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VIA ELECTRONIC SUBMISSION

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: Capital Requirements of Swap Dealers and Major Swap Participants RIN 3038-AD54

Dear Mr. Stawick:

On behalf of Hess Corporation ("Hess Corp.") and Hess Energy Trading Company, LLC ("HETCO") (collectively "Hess"), we respond to the proposed rule regarding capital requirements of swap dealers and major swap participants ("Proposed Capital Rule").[1] The U.S. Commodity Futures Trading Commission ("Commission" or "CFTC") issued the rule under Section 4s(e) of the Commodity Exchange Act ("CEA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

Hess urges the Commission and CFTC Staff to reconsider the proposal to permit the use of parent guarantees in the capital requirements calculation. Among commercial entities, parent guarantees are a well-established and widely-accepted instrument used by affiliates to demonstrate financial security to their counterparts and an ability to perform their financial obligations. They should therefore be recognized as an integral component when determining the capitalization of a commercial, non-bank swap dealer or major swap participant. Indeed, parent guarantees are directly relevant to how many non-bank swap dealers manage their risk. Revising the Proposed Capital Rule to recognize parent guarantees is also consistent with the Commission's stated goal to embrace those existing commercial practices which satisfy the standards articulated in the Dodd-Frank Act. To do otherwise may cause commercial entities to exit the swaps markets thereby further concentrating swap activities among the very financial institutions that were the focus of the Dodd-Frank Act. This should not be the result of the Proposed Capital Rule.

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

Hess Corp. 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 and electricity.

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[1] 76 Fed. Reg. 27,802, Capital Requirements of Swap Dealers and Major Swap Participants (May 12, 2011).

Hess Corp. is listed on the New York Stock Exchange. Through its subsidiaries, Hess Corp. is involved in exploration and production operations located within and outside the United States.

Hess Corp.'s Energy Marketing division markets refined oil products, natural gas, and electricity to a vast array of utilities and other industrial and commercial customers. The company's 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 Corp. enters into derivatives contracts to manage the fixed price risk associated with these activities.

HETCO is a Delaware limited liability company established in 1997. HETCO has branches in Geneva and Dubai and operates three United Kingdom corporations (two of which are registered with the Financial Services Authority), and a corporation organized in Singapore. Together, these entities execute worldwide energy trading strategies involving forward physical purchase and sales agreements, foreign exchange transactions (used for hedging), physical oil storage and chartered vessel transactions, and swaps and other derivative transactions involving crude oil, other petroleum products, natural gas, power, and freight.

II. The Commodity Exchange Act and the Proposed Capital Rule

CEA Section 4s(e)(1)(B) requires all non-bank swap dealers to comply with "such minimum capital requirements . . . as the [Commission] shall by rule or regulation prescribe."[2] Under the CFTC's new definition of "swap dealer," commercial entities with a regular business of swap trading could be designated "non-bank swap dealers" and subject to minimum capital requirements for the first time. Historically, capital requirements have applied to banks, commodity brokers, and other similar institutions who, as financial intermediaries, need to keep a significant portion of their assets in cash or similarly liquid assets primarily to satisfy their customers' demands and meet their customers' obligations. Indeed, the proposed capital requirements for banks are nearly identical to those under which they currently operate. However, for a commercial firm, this new type of regulation, regardless of its construct, will be a new cost and regulatory burden. As such, the application of a capital regime to non-bank swap dealers, the consequence of which may be to force these commercial entities to substantially restructure their business, may result in companies reducing the size of (or even eliminating) their swap businesses with no demonstrable reduction of risk or benefit to market stability.

The Proposed Capital Rule relies heavily on existing regulatory requirements for FCMs. However, the Commission recognized that there are significant, historical differences between financial institutions engaged in swap activities and their non-bank counterparts (e.g., commodity merchants) when it proposed to allow non-bank swap dealers to meet their capital requirements based on "tangible net equity" as opposed to "adjusted net capital" for FCMs. In contrast to adjusted net capital, which is limited to "current assets" (i.e., cash and other highly

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[2] CEA Section 4s(e)(1)(B).

liquid assets),[3] tangible net equity is broader, encompassing equity "as determined under U.S. generally accepted accounting principles . . ." (i.e., liquid and potentially illiquid assets).[4] In this way, the Commission recognized that, although the capital requirements applicable to FCMs provide a useful starting point for developing new capital requirements for non-bank swap dealers, this framework needed to be modified to address fundamental differences between how financial institutions and non-bank swap dealers operate.

Although the Proposed Capital Rule is more flexible than the current capital requirements applicable to FCMs, it does not go far enough because it does not include parent guarantees. As a result, the Proposed Capital Rule does not consider the current capital structure of numerous non-bank swap dealers that has existed for years. In addition, the Proposed Capital Rule draws an unnecessary distinction between non-bank swap dealers that guarantee the obligations of a subsidiary or affiliate and non-bank swap dealers that *are guaranteed by* a corporate parent because it:

- *Requires* a swap dealer to consolidate in a single tangible net equity computation the assets and liabilities of any subsidiary or affiliate that the swap dealer guarantees; and

- *Permits* a swap dealer to consolidate in a single tangible net equity computation the assets and liabilities of any subsidiary or affiliate that the swap dealer majority owns or controls, provided that the swap dealer provides and periodically updates an opinion of counsel that the net asset value (or relevant portion thereof) of the subsidiary or affiliate may be caused by the swap dealer (or an appointed trustee) to be distributed to the swap dealer within 30 calendar days;[5] but

- *Would not* permit a swap dealer to consolidate in a single tangible net equity computation the assets and liabilities of a *parent corporation*, even if the parent corporation and the swap dealer have consolidated financial statements and the parent corporation has expressly and unconditionally guaranteed the swap dealer's liabilities.[6]

Hess respectfully submits that the Commission should modify the Proposed Capital Rule to permit non-bank swap dealers to include parent guarantees when calculating tangible net equity to satisfy its capital requirements.

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[3] 17 C.F.R. §1.17(c)(5).

[4] The Commission said that the tangible net equity approach "would allow swap dealers . . . to include in their minimum capital computation assets that would not qualify as current assets under FCM adjusted net capital requirements, such as property, plant and equipment, and other potentially-illiquid assets." 76 Fed. Reg. at 27,807.

[5] 76 Fed. Reg. at 27,828.

[6] The CFTC and the National Futures Association ("NFA") (which is involved in administering compliance with FCM (and in the future SD) capital requirements) have both concluded that parent guarantees could not be used by swap dealers to comply with the tangible net equity requirement in Proposed CFTC Rule 23.102(a).

III. The Proposed Capital Rule Should be Refined to Reflect How Commercial Businesses Operate.

By proposing a definition of tangible net equity that is broader and more flexible than the definition of adjusted net capital, the Commission, we believe appropriately, attempted to establish a capital standard that allows non-bank swap dealers to take advantage of their current business practices so long as these practices are designed and monitored to ensure that they effectively manage the entity's risk. However, for reasons not expressly articulated in the Proposed Capital Rule, the Commission did not permit the use of parent guarantees. Further review of the FCM model and the application of parent guarantees to the capital requirements of an FCM suggests that the proposed exclusion is not necessary for non-bank swap dealers for at least two reasons:

First, the business of an FCM, which typically acts as a financial intermediary, is fundamentally different than the business of a non-bank swap dealer. As the Commission explained, "readily available liquid assets are essential for FCMs to meet their key financial obligations."[7] In contrast, non-bank swap dealers do not hold deposits for or on behalf of customers. Nor do they guarantee customer obligations with derivatives clearing organizations (including obligations to make appropriate initial and variation margin payments). In fact, swap dealers (bank or non-bank) cannot engage in transactions with customers trading on designated contract markets without registering as FCMs. Accordingly, non-bank swap dealers do not have the same liquidity requirements as a financial institution that acts as an intermediary for customer transactions. Indeed, consistent with this conclusion, Chairman Gensler noted that "non-banks generally have different assets than traditional financial institutions," and that the "current regulatory capital standards for banks and other financial institutions most likely are not directly applicable to non-bank entities."[8]

Second, as Hess understands it, FCMs have historically resided at (or near) the top of the organizational structure. Accordingly, guarantees involving FCMs have typically flowed from the FCM to downstream entities, e.g. introducing brokers, not in the other direction. Consistent with this typical relationship, the existing capital requirements for FCMs allow an FCM to count a downstream entity's assets toward its capital requirement where the FCM demonstrates that it can control the downstream entity, i.e. liquidate it unilaterally, such that the subsidiary's entire assets are obtained. However, because most FCMs and their affiliates are not structured such that parent guarantees would be common or useful, parent guarantees simply were not contemplated under the FCM capital requirements. Given this fact, and recognizing that the CFTC has previously seen fit to allow parent guarantees to be used under certain circumstances, the Proposed Capital Rule should reflect the different capital structure used by many non-bank swap dealers.

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[7] 76 Fed. Reg. at 27,807.

[8] Gary Gensler, Chairman, Commodity Futures Trading Commission, Opening Statement, Public Meeting of the CFTC (Dec. 1, 2010).

Hess agrees that non-bank swap dealers should be well-capitalized, financially sound market participants. But, as the Commission has noted, non-bank swap dealers do not have the same liquidity needs and obligations to manage customer business as FCMs.[9] Indeed, many potential non-bank swap dealers have a core business other than swap dealing, such as physical energy trading, that requires continual sources of capital to be sustainable. Thus, the same reasoning used to justify different standards for tangible net equity and adjusted net capital supports expanding the Proposed Capital Rule to permit the use of parent guarantees to meet the capitalization requirements applicable to non-bank swap dealers.

IV. Permitting the Use of Parent Guarantees Under Narrowly-Defined Conditions Will Substantially Reduce the Cost of the Proposed Capital Rule for Non-Bank Swap Dealers Without Compromising the Policy Goals of CEA Section 4s(e).

A. *Disclosure requirements and an ability to audit a guarantor would provide the Commission with sufficient transparency to ensure that non-bank swap dealers comply with the CFTC's capital requirements.*

Notwithstanding the above, Hess appreciates that the Commission may have certain reservations with the inclusion of parent guarantees in the capital requirements calculation given a perceived lack of authority over, or access to information residing in, the issuing parent company. However, these transparency concerns may be addressed through appropriate disclosure requirements and by granting the Commission the ability to audit the guarantor, which would allow the CFTC to "look through" the swap dealer to monitor and analyze the guarantor's financial condition. The Commission can create sufficient transparency in more than one commercially practicable way:

- *Permit the use of guarantees where the guarantor is an issuer of securities that are registered under section 12 of the Securities Exchange Act of 1934, the guarantor and the non-bank swap dealer have consolidated financial statements, and the guarantor consents to audit and inspection by the CFTC (or NFA).* Where the above criteria are met, the Commission should permit a swap dealer to use a parent guarantee to meet its capital requirement. The CFTC will be able to monitor and analyze the guarantor's financial condition through its consolidated and audited financial statements and other public filings made pursuant to the Exchange Act. The guarantor would permit the CFTC and NFA to audit its records to ensure compliance with the capital requirement.

- *Permit guarantees where the guarantor is a "Registered Credit Support Provider".* Alternatively, the Commission should consider establishing a new category of registrant for "Registered Credit Support Providers." Registered Credit Support Providers would serve the limited purpose of providing capitalization support to a non-bank swap dealer through a payment guarantee or other means. To ensure that the CFTC (and NFA) would

[9] *See* 76 Fed. Reg. at 27,807 ("The Commission believes that setting a capital requirement that is different from the traditional FCM adjusted net capital approach is appropriate for SDs and MSPs that are not acting as market intermediaries in the same manner as FCMs.").

be able to monitor and analyze a Registered Credit Support Provider's financial condition on an ongoing basis, these registrants could be subject to books and records requirements, including provision of periodic financial reports, submission to audits and inspections, and compliance with other requirements designed to enhance transparency. Although the Registered Credit Support Provider, in most cases, would itself not be subject to capital requirements, comprehensive disclosures combined with authority vested in the CFTC to verify the registrant's financial condition would provide sufficient transparency to ensure that non-bank swap dealers remain in compliance with the capital requirements at all times. This is particularly true where a swap dealer and its parent-guarantor have consolidated financial statements that present the financial condition of both entities on an aggregated basis.

B. *Requiring non-bank swap dealers to comply with capital requirements without the benefit of parent guarantees is inefficient and potentially contrary to the goals of the Dodd-Frank Act.*

As evidenced by the proposed definition of tangible net equity, the Commission recognizes the value of permitting non-bank swap dealers to use a variety of non-cash assets to satisfy their capital requirements. However, by precluding the use of parent guarantees when calculating a non-bank swap dealer's capitalization, the Commission effectively dictates that such entities will not have access to the most efficient tools to manage its risks.

Within a commercial organization, non-cash assets like pipelines, plants, vessels, etc., are typically held by a corporate entity that is legally distinct from the organization's affiliates, including those that may fall under the Commission's definition of a "swap dealer". Therefore, under the Proposed Capital Rule, to ensure that such assets could be counted toward the non-bank swap dealer's capital requirement, the parent would have to transfer the assets onto the books of the non-bank swap dealer. This could result in unnecessary and unanticipated legal, tax, or operational problems. For example, if a commercial entity transfers ownership of a refinery to a non-bank swap dealer affiliate to enable the non-bank swap dealer to count the value of the plant as part of its tangible net equity, the non-bank swap dealer would no longer be permitted to hedge the commercial risk associated with operating the refinery using the end user exception to mandatory clearing because the owner of the refinery would be a "financial entity". This could result in significant, increased costs to the commercial organization. In contrast, by leaving the asset on the books of the parent company, the risk associated with the asset can be hedged using uncleared swaps, resulting in greater flexibility and lower cost for the commercial entity. Equally important, the asset would remain available to support the guarantee provided by the parent to the non-bank swap dealer.

C. *HETCO's counterparties, and HETCO as a counterparty, rely upon and accept parent guarantees in the normal course of their businesses.*

HETCO currently operates as a separate and independent legal entity from Hess Corp. For commercial reasons, Hess Corp. typically serves as HETCO's guarantor when HETCO transacts with counterparties. The Hess Corp. parent guarantee enhances HETCO's credit worthiness and ability to transact with counterparties efficiently by allowing HETCO to rely on

Hess Corp. and HETCO's consolidated balance sheet, which includes Hess Corp.'s substantial physical assets, without requiring the entities to actually exchange any tangible property. Many commercial entities in the commodities marketplace rely on parent guarantees for these same reasons. For example, Hess Corp. has over 300 parent company guarantees outstanding with HETCO counterparties. HETCO, in turn, has received over 100 parent company guarantees from its counterparties. HETCO and its counterparties recognize that these parent guarantees decrease the credit risk associated with individual transactions and improve the stability and financial integrity of the market as a whole. The Commission should do the same by allowing non-bank swap dealers to rely on parent guarantees that comply with reasonable requirements, described above.[10]

V. Non-Bank Swap Dealers May Be Required to Register With The Commission Before They Have Adequate Notice of the Regulatory Requirements to Which They Will be Subject.

Swap dealers must register with the CFTC no later than the effective date of final regulations further defining the term "swap dealer," "major swap participant," or "swap", whichever occurs last.[11] Although the CFTC's timeline for finalizing regulations is not certain, CFTC Staff have indicated that the Proposed Capital Rule likely will not be adopted in final form until *after* the date on which swap dealers are required to register. As a result, many commercial entities will be required to make critical business decisions (*e.g.*, whether to remain in a business that would require registration as a swap dealer) without the ability even to estimate the cost of complying with these still-pending capitalization requirements. This dilemma is particularly acute for commercial entities that will be subject to capital requirements for the first time if they are required to register as swap dealers.

To avoid (or at least minimize) the potentially tremendous cost associated with capitalizing a new non-bank swap dealer affiliate, the Commission should modify the Proposed Capital Rule to permit non-bank swap dealers to include parent guarantees in their capitalization calculation. Such a modification will provide commercial entities with additional flexibility that will make it more likely that they will be able to comply with the capital requirements applicable to non-bank swap dealers without substantial business disruption and without compromising the policy goals of CEA Section 4s(e). In contrast, if the Commission excludes parent guarantees from the capital calculation, commercial entities may reduce or discontinue their swap dealing business rather than have to separately to capitalize their swap dealer affiliate. Notably, because of the timing of the swap dealer registration requirement, this decision could only come *after* a

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[10] This is particularly true for non-bank swap dealers that are, along with their affiliates, treated as a single entity for purposes of other CFTC regulatory requirements. For example, under the CFTC's Position Limits Rule, entities are required to determine whether they comply with speculative position limits on an aggregate basis that, subject to limited exceptions, includes an entity's own positions, plus the positions of any other entity subject to common ownership (greater than 10 percent) or control. To the extent that the Commission already views certain affiliated entities as one for position limits purposes, any group of affiliates so treated should, subject to reasonable conditions, also be treated as a single entity for purposes of capital requirements.

[11] 17 C.F.R. § 3.10(a)(2).

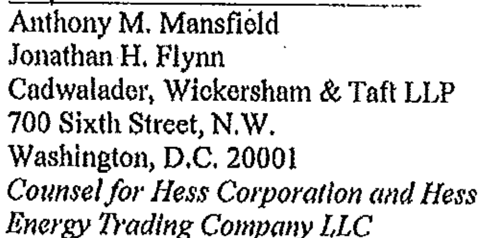
company has expended substantial time and resources to comply with other requirements applicable to swap dealers (*e.g.*, spinning off and novating trades to a swap dealer affiliate, negotiating trading relationship documentation with counterparties, drafting and implementing compliance policies and procedures, etc.).

Prohibiting the use of parent guarantees may inadvertently create an implicit preference for swap dealers that are already structured and capitalized as banks. Because the cost of capitalizing a non-bank swap dealer that relies on a parent guarantee will be substantially higher than the cost of capitalizing a financial institution that already has a robust balance sheet and existing capital requirements, swap activity may migrate away from non-bank swap dealers to the largest financial swap dealers. As a result, the capital requirements may have the unintended result of foreclosing all but the largest financial firms from acting as swap dealers. This concentration of swaps activity (and corresponding risk) is contrary to the goals of the Dodd-Frank Act. Accordingly, the Commission should expand the Proposed Capital Rule in a way that fosters a financially sound, but well-diversified derivatives market that includes non-bank swap dealers by permitting the use of parent guarantees.

VI. Conclusion

Hess welcomes the opportunity to discuss these issues further with the Commission and its Staff. Please contact us at (202) 862-2321 if you have any questions regarding Hess's comments.

Respectfully submitted,



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