 75 Fed. Reg. 65657 (Nov. 3, 2010) (proposed §§ 180.1, 180.2).

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### III. CONCLUSION

The Commission should suspend this Options NOPR until it issues a separate NOPR that propose a definition of the term "swap." However, if the Commission determines to move forward with the Options NOPR, it must make clear that no physically settled agreements are covered, included in any rule pertaining to swaps. Further, the Commission should eliminate the proposed anti-fraud provision as redundant. If it retains the provision, it should revise it to require the element of intent.

Respectfully submitted,

/s/ David M. Perlman

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cc: COPE Members