From: Rahman, Lamiya <Lrahman@mwe.com>
Sent: Monday, September 20, 2010 6:58 PM
To: dfadefinitions <dfadefinitions@CFTC.gov>
Cc: rule-comments@sec.gov
Subject: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act / SEC File Number S7-16-10
Attach: Hess Corporation - Definitions Contained in Title VII of Dodd-Frank Act.PDF

Attached please find the comments of Hess Corporation and its affiliates on Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act.

Lamiya Rahman
Project Assistant
McDermott Will & Emery LLP
600 13th Street, NW
Washington, DC 20005
tel: 202.756.8618
fax: 202.591.2949
lrahman@mwe.com

McDermott
Will&Emery

Boston Brussels Chicago Düsseldorf Houston London Los Angeles Miami Milan
Munich New York Orange County Rome San Diego Silicon Valley Washington, D.C.

Strategic alliance with MWE China Law Offices (Shanghai)

Anthony M. Mansfield
Attorney at Law
amansfield@mwe.com
+1 202 756 8232

September 20, 2010

Via Electronic Mail: dfadefinitions@cftc.gov

Mr. David A. Stawick
Secretary
U.S. Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act 75 F.R. 51429 (Aug. 20, 2010)

Dear Mr. Stawick:

On August 20, 2010, the U.S. Commodity Futures Trading Commission (the "Commission" or "CFTC") and the Securities and Exchange Commission issued an Advanced Notice of Proposed Rulemaking ("ANOPR") in the Federal Register.[1] The ANOPR invites interested persons to submit comments pertaining to the definitions of certain "key terms" in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act"), including the definition of "swap", "security based swap", "swap dealer", "security-based swap dealer", "major swap participant", "major security-based swap participant", "eligible contract participant", and "security-based swap agreement."

On behalf of Hess Corporation and its affiliates (collectively "Hess"), we hereby submit comments on the definitions of "major swap participant" and "swap dealer."

Description of Hess and its Interest in the ANPOR

Headquartered in New York, Hess is a fully integrated energy company engaged in the exploration for and the development, production, purchase, transportation and sale of crude oil and natural gas, and the manufacturing, purchase, transportation, and marketing of refined petroleum, natural gas, and electricity. Hess is listed on the New York Stock Exchange.

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1 *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act*, 75 F.R. 51429 (Aug. 20, 2010).

Hess has subsidiaries involved in exploration and production operations located in the United States, United Kingdom, Norway, Denmark, Equatorial Guinea, Algeria, Malaysia, Thailand, Russia, Gabon, Azerbaijan, Indonesia, Libya and Egypt. In addition, Hess's international portfolio has recently grown to include new licenses in Australia, Egypt, Ghana, Norway, Ireland, Russia, Brazil and Peru.

Hess is a leading independent gasoline convenience store retailer on the East Coast with more than one thousand Hess branded locations. Hess's Energy Marketing business includes the marketing of refined oil products, natural gas and electricity to a vast array of utilities and other industrial and commercial customers located from the Ohio Valley to the East Coast. Hess enters into derivatives contracts to manage the fixed price risk associated with this activity. In addition, Hess operates a network of strategically located petroleum storage terminals that support its marketing operations. Through subsidiaries and joint venture agreements, Hess also operates a fluid catalytic cracking unit in Port Reading, New Jersey, and the Hovensa Refinery in the U.S. Virgin Islands.

The Supply, Trading and Transportation division of Hess markets several hundred thousand barrels per day of crude oil and gas liquids, and trades (purchases and sells) hundreds of thousands of physical barrels per day of refinery feedstocks, intermediates, and finished petroleum products. Hess also enters into derivatives contracts to manage the price risk associated with this activity.

Comments to the Key Terms Identified in the ANOPR

Consistent with any rulemaking process, Hess encourages the Commission to define these key terms in a way that is consistent with Congress's intent, and that ensures that each term, as it is applied in one section of the Dodd-Frank Act, does not frustrate the purpose or operation of another section of the Act where the same term is used. In particular, Hess urges the Commission to take great care to preserve the distinction between financially-sophisticated entities that may be regulated as major swap participants or swap dealers, and commercial entities, whose businesses are centered around the management of physical assets, that should be regulated as end users.

Congress's intent and expectations on this point are set forth clearly in the June 30, 2010 letter from Senators Christopher Dodd and Blanche Lincoln to Congressmen Barney Frank and Collin Peterson, subsequently read into the Congressional Record:

> In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. *Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business.* For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce

> electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business.[2]

Maintaining a clear distinction between these categories of participants is important, not only to avoid regulatory uncertainty, but also to ensure that commercial end users, like Hess, are able to continue using the over-the-counter swaps markets for risk management purposes. End users rely on cost-effective swaps to hedge and manage the commercial risk associated with their regular business activities. If the definitions of key terms in the Dodd-Frank Act like major swap participant and swap dealer are blurred, end users may be subject to additional regulation that Congress explicitly recognized was appropriate for those market participants whose positions pose a systemic risk to the financial system. The expense associated with these unwarranted regulatory burdens will increase the cost of doing business for commercial end users – costs that ultimately may be passed on to individual consumers.[3]

The Definitions of "Major Swap Participant" and "Swap Dealer"

The language of the Dodd-Frank Act makes plain Congress' purpose to distinguish between major swap participants and swap dealers on the one hand, and commercial end users on the other hand. Congress differentiated these categories of participants among other ways, by reference to the purposes for which they use the swaps markets. An end user uses swaps largely to hedge or mitigate commercial risk.[4] A major swap participant and a swap dealer, as their primary business, do not.[5] In defining the key terms identified in the ANOPR, the Commission should endeavor to make explicit that end users who primarily use swaps to hedge or mitigate commercial risk should not be regulated as major swap participants or swap dealers.

The Definition of "Major Swap Participant" should Exclude Commercial End Users

The Dodd-Frank Act defines a major swap participant as any person who is not a swap dealer and who maintains a "substantial position" in swaps (excluding positions held for hedging or mitigating commercial risk), whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets, or who is a highly leveraged financial entity that holds a substantial

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2 156 Cong. Rec. H5248 (daily ed. Jun. 30, 2010) (Dodd-Lincoln Letter) (emphasis added).

3 End users who are regulated as swap dealers or major swap participants will be subject to significant new regulatory obligations, including mandatory clearing and exchange-trading of certain swap activity, minimum capital requirement, and margin requirements. Dodd-Frank Act, Pub. L. No. 111-203 § 723(a) (to be codified as CEA § 2(h) (clearing requirement)); *Id.* at § 731 (to be codified as CEA § 4s(e) (capital and margin requirements)).

4 *See, e.g. Id.* at § 723(a) (to be codified as CEA § 2(h)(7)(A)) ("The requirements of paragraph (1)(A) shall not apply to a swap if 1 of the counterparties to the swap . . . (ii) is using swaps to hedge or mitigate commercial risk…").

5 *See, e.g., Id.* at § 721(a) (to be codified as CEA § 1a(33)) ("The term 'major swap participant' means any person who is not a swap dealer, and – (i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding – (I) positions held for hedging or mitigating commercial risk…").

position is swaps.[6] The Commission is required to define what constitutes a substantial position in terms of systemic risk by establishing a threshold at a level that it "determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States."[7] The determination of what constitutes a substantial position must take into account the risk associated with an entity's swap portfolio, including "the value and quality of collateral held against counterparty exposures."[8]

Commercial end users who primarily use swaps to hedge or mitigate commercial risk do not hold a substantial position in swaps or otherwise threaten the financial stability of the U.S. banking system or financial markets. Accordingly, Hess encourages the Commission to provide a definition of major swap participant that clearly excludes commercial end users. To achieve this end, Hess recommends that the Commission consider the following factors:

> ***The Commission should define "commercial risk".*** Commercial risk is an essential concept in several key provisions of the Dodd-Frank Act. For example, the definition of major swap participant expressly excludes positions held for hedging or mitigating commercial risk from the definition of a substantial position for non-financial entities. Similarly, the exception to the mandatory clearing and exchange-trading requirements applies only if one of the counterparties to the transaction "uses swaps to hedge or mitigate commercial risk."[9] The Dodd-Frank Act specifically authorizes the Commission to define commercial risk through rulemaking.[10] The Commission should use this authority and propose a definition of commercial risk that fully encapsulates the breadth of end users' businesses. Doing so will provide greater certainty to end users and other market participants as to how they will be regulated and how key provisions of the Dodd-Frank Act will be applied in practice.
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> ***The definition of "commercial risk" should be consistent wherever it is used, and with other provisions of the Commodity Exchange Act ("CEA").*** The definition of commercial risk should be the same regardless of where it is used in the CEA or the Commission's existing regulations and prospective regulations implementing the Dodd-Frank Act. A single, consistent definition will promote a predictable and commercially workable regulatory system that is free from disruptive internal contradictions. For example, if the Commission defines commercial risk broadly in the context of the end user exception, but narrowly in the context of the definition of major swap participant, an end user otherwise entitled to rely on the clearing exception would be prohibited from doing so if it were characterized as a major swap participant. Separate but related, the Commission should define commercial risk in a way that is at least as broad as the

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6 *Id.* at § 721(a) (to be codified as CEA § 1a(33)(A)).
7 *Id.* at § 721(a) (to be codified as CEA § 1a(33)(B)).
8 *Id.*
9 *Id.* at § 723(a) (to be codified as CEA § 2(h)(7)(A)(ii)).
10 *Id.* at § 721(b).

concept of "bona fide hedging transaction and position."[11] Both terms relate to the "conduct and management of a commercial enterprise" using the derivatives markets to manage price risk associated with, among other things, its physical business, and are integral to the regulation of hedging activity under the CEA.[12]

Substantial position should be defined in terms of risk and exposure, not volume. The Commission should define what constitutes a substantial position in swaps based on the actual risk associated with an entity's swaps portfolio, including "the value and quality of collateral held against counterparty exposures," rather than the volume of swaps or another overly simplistic measure of risk.[13] Well-collateralized swaps do not significantly increase systemic risk, particularly when they are used by end users to hedge or mitigate commercial risk. On the contrary, as Senator Blanche Lincoln noted prior to enactment of the Dodd-Frank Act, "[b]ilateral collateralization and proper segregation *substantially reduces* the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently."[14] Counting all swaps equally, regardless of their specific risks and counterparty exposure, would result in an over-broad definition of major swap participant that subjects end users to onerous additional regulation with little benefit to the financial system as a whole.

The Definition of "Swap Dealer" should Exclude Commercial End Users

Guided by the principles Congress articulated in the context of defining "major swap participant", the Commission should be similarly judicious in its approach to the definition of "swap dealer". The Dodd-Frank Act defines a swap dealer as any entity who holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties in the ordinary course of business for its own account, or is commonly known as a swap dealer.[15] Read literally, the definition of swap dealer potentially would capture many end users who primarily use swaps to hedge or mitigate commercial risk.

Hess encourages the Commission to provide a definition of swap dealer that clearly and thoroughly excludes commercial end users. To achieve this end, Hess recommends that the Commission consider the following factors:

An end user that primarily uses swaps to hedge or mitigate commercial risk does not "hold itself out" as a dealer. Unlike a "dealer" who typically is willing to take either side of a swap in an effort to profit from the trade itself, most end users use swaps only to hedge commercial risks associated with an underlying commodity position. The

11 *See, e.g.*, 17 CFR § 1.3(z) (2010).
12 Dodd-Frank Act § 737(c) (to be codified as CEA § 4a(c)(2)).
13 Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(33)(B)).
14 156 Cong. Rec. S5907 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln) (emphasis added).
15 Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(49)).

Commission, therefore, should clarify that an entity "holds itself out" as a dealer in swaps when it regularly markets itself to unaffiliated third-parties as available to trade on either side of a swap in an effort to profit from the trade.[16]

An end user that primarily uses swaps to hedge or mitigate commercial risk does not "make a market" in swaps. The Commission should clarify that an end user does not "make a market" in swaps unless it is ready, willing, and able to make two-way markets in swaps without regard to managing the risks associated with a commodities business. Depending on market conditions and the economics and the particular business, a commercial entity may buy and sell commodity swaps at the same time, but this activity is not "making a market" in swaps in any conventional sense.

For example, a petroleum refiner may manage the price risk associated with future sales and purchases on a portfolio basis. Because some assets are more efficient than others, and because a single facility may be more efficient at certain levels of output, such assets can be modeled and risk-managed according to their marginal cost of production. Typically, at any given level of expected production, each unit of additional production is more expensive than the preceding unit. The refiner can, therefore, minimize its total costs (and, thus, the overall price paid by its customers) by either buying from or selling to the market when doing so is economical. In this example, the refiner could reduce its overall operating costs by: (1) buying refined products from the market (including the market for financially-settled swaps) when the market price is lower than its marginal cost to increase production; and (2) selling refined products into the market when the market price is higher than its marginal cost to decrease production. As a direct result of its variable marginal costs and demand obligations, the refiner is commonly willing to "buy low and sell high" to optimize the value of its assets. Such prudent use of derivatives is not market making and should not cause an end user to be characterized as a swap dealer.

An end user that primarily uses swaps to hedge or mitigate commercial risk does not "regularly enter[] into swaps with counterparties as an ordinary course of business" even if it enters into such swaps on a "regular" basis. End users enter into swaps regularly to prudently manage the commercial risk associated with their businesses, but this does not make them "dealers" in any conventional sense.[17] This is equally true for

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16 The Commission has addressed the meaning of "holding oneself out" in the context of the definition of "commodity trading advisor", explaining that an entity "holds itself out" if it engages in outward marketing activities, including: promoting itself through mailings, directory listings, and stationery, or otherwise initiating contacts with prospective clients. *See, e.g., Interpretive letter No. 91-9*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,189 (CFTC Dec. 30, 1991); *CFTC No-Action Letter 02-59*, Comm. Fut. L. Rep (CCH) ¶ 29,063, at *17 n.22 (CFTC May 17, 2002).

17 As the Commission has explained in the context of power marketers in the electric power industry, "[a dealer] *does not in the normal course of business hedge or speculate in electricity markets…* [but rather] routinely engage[s] in both buying and selling, including with other [dealers and] power marketers." CFTC No-Action Letter No. 99-67, Comm. Fut. L. Rep (CCH) ¶ 27, 970, (CFTC Dec. 16, 1999).

end users who have centralized their hedging activity in a single affiliate. For example, a refinery could regularly hedge the price risk associated with its future production by entering into a swap directly with a third party. Alternatively, the refinery could implement an economically equivalent hedge by entering into a swap with a hedging affiliate, who in turn enters into a back-to-back swap with an unaffiliated entity. In either case, the end user (and its affiliate) are not "dealing" in swaps. Even though many end users (and hedging affiliates) "regularly enter[] into swaps with counterparties as an ordinary course of business," if the Commission treats *every* entity that regularly enters into swaps as a swap dealer, without regard to who the entity is our how those swaps are used, virtually *all* end users (and hedging affiliates) will be swap dealers. Congress did not intend this result.

Whether a particular hedging transaction is entered into by the end user itself or through an affiliate, swaps that hedge or mitigate commercial risk contribute to the stability of the market, not systemic risk. The Commission should define swap dealer in a manner that is consistent with other provisions of the Dodd-Frank Act and clarify that any end user (or hedging affiliate) that primarily uses swaps to manage commercial risk falls outside of the definition of swap dealer.

Swaps that hedge or mitigate commercial risk should be excluded as "de minimis". As Senators Christopher Dodd and Blanche Lincoln noted, "Congress incorporated a *de minimis* exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation."[18] The Commission should use the *de minimis* exception to clearly exclude end users that primarily use swaps to hedge or mitigate commercial risk. The Commission should similarly exclude entities that may engage in a small amount "swap dealing", by setting the *de minimis* threshold at a level that excludes all entities that do not significantly increase systemic risk. For example, the Commission could set the *de minimis* threshold at a level that is based on a percentage of the total swap activity in a particular market (after excluding swaps that hedge or mitigate commercial risk, and other low-risk swaps that do not contribute to systemic risk). Subjecting end users to additional regulation, even if they enter into small amount of swaps that are unrelated to hedging or mitigating commercial risk, is unnecessary and inconsistent with Congress's expressed intent.

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18 156 Cong. Rec. H5248 (Dodd-Lincoln Letter).

Conclusion

Hess appreciates the opportunity to provide the Commission with the perspective of a commercial end user on certain key terms in the Dodd-Frank Act. Hess encourages the Commission, consistent with its comments, to define these key terms in a way protects the ability of end users to hedge the commercial risk effectively and economically. Hess welcomes the opportunity to discuss these issues further with the Commission and its Staff.

Please contact us at (202) 756-8000 if you have any questions regarding Hess's comments.

Respectfully submitted,

Anthony M. Mansfield
Jonathan H. Flynn
McDermott Will & Emery LLP
600 Thirteenth Street, N.W.
Washington, D.C. 20005
(202) 756-8000

Counsel for Hess Corporation

Cc: SEC File Number S7–16–10, via e-mail (rule-comments@sec.gov)