

February 22, 2011

VIA ELECTRONIC SUBMISSION

David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

**Re: Further Definition of "Swap Dealer" (RIN 3038-AD06)**

Dear Mr. Stawick:

On behalf of Hess Corporation and its affiliates (collectively "Hess"), we hereby submit comments in response to the joint proposed rule ("Proposed Rule")<sup>1</sup> issued by the Commodity Futures Trading Commission ("Commission" or "CFTC") and the Securities and Exchange Commission regarding the definition of certain key terms in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").<sup>2</sup> Hess appreciates the opportunity to provide the Commission with a commercial end-user's perspective on the potential scope of the proposed definition of "swap dealer." In particular, Hess believes that the Commission should further define "swap dealer" in a manner that: (1) clearly excepts ancillary swap activity that is not part of a regular physical commodity business; and (2) expressly permits commercial entities that use swaps primarily to hedge or mitigate commercial risk also to engage in a relatively small amount of proprietary trading activity that indirectly supports its commercial business.

**I. Description of Hess and its Interest in the Proposed Rule**

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 the manufacturing, purchase, transportation, and marketing of refined petroleum, natural gas, and electricity. Hess is listed on the New York Stock Exchange. Through its subsidiaries, Hess is involved in exploration and production operations located in the United States, the United Kingdom, Norway, Denmark, Equatorial Guinea, Algeria, Malaysia, Thailand, Russia, Gabon, Azerbaijan, Indonesia, and Libya. Hess' international portfolio has recently grown to include new licenses in Australia, Egypt, Ghana, Norway, Ireland, Russia, Brazil, and Peru.

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<sup>1</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. 80,174, RIN 3038-AD06 (Dec. 21, 2010).

<sup>2</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Hess' Energy Marketing division markets 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.

Hess' Supply, Trading and Transportation division 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 enters into derivatives contracts to manage the price risk associated with this activity as well.

As a commercial participant in the physical commodities markets, Hess does not anticipate being required to register with the CFTC as a swap dealer or major swap participant. However, Hess' subsidiaries and affiliates are engaged in a range of activities that may not fit easily into the categories of participants defined by Congress. An overly broad definition of "swap dealer" could significantly reduce Hess' ability to continue utilizing important risk management tools currently available through the over-the-counter swaps markets in an efficient and cost-effective manner. Given the considerable uncertainty as to how the Commission will define what constitutes a "swap" or "swap dealing," Hess, on its own and on behalf of its subsidiaries and affiliates, has an interest in the Proposed Rule.<sup>3</sup>

## II. Scope of the "Swap Dealer" Definition

Title VII of the Dodd-Frank Act imposes significant new regulatory requirements on various financial businesses that, because of their functional role or overall size, may pose a significant risk to the stability and integrity of the U.S. banking system or financial markets. However, Title VII largely excludes from regulation *non-financial* businesses that do not engage in dealing as part of a regular business and are not otherwise sufficiently large market participants to warrant regulation. This distinction between financial and non-financial businesses recognizes the fundamentally different ways in which the two types of entities operate in the commodities and derivatives markets.

Historically, financial entities that operated as "dealers" acted as intermediaries making themselves available to transact with both buyers and sellers. As intermediaries, their business was largely based on profits from the bid-ask price spread in each transaction. Dealers typically did not enter into swaps to manage risk or trade on a proprietary basis in connection with a physical commodity business. Rather, dealers accommodated whatever the market demanded, regardless of whether a potential counterparty sought to be long or short and usually for a wide

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<sup>3</sup> Hess is commenting on this Proposed Rule even though "swap" has not yet been defined. Hess respectfully reserves the right to amend or supplement its comments in the future depending on how that term is defined.

range of different commodities. Because dealers sought to profit from the bid-ask spread, they benefited more from a high overall volume of swap activity than from changes in values of particular swaps, or the prices of the commodities underlying those transactions.

In contrast, non-financial businesses that participate in the swaps markets are typically long or short physical commodities because of their regular commercial business activity. These natural physical positions tend to drive commercial participants' use of swaps and often, if not always, define the particular swaps markets that are utilized. For example, a consolidated energy company that refines crude oil and supplies fuel to wholesale customers is naturally short crude oil (to supply its refineries) and long fuel oil (to sell to its customers). Although such an entity may use specific swaps for a number of different purposes, effectively managing the commercial risk associated with the physical commodity business, whether on its own or on behalf of its customers, remains the primary purpose of such an entity's swap activity.

Aware of the relevant commercial and regulatory context, Congress defined a swap dealer as any person who:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.<sup>4</sup>

Congress also provided two express statutory exceptions from the definition of swap dealer for any entity that "enters into swaps for such person's own account . . . but not as a part of a regular business" and for any entity that only engages in a "*de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."<sup>5</sup>

In the Proposed Rule, the Commission provides that the term "swap dealer" and the statutory exceptions to the definition are to be interpreted in a functional manner, based upon how an entity "holds itself out in the market" and "the nature of the conduct engaged in by the [entity]" rather than by reference to "rigid standards" or fixed criteria.<sup>6</sup> To that end, the Proposed Rule lists several characteristics that, according to the Commission, may clarify the concept of "dealing" and thereby distinguish swap dealers from other market participants. For example, the Commission suggests that swap dealers:

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<sup>4</sup> Dodd-Frank § 721(a) (to be codified as CEA § 1a(49)).

<sup>5</sup> Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(49)(C)-(D)).

<sup>6</sup> 75 Fed. Reg. at 80,176.

- accommodate demand for swaps from other parties;
- are generally available to enter into swaps to facilitate other parties' interest in entering into those instruments;
- do not request that other parties propose the terms of swaps, but rather enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest; and
- have the ability to arrange customized terms for swaps upon request, or to create new types of swaps on their own initiative.

To the extent that an entity does not fall within the definition or qualifies for one of the express statutory exceptions, it will not be regulated as a swap dealer under the Proposed Rule.

### **III. Congress Only Intended for the Commission to Regulate Swap Activity that is Part of an Entity's "Regular Business."**

Consistent with Congress' intent, Hess believes that a commercial entity that accommodates demand for swaps, but only as an ancillary service to its physical commodity business, should not be required to register as a swap dealer because such an entity "enters into swaps for [its] own account . . . but not as a part of a regular business." Similarly, Hess believes that a commercial entity that uses swaps primarily to hedge or mitigate its commercial risk related to its regular business should not be required to register as a swap dealer, even if it also enters into a relatively small number of swaps for its own account for other purposes, particularly where those other purposes are ultimately intertwined with the entity's hedging activities. In both scenarios, the regular business of a physical commodity market participant remains that entity's commercial business.

For example, many commercial entities, including Hess, periodically enter into financial transactions with their customers to provide limited risk management services related to their regular physical commodity business. Due to the nature and purpose of these ancillary transactions, Hess only accommodates demand for these financial transactions from its existing physical commodity customers, and only when such transactions are directly and significantly connected to the parties' regular physical commodity business.<sup>7</sup> Hess enters into these ancillary transactions because they provide value to its customers, while helping to mitigate the risk to Hess that its customers will not perform. By entering into a hedge with Hess, the customer does not need to establish a trading relationship with a third-party that would require it to post

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<sup>7</sup> In other words, Hess would not enter into a swap with a customer based on electricity prices in California because Hess does not buy or sell physical electricity in California, nor does it have any physical electricity assets in California.

collateral that could not be offset against its related physical positions.<sup>8</sup> This makes hedging risk easier and more efficient for Hess' customers. At the same time, Hess benefits because, to the extent its customers have effectively hedged their exposure, there is less risk that they will not perform on their physical commodity transactions.<sup>9</sup> Because it only accommodates demand for financial risk management transactions as an ancillary service to its physical commodity customers, Hess does not believe that this swap activity is a part of its "regular business."

Nevertheless, given what it considers to be potential ambiguity in the statutory guidelines and the Commission's explanation of what constitutes dealing activity, Hess believes that the Commission should expressly clarify that the proposed definition of "swap dealer." For example, Hess believes that the Commission should confirm that "swap dealer" *includes* only entities that accommodate demand for swaps from other parties as an ordinary course of business. Similarly, Hess believes that the Commission should confirm that the definition expressly *excludes* entities that enter into swaps as an ancillary or incidental part of a non-dealing business (*i.e.*, a commercial entity that accommodates demand for swaps as an ancillary service to physical commodity customers, or that trades on a proprietary basis to indirectly support its regular commercial business). To the extent that this does not accurately reflect the Commission's interpretation of the definition of "swap dealer" or the regulations in the Proposed Rule, Hess respectfully requests that the Commission clarify how such activity would be regulated under the relevant statutory authority.

A. *Accommodating Demand for Swaps is not the "Regular Business" of a Commercial Entity in the Physical Commodity Markets.*

Hess believes that in most cases it will be clear when an entity "regularly enters into swaps with counterparties as an ordinary course of business" and when an entity "enters into swaps . . . but not as part of a regular business." For example, an entity that serves as a financial intermediary with a trading desk that regularly accommodates demand for swaps from unrelated

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<sup>8</sup> For example, a customer that purchases physical fuel oil from a supplier pursuant to a long-term supply agreement may need to provide financial security to demonstrate that it will be able perform if the price of fuel oil increases substantially. If the customer hedges that exposure with a third-party, it may be required to post collateral if prices move in *either* direction: to the supplier (if prices go up); or to the hedge provider (if prices go down). In such a scenario, the customer may decide, because of the cost of capital, not to hedge its exposure at all. If, however, the customer hedges the exposure from the supply agreement with the supplier, the agreement could provide that the exposure from the physical and financial agreements would be netted, minimizing the amount of collateral required without decreasing the effectiveness of the hedge.

<sup>9</sup> The concept that an entity should not be deemed to be a swap dealer to the extent it offers to enter into swaps with its customers in connection with their regular business already exists in the definition of "swap dealer." Congress recognized that insured banking institutions often require customers requesting a loan to enter into swaps to mitigate the risks associated with the transaction, and that, for convenience, these swaps are sometimes provided by the bank that originates the loan as an ancillary service for its customers. Even though the banks may be construed as accommodating the demand of other parties to enter into swaps, Congress excluded entities that engage in such ancillary activity from the definition of swap dealer. Dodd-Frank Act § 721(a) (to be codified as CEA § 1a(49)).

third-parties by taking both long and short positions and profiting principally from the bid-ask spread on its portfolio would, in all likelihood, be a swap dealer because it accommodates demand for swaps from other parties as an ordinary course of business. Conversely, an energy marketer that sells physical product, and that uses swaps primarily to hedge or mitigate the business' commercial risk would *not* be a swap dealer because it enters into swaps only as an ancillary or incidental part of a non-dealing business.

However, in those cases where it may be unclear whether an entity's regular business is accommodating the demand of other parties to enter into swaps, Hess suggests that the Commission can effectively enforce this distinction by following a flexible and functional approach. Indeed, as the Commission correctly noted in the Proposed Rule, the definition of swap dealer must be interpreted "in a functional manner, encompassing how a[n] [entity] holds itself out in the market, the nature of the conduct engaged in by the [entity], and how the market perceives the [entity's] activities," rather than according to "rigid standards" or fixed criteria.<sup>10</sup> Hess believes that the following list of general characteristics may be useful to the Commission to determine whether an entity's "regular business" is dealing:

- Resources allocated to swap activity. Swap dealers are more likely to allocate a substantial portion of their staff and technological resources to swap activity and other financial activities. In comparison, non-financial swap market participants, more often than not, allocate a small portion of their business resources to support their swap activity. Although large commercial entities may have relatively sophisticated trading operations, such activity is often necessary to support the organization's correspondingly large hedging and related risk management needs, and nevertheless, remains a small component of the organization's overall business.
- Profit generated by swap activity. Swap dealers are more likely to derive a large portion of their revenue and profit from "dealing" activity. To the extent that commercial entities and other non-financial swap market participants derive any income from their swap activity, it is usually a small percentage of the entity's overall profit.
- Related physical assets. Swap dealers are less likely to own physical assets related to the derivatives markets in which they trade, and even where they own physical assets, their swap activities typically are not limited to the regions or specific markets in which their assets are located. In contrast, commercial entities and other non-financial swap market participants, by definition, have substantial investments in pipelines, refineries, storage facilities or other physical market infrastructure. Their swap activity tends to be limited to financial instruments that are linked to the physical commodities with which they are involved (*i.e.*, an

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<sup>10</sup> 75 Fed. Reg. at 80,176.

energy company, like Hess, will not be involved in agricultural or metals swaps), and focused on the geographic regions or specific markets in which they have physical assets.

- Frequency of swap activity. Entities that regularly enter into swaps with counterparties as an ordinary course of business are more likely to enter into swaps more frequently than commercial entities and other non-financial swap market participants that enter into swaps, but not as part of a regular business.

Hess believes that consideration of these basic attributes will allow the Commission to properly distinguish between the swap activity characteristic of the entities who act as financial intermediaries that Congress intended to regulate comprehensively, and the swap activity of commercial entities and other non-financial businesses that Congress determined need not be subject to regulation under the Dodd-Frank Act. Indeed, as Congressman Collin Peterson made clear, when Congress passed the Dodd-Frank Act “[it] focused on creating a regulatory approach that permits the so-called end users to continue using derivatives to hedge risks associated with their underlying businesses, whether it is energy exploration, manufacturing or commercial activities. End users did not cause the financial crisis of 2008. They were actually victims of it.”<sup>11</sup>

B. *A Limited Amount of Proprietary Trading is not the “Regular Business” of a Commercial Entity in the Physical Commodity Markets.*

Similarly, Hess does not believe that the definition of “swap dealer,” as further defined by the Proposed Rule, includes a commercial entity that primarily uses swaps to hedge or mitigate its commercial risk related to its regular business even if it also enters into a relatively small number of swaps for its own account for other purposes. Although Hess primarily uses swaps to hedge or mitigate its commercial risk, it occasionally enters into swap transactions for price discovery and other related purposes. Better market intelligence from this trading activity allows Hess to manage better its commercial business by, among other things, helping it hedge the commercial risk associated with its physical commodity business more effectively. Because it trades on a proprietary basis to support its regular commercial business, Hess does not believe that this swap activity is part of its “regular business.” Indeed, given the definition of swap dealing provided by Congress, Hess respectfully questions whether proprietary trading of and magnitude falls within the definition.


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<sup>11</sup> 156 Cong. Rec. H5245 (daily ed. June 30, 2010) (statement of Rep. Collin Peterson).

#### IV. Conclusion

Hess appreciates the opportunity to comment on the Commission's Proposed Rule to further define "swap dealer." Hess welcomes the opportunity to discuss these issues further with the Commission or its Staff. Please contact us at (202) 862-2200 if you have any questions regarding Hess' comments.

Respectfully submitted,



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