

April 11, 2011

VIA ELECTRONIC SUBMISSION

David A. Stawick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Notices of Proposed Rulemaking Regarding Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants (RIN 3038-AC96) and Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants (RIN 3038-AC96)

Dear Mr. Stawick:

On February 8, 2011 the Commodity Futures Trading Commission ("Commission") published two notices of proposed rulemaking pursuant to Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")¹ regarding: (1) Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants ("Documentation Rule");² and (2) Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants ("OLA Rule" and, together with the Documentation Rule, the "Proposed Rules").³ Hess Energy Trading Company, LLC and its wholly-owned subsidiaries (collectively "HETCO") appreciate the opportunity to provide the Commission with comments regarding the Proposed Rules.⁴

Respectfully, HETCO believes that the Proposed Rules require certain limited revisions to better achieve the risk management goals of the Dodd-Frank Act. Specifically, HETCO believes that the requirements of the Proposed Rules regarding documentation audits, valuation

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² *Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 6715 (Feb. 8, 2011).

³ *Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 6708 (Feb. 8, 2011).

⁴ HETCO is commenting on the Proposed Rules even though "swap" has not yet been defined. HETCO respectfully reserves the right to amend or supplement these comments in response to any future releases by the Commission regarding the definition of such term.

procedures, and dispute reporting should be revised in order to respond better to the relative size, sophistication, and level of risk that various market participants pose to the stability of commodity and derivatives markets.⁵

I. Description of HETCO and its Interest in the Proposed Rules

HETCO is a Delaware limited liability company established in 1997. HETCO recently organized a branch in the Dubai International Financial Center and operates with three United Kingdom corporations, two of which are registered with the Financial Services Authority, a Cayman Islands exempted company, and a corporation organized in Singapore. All of these entities are used in the continually evolving development and implementation of a worldwide energy trading strategy effectuated by a series of spot and forward purchase and sales agreements, equity, foreign exchange, physical oil storage and chartered vessel transactions from time to time, swaps and other derivatives transactions in crude oil, petroleum products, natural gas and power, and freight transactions. Given the considerable uncertainty as to how, in other rulemakings, the Commission will define what constitutes a “swap” or “swap dealing,” HETCO has a significant interest in the Proposed Rules.

II. The Scale and Frequency of the Documentation Audit Requirement Should be Proportional to a Market Participant’s Size and Sophistication.

The Documentation Rule would require each swap dealer and major swap participant to have “an independent internal or external auditor examine no less than 5% of the swap trading relationship documentation . . . created during the previous twelve month period” on an annual basis.⁶ According to the Documentation Rule, the purpose of the annual documentation audit is “to ensure compliance with Commission regulations and the [entity’s] written policies and procedures”⁷

HETCO respectfully submits that a prescriptive, one-size-fits all audit process may not be the most effective way to achieve the Dodd-Frank Act’s risk management and market integrity objectives. Moreover, HETCO believes that the proposed audit requirement may be duplicative of, or even inconsistent with, other rules the Commission has proposed under the Dodd-Frank

⁵ Although the Proposed Rules apply only to documentation requirements applicable to swap dealers and major swap participants, because end-users typically rely on swap dealers to hedge their risk, commercial end-users also may be significantly impacted by the Proposed Rules. As such, HETCO asks the Commission to account for the real possibility that the limitations the Commission proposes to place on the swap documentation terms will impact the negotiation dynamic between dealers and end-users. In that regard, Hess Corporation submitted comments separately regarding the end-user exception to mandatory clearing of swaps. See Letter from Anthony M. Mansfield to David A. Stawick, Secretary of the Commission, *End-User Exception to Mandatory Clearing of Swaps (RIN 3038-AD10)*, (Feb. 22, 2010).

⁶ 76 Fed. Reg. at 6726 (Proposed Rule 23.504(c)).

⁷ *Id.*

Act with respect to trading documentation, risk management, and the general supervisory requirements that will apply to swap dealers and major swap participants.⁸

In particular, HETCO believes that although an annual audit of 5% an entity's swap trading relationship documentation may be appropriate for large swap dealers and major swap participants, the same requirement may be inappropriate and burdensome for smaller swap dealers, particularly those that serve a limited number of customers in a limited number of markets and products. Many large swap dealers and major swap participants have a dedicated staff of attorneys whose primary job function is the negotiation and execution of trading documents. The audit requirement in the Documentation Rule may not pose a significant challenge to such large and sophisticated entities because they likely have sufficient resources to conduct frequent and full documentation reviews without substantially disrupting their operations. In contrast, smaller swap dealers may not have the resources needed to conduct such audits effectively and economically.⁹

Instead of imposing a requirement that specifies how many documents must be reviewed in a given year (*i.e.*, the 5% limitation), HETCO recommends that the Commission adopt a proportional, principles-based approach that is compatible with the risk management requirements the Commission has proposed generally for swap dealers and major swap participants. Consistent with the proposals included in the Commission's proposed rules regarding the general supervisory policies and procedures applicable to swap dealers and major swap participants, HETCO believes the Commission should not impose a prescriptive audit program so long as a swap dealer's or major swap participant's compliance procedures are able to adequately identify and address shortcomings in its documentation.¹⁰ The Commission has stated that it "recognizes that an individual firm must have the flexibility to implement specific policies and procedures unique to its circumstances. The Commission's rules have been designed such that the specific elements of a risk management program will vary depending on the size and complexity of a swap dealer's or major swap participant's business operations."¹¹

A principles-based approach would be more flexible and commercially practicable because it could take into account each market participant's relative resources and the operational and legal risks that poor documentation practices by such market participant pose to the broader swaps market. Under such an approach, larger and more sophisticated swap dealers

⁸ HETCO notes that other commenters have pointed out the disparity between the prescriptive policies and procedures requirements of the Proposed Rules and the general risk management policies and procedures requirements the Commission has proposed with respect to swap dealers and major swap participants under the Dodd-Frank Act.

⁹ The Commission has explicitly acknowledged that a select few swap dealers possess the largest portfolio of swaps. *See* 76 Fed. Reg. at 6716. Accordingly, the operational and legal risks related to swap documentation is highest at such institutions.

¹⁰ *See Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants*, 75 Fed. Reg. 71397, 71400 (Nov. 23, 2010) (discussing the requirement that a swap dealer's risk management program be reviewed quarterly by internal audit staff or an external third party service).

¹¹ 75 Fed. Reg. at 71399; 75 Fed. Reg. at 71404 (Proposed Rule 23.600).

and major swap participants with robust middle and back office infrastructures could be required to perform more detailed or more frequent audits to demonstrate compliance with the Commission's regulations and the entity's own policies and procedures. In contrast, smaller swap dealers with more focused portfolios and limited exposures may be able to demonstrate compliance with more narrowly tailored audits conducted on a less frequent basis (*e.g.*, once every two or three years).

Moreover, as a practical matter, HETCO believes that a fixed audit requirement may not be compatible with the manner in which most market participants negotiate, amend, and transact in swaps. No single document that is a component of the set of agreements between counterparties that constitutes "swap trading relationship documentation" can be read in isolation. As the Documentation Rule notes, "swap trading relationship documentation" includes swap confirmations, as well as any agreements between the parties regarding payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures.¹² Such terms may be amended by the parties in any number of subsequent agreements, pursuant to mutually agreed upon business terms. Indeed, as the Commission makes clear in the Documentation Rule, agreements between swap trading counterparties are highly "relationship" specific, in that each document a counterparty executes as part of a swap transaction will often incorporate by reference the terms of other agreements executed bilaterally between the parties.

For example, a swap dealer that obtains improved margin terms from a number of its counterparties will often seek to enter into agreements amending its credit support documents. Even if such amendment agreements were the only "swap trading relationship documents" created by such counterparty in a given year, an audit of each such amendment agreement would, to ensure the quality of the audit, trigger the review of each of the underlying credit support arrangements, and potentially the master trading agreement as well. Any audit of any particular document created in any particular year would be potentially incomplete or inaccurate without reference to the terms of the agreements that such document incorporates by reference. If the fixed 5% requirement is applied literally, the audit provision likely would be too narrow, excluding many inter-connected documents and, therefore, do little to further the Dodd-Frank Act's risk management goals. Alternatively, if the fixed 5% requirement is interpreted to include all documents with interconnected terms, the scope of the audit likely would be so broad that, as a practical matter, the majority of an entity's trading documents would be subject to review every year. HETCO does not believe that either extreme is the most effective way to achieve the Dodd-Frank Act's risk management and market integrity objectives.

¹² See 76 Fed. Reg. at 6726 (Proposed Rule 23.504(b)(2)); *Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants*, 75 Fed. Reg. 81519, 81522 (Dec. 28, 2010) (discussing proposed requirements regarding acknowledgement and confirmation of swaps). The Commission should note that many swap dealers may trade swaps as end-users. End-users generally will execute swap transactions by sending their counterparty an "acknowledgement" of the terms of a trade. See 75 Fed. Reg. at 81531 (Proposed Rule 23.501(a)(2)). HETCO encourages the Commission to clarify whether acknowledgements of trades are subject to the 5% audit requirement.

III. The Goals of the OLA Rule Are Better Achieved By a Simple Notice Requirement.

The Commission's OLA Rule proposes mandatory inclusion of a specific contractual provision in all swap trading documentation to which a swap dealer or major swap participant is a counterparty. The proposed mandatory provision (the "OLA Provision") would provide for certain rights and restrictions regarding treatment of the swap in the event one of the parties to the swap is identified as a systemically significant "covered financial company" subject to special liquidation proceedings by the Federal Deposit Insurance Corporation under Title II of the Dodd-Frank Act.

HETCO suggests that a mandatory limitation on counterparties' rights and remedies is unnecessary to achieve the goals of the OLA Provision as outlined by the Commission itself in the OLA Rule. Specifically, the Commission stated that the OLA Provision is intended to,

[E]nsure both counterparties to a swap *understand* that under particular, unique circumstances, described in detail below, if one of the counterparties defaults, the non-defaulting party's positions *could be* transferred to a new, solvent counterparty by the FDIC, and the non-defaulting party *may not be able* to terminate its claims against the defaulting counterparty until 5 p.m. (U.S. eastern time) on the business day following the day the FDIC is appointed receiver.¹³

HETCO notes that many swap dealers and major swap participants will *not* be subject to Title II of the Dodd-Frank Act and, indeed, it is as yet unclear under what circumstances the provisions of Title II of the Dodd-Frank Act may be exercised. In lieu of the mandatory OLA Provision, which could permanently limit the rights and remedies available to the parties under contract, HETCO recommends a simple "check-the-box" or notice requirement which would be supplied by swap dealers and major swap participants to their counterparties. Such a notice requirement would not otherwise limit the rights and remedies of freely contracting parties.¹⁴

IV. Swap Valuation Requirements Should be Flexible to Enhance Price Discovery and Foster Innovation.

The Dodd-Frank Act requires the Commission to adopt rules relating to the "timely and accurate . . . valuation of all swaps."¹⁵ In response, Proposed Rule 23.504(b)(4) would require "written documentation in which the parties 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 the swap" (the "Swap Valuation Provision").¹⁶ In addition, Proposed Rule

¹³ See 76 Fed. Reg. at 6709 (emphasis added).

¹⁴ Note that other commenters have questioned the constitutionality of mandating such a limitation on the rights of contracting parties.

¹⁵ See Dodd-Frank Act § 731 (adding Commodity Exchange Act ("CEA") § 4s(i)).

¹⁶ 76 Fed. Reg. at 6719.

23.504(b)(4) requires that the Swap Valuation Provision: (i) be based on “objective criteria;”¹⁷ (ii) contain “methods, procedures, rules, and inputs” that have been agreed *ab initio*;¹⁸ (iii) be capable of reverse engineering by regulatory authorities;¹⁹ and (iv) contain alternative valuation methods for situations where agreed inputs become unavailable.²⁰

HETCO generally agrees that swap trading documentation should, to the extent possible, contain terms that provide for objective guidelines regarding the valuation of a swap and associated collateral. However, HETCO believes that the detailed requirements of Proposed Rule 23.504(b)(4) – particularly the implicit prohibition against applying dynamic valuation techniques over the life of a swap – are unworkable in practice and may lead to unintended market distortions.²¹ HETCO respectfully submits that the Dodd-Frank Act does not require the parties to a swap to fix by contract the valuation methods that will be used over the entire life of the swap. Rather, HETCO understands the relevant language of the Dodd-Frank Act to merely require the Commission to establish rules regarding “timely and accurate” valuation.²²

The lack of flexibility in valuing swap transactions that would accompany a lock-up of valuation “methods, procedures, rules, and inputs” could exacerbate pricing distortions in times of market volatility. In HETCO’s experience, markets become susceptible to volatility when existing pricing models applied by market participants prove inaccurate or incomplete. If the Commission mandates adherence to valuation models that may have become inaccurate or incomplete, the Commission could inadvertently but substantially prolong or exacerbate market volatility by forcing participants with existing trades to ignore changed circumstances. Moreover, mandating continued application of subsequently disproved models could create arbitrage opportunities between market participants as between existing and new trades – meaning, a counterparty with an existing trade based on a disproven model would be compelled, given changed market circumstances, to trade away from a counterparty with whom he had an outdated model (*i.e.*, by seeking early termination of his trade), with a view to reestablishing the same trade, under new valuation techniques, with the same or another dealer. HETCO does not

¹⁷ 76 Fed. Reg. at 6726 (Proposed Rule 23.504(b)(4)).

¹⁸ 76 Fed. Reg. at 6726 (Proposed Rule 23.504(b)(4)(i)).

¹⁹ *Id.* Note that the requirement for transparency of models pushes up significantly against Proposed 23.504(b)(4)(iii), which states that counterparties are generally not required to disclose to market participants any confidential, proprietary information regarding valuation models.

²⁰ 76 Fed. Reg. at 6726 (Proposed Rule 23.504(b)(4)(ii)).

²¹ Note that standard swap documentation utilized by the majority of market participants, such as the form International Swaps and Derivatives Association Master Agreement, generally contains requirements as to the party or parties which are obligated to determine swap and collateral values.

²² Dodd-Frank Act § 731 (adding CEA § 4s(i)) (“Each registered swap dealer and major swap participant shall conform with such standards as may be prescribed by the Commission by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps. . . The Commission shall adopt rules governing documentation standards for swap dealers and major swap participants.”). It is not even entirely clear from the drafting of the relevant language in the Dodd-Frank Act whether the Commission is in fact mandated to adopt rules regarding valuation of swaps *per se*, or merely rules regarding documentation generally.

believe that such an outcome would be beneficial or consistent with the overall objectives of the Dodd-Frank Act.

HETCO strongly encourages the Commission to consider the practical effects that such locked-in valuation procedures may have on the energy commodity markets. The ability of the market to provide accurate prices depends on continuously evolving pricing inputs from market participants. Particularly for relatively illiquid markets, dynamic pricing models must be flexible enough to adapt to the constantly changing political, economic, and other risks often associated with buying and selling scarce commodities. Restricting swap dealers and major swap participants to pre-approved valuation methods will inhibit trading and the development of new, more accurate pricing models. Such a limitation would make it more difficult for market participants to respond to developments in a timely manner, stifling innovation in new and developing risk management products, and compromising the core price discovery function of the markets.²³ Accordingly, HETCO urges the Commission to amend the Swap Valuation Provision to provide for flexibility in valuation techniques over the life of a swap and to adopt a more flexible and commercially practicable approach to the Swap Valuation Provision in its final rule.

V. Valuation Disputes Should be Reported Only if they Exceed Certain Materiality Thresholds.

The Documentation Rule would require each swap dealer and major swap participant to notify the Commission of any swap valuation dispute not resolved within: (1) one business day, if the dispute is with a counterparty that is a swap dealer or major swap participant; or (2) five business days, if the dispute is with a counterparty that is not a swap dealer or major swap participant.²⁴ HETCO appreciates that valuation disputes are an indicator of potential market volatility or stress and that, in circumstances where such disputes indicate significant pricing disparities that may contribute to systemic risk, it is valuable for market participants to report such disputes to the Commission.

Even though the size of a valuation dispute typically determines whether or not the dispute may have an effect on the market as a whole, the Documentation Rule would require swap dealers and major swap participants to report *all* disputes lasting more than one or five business days. HETCO believes that, as proposed, the Documentation Rule would require market participants to report a large number of valuation disputes that are not material the stability or integrity of the financial system.

HETCO respectfully submits that the Commission should only require market participants to report valuation disputes that exceed an express materiality threshold. Such a materiality threshold should be capable of reflecting the degree of risk that the disputing parties'

²³ An overly prescriptive valuation provision also could interfere with market participants' ability to privately negotiate the price and value of their transactions. HETCO believes that such a restriction is unnecessary and, ultimately, inefficient for market participants and the market as a whole.

²⁴ 76 Fed. Reg. at 6726 (Proposed Rule 23.504(e)); 76 Fed. Reg. at 6719.

portfolios pose to the market, and should be based on the size of a dispute relative to the disputed trade, collateral, or size of the disputing counterparties (*e.g.*, the notional value of the disputed portfolio or the aggregate value of posted margin or capital of the counterparty). HETCO believes that such a threshold would increase the probative value of disputes that are reported to the Commission by only supplying information regarding disputes that have the potential to impact market stability. HETCO, therefore, urges the Commission to revisit the dispute reporting requirement with a view to establishing an appropriate materiality threshold to improve the quality of dispute reporting the Commission receives.

VI. Conclusion

HETCO appreciates the opportunity to provide the Commission with its perspective on the Proposed Rules and the impact that they will have on swap documentation audits, valuation procedures, and dispute reporting. HETCO encourages the Commission to refine the Proposed Rules to better respond to the relative level of risk various counterparties pose to market stability.

HETCO welcomes the opportunity to discuss these issues further with the Commission and its Staff. We are available to answer any additional questions you may have at your convenience.

Respectfully submitted,



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