

April 11, 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 (COPE)  
Swap Trading Relationship Documentation Requirements for Swap Dealers and  
Major Swap Participants, RIN No. 3038-AC96**

Dear Mr. Stawick:

The Coalition of Physical Energy Companies ("COPE") hereby provides comments to the Commodity Futures Trading Commission's ("CFTC" or "the Commission") proposed rules concerning "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants" (the "NOPR" or "Documentation NOPR") published in the Federal Register on February 8, 2011.<sup>1</sup>

The members of COPE are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale.<sup>2</sup> COPE members utilize swaps to hedge the commercial risk of their physical businesses. COPE members often transact swaps with entities that will likely be Swap Dealers and Major Swap Participants under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act").<sup>3</sup> Accordingly, the Documentation NOPR will impact COPE members as contract parties.

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<sup>1</sup> *Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 6715 (Feb. 8, 2011).

<sup>2</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.

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

The Documentation NOPR was issued by the Commission to comply with Section 731 of Dodd-Frank. Section 731 provides "the Commission shall adopt rules governing documentation standards for Swap Dealers and Major Swap Participants."<sup>4</sup> The topics referenced by the Act include "timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps."<sup>5</sup>

COPE members are end-users of swaps that use these instruments to mitigate or hedge the commercial risks of their physical businesses. It is important to COPE that the members' existing swap documentation, typically ISDA Master Agreements,<sup>6</sup> are not disrupted by the proposed rules set forth in the NOPR. COPE members are particularly concerned that the credit-related provisions of their agreements may be brought into question or required to be altered by the proposed rules. As end-user counterparties of Swap Dealers and Major Swap Participants, COPE members are not aware of any current issues with swap documentation typically in use today. It is well understood and legally sound.

In addition, the NOPR proposes to place certain documentation requirements on end-users. That requirement, to provide as-yet undefined documentation to Swap Dealers and Major Swap Participants, is redundant to other proposed CFTC regulations and will be disruptive to trading. COPE requests it be deleted from any final rule.

Finally, COPE requests that the Commission confirm that non-conformance with any final rule by Swap Dealers and Major Swap Participants will not affect the enforceability of a swap or master agreement.

### **The Commission Should Confirm that ISDA Agreements and Related Swaps Satisfy the Rules**

COPE members typically execute swaps pursuant to ISDA Agreements.<sup>7</sup> As a general matter, prior to trading, an ISDA will be negotiated to create a vehicle to effectuate a trading relationship in which general commercial terms can be agreed up front, leaving only trade-specific matters to be included in a transaction.<sup>8</sup> Critical to the "up front" negotiation are the credit-related aspects of the trading relationship. Credit review and associated arrangements are typically comprehensive and fully negotiated.

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<sup>4</sup> Dodd-Frank at § 731 as codified at 7 U.S.C. § 4s(i)(2).

<sup>5</sup> *Id.*

<sup>6</sup> See *International Swap Dealers Association Master Agreement (Multicurrency-Cross Border) (1992 & 2002)* ("ISDA" or "ISDA Agreement").

<sup>7</sup> Swaps are also documented on long-form confirmations.

<sup>8</sup> A long-form transaction will typically be used with a counterparty that does not have an existing ISDA to promptly document a transaction.

In contrast to the process to put a master agreement in place, swaps in volatile energy markets are often entered into on a "real-time basis" rather than after lengthy negotiation. Some more structured swaps may require a negotiation period. COPE members enter into swaps directly with counterparties and through brokers and trading platforms such as the Intercontinental Exchange. Generally, swaps are entered into over the course of a day and are subject to a written confirmation sent, at the earliest, at the close of business on the same day. Further, pursuant to the ISDA, swap transactions are binding when made orally with the confirmation process serving to provide a *written confirmation* of a transaction.

Given this existing documentation structure, COPE requests that the Commission make clear in its final rules based on the NOPR that:

- ISDA Agreements or any substantially similar master agreements satisfy the documentation requirements of the final rules;
- in accordance with the ISDA Agreements and applicable state law,<sup>9</sup> swaps are binding when made orally; and
- long-form confirmations that contain all requisite legal terms to establish a binding agreement also satisfy the requirements of the final rules.

### **Margin and "Haircut" Determinations Should Be Agreed by Counterparties**

As noted above, a critical aspect of the trading relationships COPE members have with their Swap Dealers and Major Swap Participants counterparties is the credit arrangements agreed to in an ISDA Agreement. As the Commission knows, issues relating to appropriate collateral and margin requirements that may be imposed on end-users remain significant outstanding issues on the Commission's Dodd-Frank agenda. Chairman Gensler has testified before Congress that the Commission does not intend to impose regulatory requirements relating to margin on end-users. Specifically, the Chairman has said that "[r]ules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users."<sup>10</sup>

Accordingly, COPE requests that the Commission make clear in the provisions regarding credit documentation that the language relating to initial and variation margin<sup>11</sup> and asset "haircuts"<sup>12</sup> are not mandates to Swap Dealers and Major Swap Participants. Instead, the Commission should clarify that these provisions require that while trading documentation must include any applicable margin requirements, those margin requirements should only be those agreed to between the Swap Dealer or Major Swap Participant and an end-user counterparty. Similarly,

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<sup>9</sup> See, e.g., N.Y. Gen. Oblig. Law § 5-701 (2006).

<sup>10</sup> Gary Gensler, Testimony Before the U.S. Senate Committee on Agriculture, Nutrition & Forestry (Mar. 3, 2011).

<sup>11</sup> NOPR at 6726 (proposed as § 23.504(b)(3)).

<sup>12</sup> *Id.*

while trading documentation should recognize the types of collateral acceptable under its terms, a "haircut," if any, to the value of the collateral should only be to the extent agreed between the Swap Dealer, or Major Swap Participant, and an end-user. In no way should the Documentation NOPR impose any substantive credit requirements.

### **Swap-by-Swap Valuations Should Not Be Required**

The Documentation NOPR proposes to require that the parties to swap trading documentation include provisions in which they "agree on the methods, procedures, rules, and inputs for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap[;] [t]o the maximum extent practicable, the valuation of each swap shall be based on objective criteria..."<sup>13</sup> COPE respectfully requests that the Commission omit this aspect of the NOPR from the final rule.

COPE members use swaps to hedge the risk of their commercial businesses. In doing so, and in accordance with current market practice, they fully consider their hedging needs, pricing trends, market projections, and other relevant data and enter into legally binding swaps. Valuation of exposures with counterparties is conducted on a total book level. COPE members have found that this process is efficient and effectively addresses credit needs associated with ISDAs. COPE is not aware of any business need for swap-by-swap valuation formulas.

The new requirement proposed by the Documentation NOPR not only lacks commercial value, but it is also likely to disrupt trading. Parties enter into swaps in dynamic markets where prices are constantly changing. It is unlikely that counterparties can "hold a price" to negotiate swap-specific valuation formulas while the market is moving. Any requirement to negotiate formula-derived swap valuations will create an unnecessary and potentially disruptive burden on today's well-functioning process.

In addition, since the forward valuation of a swap is often as much an art as it is a science, it is likely not susceptible to being accurately reduced to a formula that can be objectively calculated. Forward market value typically has an element of subjectivity and expert judgment. A forward curve for energy commodities is composed of available market data from constantly changing liquid markets coupled with traders' informed market view.<sup>14</sup> In commodity markets, the use of a formula would result in an outcome that meets a regulatory requirement but would be unlikely to accurately value the transaction.

Energy prices are affected by numerous economic factors. These include: short-term and long-term supply and demand fundamentals; weather trends; public policy determinations on federal, state, and international levels (including items such as greenhouse gas issues); technological

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<sup>13</sup> *Id.* at 6726 (proposed as § 23.504(b)(4)).

<sup>14</sup> If the Commission would accept a valuation technique that stated "the parties will utilize agreed-upon data from liquid markets to the degree possible to value the transaction," COPE would have no objection to the NOPR's proposal on this point.

innovations; cost of capital for infrastructure investment and drilling, etc.; unexpected events (Japanese nuclear issues/Gulf of Mexico drilling issues); overall economic activity; local economic activity; and many other factors. Possibly the only reliable conclusion to be drawn about forward energy prices over the last thirty years is that *the conventional wisdom is always wrong*.

As the examples above demonstrate, energy markets are affected by a myriad of highly unpredictable, interrelated, and dynamic factors. That is why energy market participants hedge their price risks. There is simply no basis to believe that counterparties could agree upon a formula that could accurately show the forward value of energy commodities for a meaningful forward period. Any such formula would amount to "false precision" and would quickly be rendered meaningless by changed circumstances. The only useful metric traders can use to predict forward prices is the then-current liquid market because that is where there is "agreement" on a forward price, as parties will transact at that price. That metric must be coupled with judgment to create a forward curve.

Given the foregoing, COPE requests that the Commission omit any swap-by-swap valuation requirement from any final rule. There is no commercial purpose to such a requirement, and it is not possible or desirable to craft an objective formula to value a swap which will likely be rendered stale by changing events.

### **End-Users Should Not Be Required To Provide Documentation To Swap Dealers**

The proposals in the Documentation NOPR go beyond the mandate of Section 731, in part by imposing documentation requirements on end-users that elect not to clear a swap pursuant to Section 723 of Dodd-Frank.<sup>15</sup> The Commission has proposed:

*For swaps excepted from a mandatory clearing requirement.* Each swap dealer and major swap participant shall obtain documentation sufficient to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement...<sup>16</sup>

The proposed requirement is burdensome and redundant to other regulations imposed by Dodd-Frank and proposed by the Commission. The requirement is also anti-competitive as it obligates end-users to share proprietary commercial information with potential competitors. As such, it should not be part of any final rule.

Pursuant to Section 723 of Dodd-Frank, the Commission has already proposed a rule according to which an end-user, each time it elects to opt out of clearing, must attest to its legitimate ability to do so under the requisite statutory criteria.<sup>17</sup> While that attestation is effectively made to the

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<sup>15</sup> See Dodd-Frank § 723, as codified at 7 U.S.C. § 2(h)(7) (exception to clearing requirement).

<sup>16</sup> NOPR at 6726 (proposed as § 23.505(a)).

<sup>17</sup> See *End-User Exception to Mandatory Clearing of Swaps*, 75 Fed. Reg. 80747 (Dec. 23, 2010).

Commission, it is relayed by the end-user's counterparty by virtue of the reporting requirements proposed by the Commission.<sup>18</sup> Given the existing process already proposed by the Commission, there is no need for the above-referenced end-user documentation requirement proposed in the Documentation NOPR.

Further, the proposal requires an end-user to provide "a reasonable basis on which to believe that its counterparty meets the statutory conditions."<sup>19</sup> This requirement places the Swap Dealer/Major Swap Participant in the role of a regulator with the job of determining whether the end-user counterparty has "reasonably" met the statutory criteria. This role is inappropriate on two levels.

First, it is inappropriate to assign an end-user's commercial counterparty the role of assessing end-user compliance with statutory criteria.<sup>20</sup>

Second, in energy markets, Swap Dealers and Major Swap Participants are often competitors of energy company end-users. Major banks are active in physical natural gas, oil, and electricity markets, and compete for transactions with energy companies in addition to providing them with financial hedges.

Swap Dealer/Major Swap Participant counterparties to end-users must know that their end-user counterparty is electing not to clear a swap as permitted by Dodd-Frank. However, it is inappropriate to require an end-user to inform its Swap Dealer/Major Swap Participant counterparty (and potential competitor) of other proprietary details about its business, including its hedging activities.

Accordingly, the Commission should omit the end-user exception documentation provision in any final rule issued after the NOPR.

### **The Commission Should Ensure that Legal Certainty Will Apply to Swaps**

Dodd-Frank contains Section 739, *Legal Certainty For Swaps*,<sup>21</sup> the purpose of which is to make clear that the failure to meet certain requirements of Dodd-Frank would not affect the enforceability of a swap. COPE believes that Section 739 or a similar administrative confirmation should apply to these proposed regulations under the NOPR.

Therefore, COPE requests that the Commission make clear that Section 739 does apply to the proposed regulations, or that Swap Dealer/Major Swap Participant noncompliance with the final

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<sup>18</sup> See *Swap Data Recordkeeping and Reporting Requirements*, 75 Fed. Reg. 76753 (Dec. 8, 2010).

<sup>19</sup> NOPR at 6726 (proposed as § 23.505(a)).

<sup>20</sup> COPE would be surprised if Swap Dealer and Major Swap Participants wanted this role to begin with.

<sup>21</sup> Dodd-Frank at § 739, as codified at 7 U.S.C. § 25(a).

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rule resulting from the Documentation NOPR will not otherwise affect the enforceability of a swap. In the event the Commission does not believe Section 739 applies, it should provide regulatory text providing the requisite clarity.

### **Conclusion**

COPE requests that the Commission clarify that the Documentation NOPR raises no issues concerning end-user margin or other credit requirements. The Commission should also clarify that today's swap documentation tools and processes, such as the ISDA Agreement, satisfy the proposed rules. COPE further requests that the Commission delete the proposed swap-by-swap valuation requirement and end-user documentation provisions from any final rule. Finally, the Commission should confirm that Swap Dealer/Major Swap Participant noncompliance with any final rules issued under the NOPR will not affect the enforceability of any swap.

Respectfully submitted,

/s/ David M. Perlman

David M. Perlman

Bracewell & Giuliani LLP

2000 K St., NW, Suite 500

Washington, D.C. 20006

T: (202) 828-5804

[david.perlman@bgllp.com](mailto:david.perlman@bgllp.com)

*Counsel to*

*Coalition of Physical Energy Companies*

cc: COPE Members