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January 31, 2012

**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,” “Security-Based Swap,” and  
“Security-Based Swap Agreement”; Mixed Swaps; Security-Based  
Swap Agreement Recordkeeping  
RIN 3038-AD46, RIN 3235-AK65, SEC File No. S7-16-11<sup>1</sup>

Dear Mr. Stawick and Ms. Murphy:

As the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (together with the CFTC, the “Commissions”) finalize rules concerning the further definition of “swap” under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”),<sup>2</sup> the American Petroleum Institute (“API”) would like to raise a concern that, if not addressed, may adversely impact many members of our industry, as well as entities outside our industry with whom we do business.

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<sup>1</sup> The joint proposed rules, *see* note 2, *infra*, referenced an incorrect RIN. The information here represents the correct RIN, which was set forth in a correction to the joint proposed rules. *See* Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 32,880 (proposed June 7, 2011) (to be codified at 17 C.F.R. pts. 1 & 240).

<sup>2</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010). The joint proposed rules are set forth in Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818 (proposed May 23, 2011) (to be codified at 17 C.F.R. pts. 1 & 240) (hereinafter, “NOPR”).

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API appreciates the Commissions' proposed interpretive guidance concerning the status of commodity options and the scope of the forward contract exclusion from the definition of "swap." We are concerned, however, that the Commissions' proposed treatment of physical commodity options and forward contracts with options operating on the delivery term would unnecessarily render "swaps" some nonfinancial commercial transactions that are an essential means of hedging risk in the energy business. Accordingly, we urge the Commissions to reconsider the treatment of these physical options that do not contain financial settlement contingencies and to interpret the exception from the swap definition for "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>3</sup> broadly to reach the full range of transactions contemplating physical settlement on which our members rely to hedge risk.

**I. All Commercial Merchandising Transactions Contemplating Physical Settlement, Including Physical Options, Should Not Be Treated as Swaps.**

The CFTC has long recognized an exception from the CEA for certain commercial merchandising transactions with physical delivery requirements that provide for deferred delivery. As the Commission stated in its Brent Interpretation, and noted in the joint proposed rules, the forward contract exclusion exists because the CEA "regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity."<sup>4</sup> For the same reasons that the CFTC has excluded these forward contracts from regulation, we believe physical option contracts that contemplate physical delivery should also be excluded from the definition of swap. We believe that a comprehensive reading of the swap definitional provision, the primary purposes of Dodd-Frank's regulation of the swaps market, and the need for the Commissions to balance the impact of the new swaps regulatory scheme on commercial parties whose businesses depend upon physical commodities all support an interpretation of the swap definition that excludes physical options.

Physical option contracts are routine, commercial transactions that help API's members manage changing physical commodity needs and allow companies involved in the entire energy value chain to balance changing and sometimes unpredictable customer or supplier demands. Most physical volume options do not incorporate any financial settlement contingencies. As compared to financial options or options on futures, the natural purchasers or sellers of physical options are those entities that transact in the underlying physical commodity, including producers, consumers, marketers, and those engaged in storage or transportation. These characteristics of physical options are also the characteristics of forward contracts. For

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<sup>3</sup> Dodd-Frank § 721(a)(21) (CEA § 1a(47)(B)(ii)).

<sup>4</sup> Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188, 39,190 (Sept. 25, 1990).



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these reasons, we believe a broad interpretation of the statutory language excluding physical options from the definition of “swap” would be consistent with the historical treatment of similarly purposed contracts. Furthermore, we believe such an interpretation is consistent with the primary purposes of Dodd-Frank.

We recognize that Dodd-Frank generally defines options, including commodity options, as swaps.<sup>5</sup> However, the Dodd-Frank statutory definition of swap also includes exclusionary language that is similar to the language of the forward contract exclusion. The exclusion focuses on transactions that are “intended to be physically settled.” We believe that the Commissions should construe the entirety of the swap definition in determining how to treat option contracts that require physical settlement upon exercise of the option. By definition, these contracts contemplate physical and not financial settlement: If the option is exercised, a physical delivery obligation is created and physical settlement occurs, and if the option is not exercised, no settlement occurs. As compared to financial options or options on futures, there is no possibility for financial settlement of these options. Read in conjunction with the exclusion for physically settled contracts for deferred shipment and delivery, and against the backdrop of Congress’s principal concern with financial transactions, we respectfully submit that, as distinguished from options that allow for financial settlement, options that require physical settlement upon exercise do not warrant the regulatory oversight needed for swaps. Instead, physical options should be read to fit within the statutory exclusion for contracts “intended to be physically settled.”

Furthermore, the new regulatory landscape created by Dodd-Frank dramatically expands the universe of transactions regulated by the CFTC and significantly increases the compliance burden on market participants. We think this counsels the CFTC to act carefully in identifying the types of transactions that truly warrant systemic regulation. Unlike financial options, in the experience of API’s members, physical options do not introduce risk into the United States financial system or energy markets. In short, the costs of regulating physical options outweigh the benefit of comprehensive regulation.

## **II. The Commissions Should Not Treat Forward Contracts Providing for Volumetric Flexibility as Swaps.**

As noted, API believes that all contracts for which the parties contemplate physical settlement (including options) should not be treated as swaps. This argument applies equally to traditional forward contracts that include embedded options. Even if the Commissions conclude that options are swaps, API believes that the forward contract exclusion should still

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<sup>5</sup> See Dodd-Frank § 721(a)(21) (CEA § 1a(47)(A)(i)).

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apply to forward contracts that provide for optionality on the delivery term, but nevertheless include an obligation for, and result in, physical delivery.

The Commissions stated in the joint proposed rules that contracts would be excluded from the definition of swap if, in view of “the specific facts and circumstances . . . as a whole,” their optionality: “(i) May be used to adjust the forward contract price, but [does] not undermine the overall nature of the contract as a forward contract; (ii) [does] not target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) cannot be severed and marketed separately from the overall forward contract.”<sup>6</sup> Conversely, the Commissions stated that commodity options would be treated as swaps if their optionality “render[s] delivery optional.”<sup>7</sup>

Based on the proposed guidance, API is concerned that forward contracts with volumetric delivery flexibility would be considered “swaps” under the proposed rules. Like physical options, forward contracts with embedded options contemplate physical settlement. In addition, many forward contracts contain embedded options operating on part, but not all, of the delivery obligation. These contracts always entail an enforceable delivery obligation -- whether or not the option is exercised. Exercise of the option simply affects the amount required for delivery. Indeed, as noted, most physical volume options do not incorporate any financial settlement contingencies. Accordingly, these transactions fit squarely within the statutory exclusion for nonfinancial forward contracts intended to be physically settled.

Just as energy companies use physical option contracts to manage needs, the volumetric flexibility provided by forward contracts with embedded options is necessary for all participants in the energy market. Consumers must manage fluctuations in demand arising from contingencies such as weather. Producers, on the other hand, must respond to fluctuations in physical supply resulting from production and infrastructure uncertainties. For example, a volumetric option could allow a consumer to agree to purchase in advance a set amount of energy, but also exercise an option to adjust upward or downward the actual amount delivered under the contract depending upon actual needs. If these transactions are treated as swaps, some market participants may, for the first time, be required to register as eligible contract participants. Given the current business relationships of some of our members, we believe the rules, as proposed, may burden entities such as hospitals and schools that may not qualify as eligible contract participants.

We recognize that the Commissions have taken a different approach to the interpretation of the forward contract exclusion and have proposed to limit the exclusion with

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<sup>6</sup> NOPR, *supra*, at 29,830.

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



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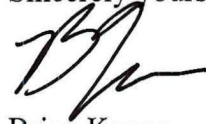
respect to contracts involving options to only those contracts with optionality as to price. We believe an approach that instead subjects only those transactions with financial settlement components or those with options that can exercise into financial settlement to the swap oversight scheme would better use CFTC resources, provide the necessary regulatory oversight of the market, and minimize the burden of regulation on our industry.

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API understands that effective implementation of Dodd-Frank depends on a definition of swap that is neither too broad nor too narrow. API also understands the Commissions' desire to provide clarity to the market about which types of options present regulatory oversight concerns that may warrant swap treatment. In this regard, we ask the Commissions to recognize that (1) the swap definition treats physically settled options differently from financially settled options, and (2) the swap definitions should preserve market participants' ability to enter into forward contracts including flexibility in the delivery term, which is necessary because of the unpredictability of supply and demand.

For all of these reasons, we respectfully request the Commissions clarify that physically settled option and forward contracts will not be treated as swaps. Such clarification is vital not just for our members, but also for consumers of energy. API would be pleased to provide additional information regarding our views on the joint proposed rules, and would welcome the opportunity to work with the Commissions.

Sincerely yours,



Brian Knapp

Policy Advisor,  
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