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# Derivatives: Introduction and Legislation in the 114<sup>th</sup> Congress

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## Summary

Derivatives are financial instruments that come in several different forms, including *futures*, *options*, and *swaps*. A derivative is a contract that derives its value from some underlying asset at a designated point in time. The derivative may be tied to a physical commodity, a stock index, an interest rate, or some other asset.

Derivatives played a role in the 2008 financial crisis in a variety of ways. The unmonitored buildup of derivatives positions in the largely unregulated “over-the-counter” (OTC) market led many major financial institutions into large financial losses. Possibly the best-known example of such losses was the insurance giant American International Group (AIG), whose massive losses from selling credit-default swaps ultimately contributed to the need for government assistance. OTC derivatives, prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203), were traded bilaterally rather than cleared through a clearinghouse, and no reporting trail existed, which created uncertainty during the crisis over the web of exposures to large derivatives losses.

The Dodd-Frank Act aimed to address these policy concerns by bringing the swaps market into a regulatory framework based on that of the futures markets, which had long been regulated by the Commodity Futures Trading Commission (CFTC). Security-based swaps tied to equities or narrow-based credit indexes were placed under the jurisdiction of the Securities and Exchange Commission (SEC) within a similar framework.

Broadly, Dodd-Frank included five major reforms. It required the

1. clearing of certain swaps through a clearinghouse, entailing the posting of margin, or cash, to cover accumulating losses;
2. trading of certain swaps on an exchange or *swap execution facility* (an electronic trading platform), with the aim of increasing price transparency;
3. reporting of all swaps transactions to a swaps data repository (SDR) to create an audit trail and more market data for regulators;
4. registration of swap dealers and major swap participants, subjecting them to regulatory oversight; and
5. establishment of margin and capital requirements by regulators for swaps that remain uncleared. Parallel provisions were enacted for security-based swaps under the SEC.

In the 114<sup>th</sup> Congress, several bills have been introduced, and two have been enacted as part of other legislation, impacting various aspects of swaps regulation largely stemming from Dodd-Frank. One of the provisions, originally in H.R. 1847 but enacted in P.L. 114-94/H.R. 22, removed a requirement added in Dodd-Frank that foreign regulators indemnify a U.S.-based SDR and the CFTC for any expenses arising from litigation related to a request for market data (with a parallel SEC provision). The other provision, originally in H.R. 1317 but enacted in P.L. 114-113/H.R. 2029, created an exception for certain corporate affiliates of nonfinancial companies, dubbed “centralized treasury units,” to the clearing and exchange-trading requirements.

The House has passed legislation, H.R. 2289, that would reauthorize appropriations to carry out the Commodity Exchange Act (CEA; 7 U.S.C. §§1 et seq.)—a process that historically has recurred every five years. H.R. 2289 also includes measures that would increase required cost-benefit analysis by the CFTC in rulemakings and broaden the definition of *bona fide hedging* to allow anticipated, as well as current, risks to be hedged, likely increasing the number of swaps qualifying as hedges for position limits, registration requirements, and other purposes. H.R. 2289

also would mandate that, starting 18 months from enactment, the swaps regulatory requirements of the eight largest foreign swaps markets must be considered comparable to those of the United States—unless the CFTC were to issue a rule finding that any of those foreign jurisdictions' requirements were not comparable to U.S. requirements. H.R. 2289 and S. 1560 also contain provisions to codify the deadline for brokers to deposit *residual interest* (capital from a futures broker that temporarily makes up the difference for insufficient margin in a customer's account) as no earlier than 6:00 p.m. on the following business day.

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## Background

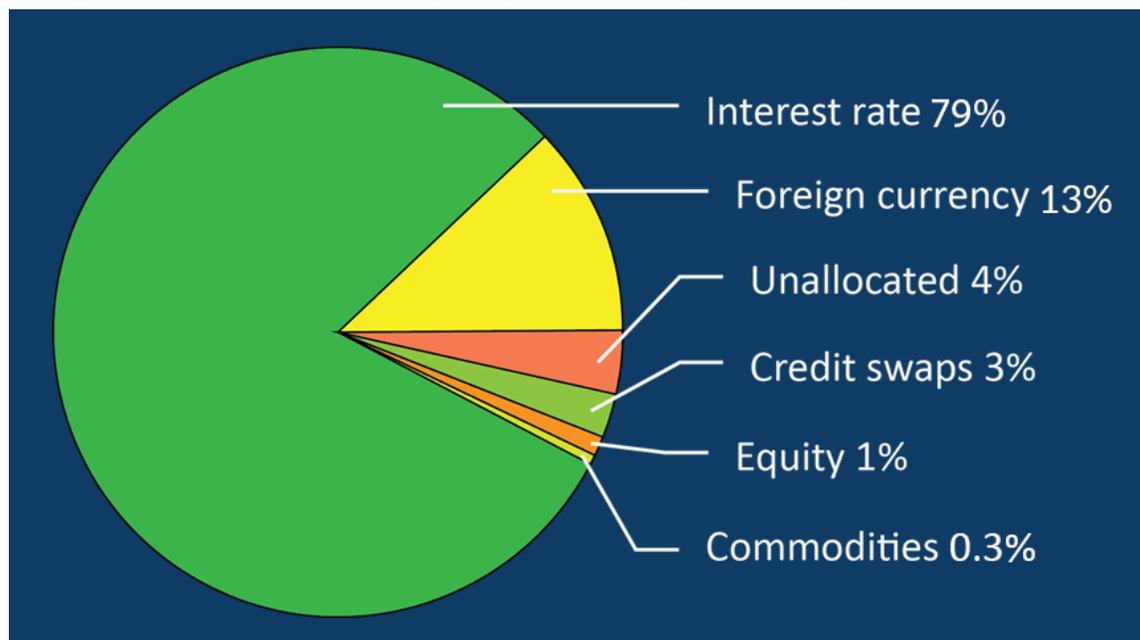
Derivatives are financial instruments that come in several different forms, including *futures*, *options*, and *swaps*. A derivative is a contract that derives its value from some underlying asset at a designated point in time. The derivative may be tied to a physical commodity, a stock index, an interest rate, or some other asset. Derivatives' prices fluctuate as the underlying assets' rates or expected future prices change, and neither a buyer nor a seller of a derivative need necessarily own the underlying asset.

Many firms use derivatives to manage risk. For example, a firm can protect itself against potential increases in the price of a commodity that it uses by entering into a derivative contract that will gain value if the price of the commodity rises. A notable instance of this type of hedging strategy was a derivatives position taken by Southwest Airlines that allowed it to buy jet fuel at a low, fixed price in 2008 even as energy prices reached record highs. When used to hedge risk, derivatives can protect businesses (and sometimes their customers) from unfavorable price shocks.

Others use derivatives to seek profits by betting on which way prices will move. Such speculation adds liquidity to the market—speculators assume risks that hedgers wish to avoid. Some observers believe that the growth of speculative derivatives trading has increased the risks of market instability and volatility, whereas others argue that such speculation adds liquidity and that more liquid derivatives markets are more efficient and more stable.

Although derivatives trading has its origins in agriculture, today most derivatives are linked to financial variables, such as interest rates, foreign exchange rates, stock prices, and the creditworthiness of bond issuers, as shown in **Figure 1**. The market is measured in hundreds of trillions of dollars, and billions of contracts are traded annually.

**Figure 1. Over-the-Counter (OTC) Contracts by Underlying Interest, June 2015**



**Source:** Bank for International Settlements (BIS).

**Note:** Figure describes global OTC derivatives market as of June 30, 2015.

Growth in derivatives markets was explosive between 2000 and the advent of the 2008 financial crisis, with some retrenchment after 2008. From 2000 until the end of 2008, the volume of derivatives contracts traded on exchanges, such as futures exchanges, and the notional value of total contracts traded in the over-the-counter (OTC) market grew by 475% and 522%, respectively. Following the 2008 financial crisis, the total notional value of OTC derivatives globally fell by about 13% between June 2008 and December 2008 but then crept upward again.<sup>1</sup> Over the longer term, total global notional values outstanding for OTC derivatives have fallen from \$684 trillion as of June 2008<sup>2</sup> to \$553 trillion as of June 30, 2015,<sup>3</sup> albeit with fluctuations, as more derivatives have been increasingly traded on exchanges rather than OTC since the crisis. Of the total, 79% of global swaps consisted of interest-rate swaps as of June 30, 2015, illustrating the predominance of financial instruments over agricultural ones.<sup>4</sup>

The financial crisis led to intense debate about whether the rapid growth in derivatives markets had contributed to structural instability in the U.S. and global financial systems. The reasons for the crisis are still the subject of wide debate, but most observers believe a major factor behind the severe market turmoil was derivatives exposures, which could not be readily quantified and exacerbated panic and uncertainty about the true financial condition of other market participants, contributing to the freezing of credit markets.<sup>5</sup> Such debates led, in 2010, to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203), which required that risk exposures of major financial institutions be backed by capital, minimizing the shock to the financial system should such firms fail. Dodd-Frank also aimed to ensure that large derivatives bets by financial firms would be collateralized by having those firms post margin, or cash, into accounts to pay for potential losses from derivatives.

Whether Dodd-Frank has been effective in lowering structural risks to the U.S. and global financial systems remains a subject of debate. In addition, some argue that Dodd-Frank has imposed costs that affect the competitiveness of U.S. financial institutions. This report discusses some of these debates as they relate to selected legislative proposals in the 114<sup>th</sup> Congress affecting the regulation of derivatives.

## Market Structure and Regulation

Prior to passage of the Dodd-Frank Act, futures and options were traded on regulated exchanges, whereas swaps were traded OTC. A *futures contract* is an agreement to buy or sell a commodity or asset at a predetermined price at a future date. An *option* is a contract that gives the holder the option, but not the obligation, to buy or sell an asset or commodity at a future date at a

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<sup>1</sup> See Bank for International Settlements (BIS), *Statistical Release: OTC Derivatives Statistics at end-December 2011*, May 2012. Total notional values fell from \$684 trillion in June 2008 to \$592 trillion in December 2008, representing a decline of 13%, before increasing again to \$648 trillion by December 2011. For additional details on over-the-counter (OTC) derivatives market trends over time, see BIS's chart on p. 2, at [http://www.bis.org/publ/otc\\_hy1205.pdf](http://www.bis.org/publ/otc_hy1205.pdf).

<sup>2</sup> See Bank for International Settlements, "Statistical Release: OTC Derivatives Statistics at end-December 2011," published May 2012. For additional details on OTC derivatives market trends over time, please see their chart on page 2, available at [http://www.bis.org/publ/otc\\_hy1205.pdf](http://www.bis.org/publ/otc_hy1205.pdf).

<sup>3</sup> See Bank for International Settlements, "Statistical Release: OTC Derivatives Statistics at end-June 2015," published November 2015, p. 2. Available at [http://www.bis.org/publ/otc\\_hy1511.pdf](http://www.bis.org/publ/otc_hy1511.pdf).

<sup>4</sup> Bank for International Settlements, "Statistical Release: OTC Derivatives Statistics at end-June 2015," published November 2015.

<sup>5</sup> For a broad look at causes of the financial crisis, including derivatives, see, for example, James Crotty, "Structural Causes of the Global Financial Crisis: A Critical Assessment Of the 'New Financial Architecture,'" *Cambridge Journal of Economics*, vol. 33, no. 4 (2009), pp. 563–580, at <http://cje.oxfordjournals.org/content/33/4/563.full.pdf+html>.

predetermined price. *Swaps* are generally agreements between two parties to exchange different cash flows over a set period of time. Although swaps, futures, and options operate differently, they generally are somewhat fungible in the sense that similar investment outcomes can be achieved by employing any one of them.

Prior to Dodd-Frank, swaps (also called OTC derivatives) were largely unregulated, whereas futures and options were regulated by the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC). The regulatory landscape since Dodd-Frank is broadly illustrated in **Figure 2**, below.

**Figure 2. Regulatory Oversight of Derivatives Under the Dodd-Frank Act**



**Source:** Congressional Research Service (CRS).

**Notes:** CFTC = Commodity Futures Trading Commission; SEC = Securities and Exchange Commission.

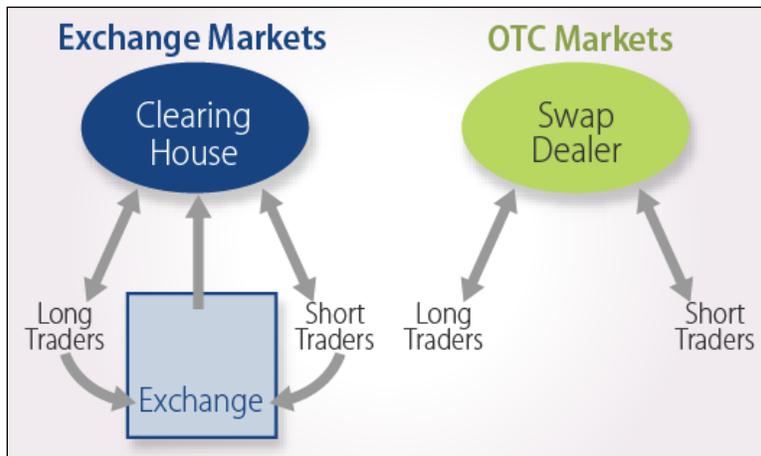
Futures contracts have long been traded on exchanges regulated by the CFTC, and stock options have been traded on exchanges under the SEC. SEC and CFTC regulation of exchanges is generally similar: federal law requires both securities and commodity exchanges to make and enforce rules to ensure fair and orderly trading and to protect public investors from fraud. Many classes of market professionals, as well as the exchanges themselves, are required to register with a federal agency or a self-regulatory organization.<sup>6</sup> Data on price and trading volumes must be publicly available on exchanges. The regulators may amend exchange rules and must approve all rule changes. Both the SEC and the CFTC have their own enforcement powers and staff.

Exchanges are centralized markets where buying and selling interests come together. Traders who want to buy, or take a long position (*longs*)—who benefit if prices of the commodity or asset rise—interact with those who want to sell, or go short (*shorts*). Shorts benefit when prices of the commodity or asset fall. Deals between those on the short and long sides of trades are made and prices are reported throughout the day. In the OTC market, however, contracts are made bilaterally, typically between a dealer and an end user. Prior to Dodd-Frank, the OTC market

<sup>6</sup> Federal securities and commodities laws permit the regulatory agencies to delegate registration and certain other functions to private groups, called self-regulatory organizations (SROs). In securities, the major SRO is the Financial Industry Regulatory Authority. In futures, it is the National Futures Association.

generally had no requirement that the price, the terms, or even the existence of the contract had to be disclosed to a regulator or to the public. **Figure 3** shows the differences between exchange-traded and OTC derivatives.

**Figure 3. Exchange-Traded vs. OTC Derivatives**



Source: CRS.

Derivatives can be volatile contracts characterized by a high degree of leverage, which can result in big gains and losses among traders. The exchanges have dealt with the issue of credit risk through a third-party clearinghouse. But the credit risk remains: How does the clearinghouse ensure that it can meet its obligations? Clearinghouses depend on a system of margin, or collateral. Before the trade, both the long and short traders deposit an initial margin payment with the clearinghouse to cover potential losses. Then, at the end of each trading day, all contracts are repriced, or *marked to market*, and those who have lost money (because prices moved against them) must post additional margin (called *variation* or *maintenance margin*) to cover those losses before the next trading session. This process is known as a *margin call*: traders must make good on their losses immediately or their brokers may close out the traders' positions when trading opens the next day. The effect of the margin system is that no one can build up a large paper loss that could damage the clearinghouse in case of default. It is certainly possible to lose large amounts of money trading on the futures exchanges, but only on a pay-as-you-go basis. Procedurally, the trade is made on the exchange floor (or electronic network) and then is sent to the clearinghouse, which guarantees payment. The process is shown in **Figure 3**, above.

The OTC market, as shown on the right side of **Figure 3**, includes a network of dealers rather than a centralized exchange. Firms that act as dealers stand ready to take either long or short positions, and they make money on the volume of trading by charging a spread, or fee, on each trade. The dealer absorbs the credit risk of customer default, and the customer faces the risk of dealer default. The OTC market has been dominated by fewer than a dozen firms—institutions such as JPMorgan Chase, Goldman Sachs, Citigroup, and their foreign counterparts. In the OTC market, prior to the Dodd-Frank Act, some but not all contracts required collateral or margin. The International Swaps and Derivatives Association, a trade group, published best practice standards for use of collateral, but compliance was voluntary. Since the Dodd-Frank Act, regulators have required the posting of margin for OTC derivatives that are not cleared by a clearinghouse.

## Derivatives in the Financial Crisis

Little consensus exists about the relative importance of the numerous factors<sup>7</sup> that have been put forward as causes of the 2008 financial crisis, including the role of derivatives. However, derivatives clearly played some role in transmitting financial shocks from firm to firm and from market to market. Several aspects of derivative finance may be implicated:

- **Complexity.** At the peak of the housing boom, home mortgage loans were packaged, repackaged, and repackaged again into highly complex securities, many of which incorporated derivatives to increase yield or to obtain AAA bond ratings. As mortgage losses began to grow, no one could be sure what the real value of these securities was. As a result, the true financial condition of banks and other holders of these securities became uncertain and interbank lending slowed, creating the conditions for panic.
- **Opacity.** In addition to the complexity of structured financial instruments, the nature of derivatives markets is to create a web of risk exposures among a wide range of markets and firms. Fears about insolvency in individual financial institutions were amplified by the knowledge that those firms might owe billions to derivatives counterparties—default of a single derivatives dealer had the potential to trigger cascading losses throughout the banking system. But no information about the extent or distribution of such potential losses was available, especially where unregulated OTC derivatives were involved.
- **Leverage.** In the post-2000 low-interest-rate environment, many market participants sought to boost investment returns through the use of leverage—supplementing their own capital with debt or derivatives. Because all derivatives trading is done on margin, a relatively small initial investment may generate a large return (or loss). Thus, the losses in U.S. mortgage lending were magnified into much greater losses throughout the global financial system.
- **Excessive Speculation.** The above factors combined to produce catastrophic losses at a number of systemically important firms that had amassed large speculative derivatives positions. A good example is insurance giant American International Group (AIG), which sold billions of dollars in credit-default swaps and had to be rescued by the government, thus preventing massive losses to AIG's counterparties that could have exacerbated the downward global financial spiral.<sup>8</sup>

The Financial Crisis Inquiry Commission<sup>9</sup> concluded that derivatives contributed to the 2008 financial crisis in three major ways. First, credit-default swaps were instrumental in fueling the securitization of mortgages and mortgage-backed securities and in the subsequent housing

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<sup>7</sup> See CRS Report R40173, *Causes of the Financial Crisis*, by (name redacted)

<sup>8</sup> See CRS Report R40438, *Federal Government Assistance for American International Group (AIG)*, by (name redacted) (out-of-print report; available from the author upon request).

<sup>9</sup> The Financial Crimes Inquiry Commission was established in 2009 as part of the Fraud Enforcement and Recovery Act (P.L. 111-21) to examine the financial crisis in the United States. The commission was composed of a 10-member panel of private citizens with experience in such areas as housing, economics, finance, market regulation, banking, and consumer protection. The commission issued its final report in January 2011. See Financial Crimes Inquiry Commission, *Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, January 2011, pp. xxiv-xxv.

bubble. Second, credit-default swaps were essential in creating synthetic *collateralized debt obligations* (CDOs), or financial instruments that served as bets on the performance of real mortgage-backed securities. The CDOs amplified the losses from the collapse of the housing bubble by allowing multiple bets on the same securities and helped to spread the losses throughout the financial system. Third, once the housing boom ended, derivatives were at the center of the crisis due to (1) concerns that losses associated with derivatives would trigger cascading losses throughout the global financial system and (2) the lack of transparency concerning the overall size of the derivatives market and the extent of derivatives transactions between systemically important financial institutions, which directly added to uncertainty and panic in global financial markets.

The AIG case illustrates two aspects of OTC markets that were central to derivatives reform. First, in a market with mandatory clearing and margin, in which AIG would have been required to post initial margin to cover potential losses, there was a stronger possibility that AIG would have run out of money long before the size of its derivatives position grew so massive.

Second, because most OTC contracts were not reported to regulators prior to 2010, the Federal Reserve and the Treasury lacked information in the crisis about which institutions were exposed to AIG and the size of those exposures. Uncertainty among market participants about the size and distribution of potential derivatives losses flowing from the failure of a major dealer was a factor that exacerbated the “freezing” of credit markets during the peak of the crisis.

One basic theme of derivatives reform proposals in the run-up to the Dodd-Frank Act was to change the OTC market to act more like the exchange-traded futures market—in particular, to have bilateral OTC swaps cleared by a third-party clearing organization. Clearing was expected to reduce counterparty risk and increase transparency. At the same time, borrowing costs can be associated with a clearing regime that requires participants to post margin.

Firms that use derivatives to hedge business risks often take positions that move in the opposite direction from the underlying market. Such commercial businesses argued that the costs of posting margin would prevent them from hedging. Nonfinancial commercial firms were ultimately exempted from the clearing and exchange-trading requirements in the Dodd-Frank Act. However, the question of which firms should be required to clear their derivatives, thereby tying up cash for any margin, remains an issue addressed in some of the legislation in the 114<sup>th</sup> Congress.

## Dodd-Frank Reforms

The Dodd-Frank Act derivatives reforms were broadly aimed at bringing the swaps market under a regulatory regime more closely resembling that of the futures markets. Dodd-Frank added five broad requirements for swaps, with certain exceptions.

First, most swaps are required to be cleared through a clearinghouse, which involves posting margin to cover any potential losses as they accumulate. Second, these swaps also are required to be traded on an exchange or an exchange-like electronic platform called a *swap execution facility* (SEF), with the goal of promoting pre-trade and post-trade price transparency. However, swaps in which one counterparty is a nonfinancial firm (e.g., a farmer, energy company, or airline) are not subject to these clearing and exchange-trading requirements. Third, all swaps must be reported to a database called a *swap data repository* (SDR) to give regulators a clearer picture of the market. Fourth, financial firms that trade swaps heavily must register with the CFTC or the SEC (the latter if the firms trade swaps related to securities) as *swap dealers* or *major swap participants* (MSPs), so as to promote more regulatory oversight of major market players. Fifth, swaps that

remain uncleared, or OTC, are subject to margin and capital requirements set by the regulators to prevent large uncollateralized exposures from accumulating.

### Five Major Dodd-Frank Swaps Reforms

- Clearing most swaps through clearinghouses, with margin posted as potential losses grow.
- Trading swaps on exchanges or swap execution facilities rather than privately between two parties.
- Reporting all swap trades to a data repository.
- Requiring entities that heavily trade swaps to register with the CFTC or the SEC as swap dealers or major swap participants.
- Subjecting swaps that remain uncleared to margin and capital requirements set by regulators.

## Clearing and Trading Requirements

The Dodd-Frank Act requires that most derivatives contracts formerly traded exclusively in the OTC market be cleared and traded on exchanges. Traders in these products now are required to post margin to cover potential losses as they accumulate on a daily basis. However, the act does not require all derivatives contracts to be traded in this way. The Dodd-Frank Act presumes that some derivatives contracts will still be traded in the OTC market, but it grants regulators broader powers to obtain information about these derivatives and to impose margin and capital requirements on them. The CFTC and the SEC have been working to issue regulations that implement these provisions.

### Clearing Requirement

Title VII of the Dodd-Frank Act creates largely parallel clearing and exchange-trading requirements for swaps and security-based swaps, as those terms are defined by Title VII and further clarified by the CFTC and the SEC in a joint rulemaking.<sup>10</sup> Section 723 creates the clearing and exchange-trading requirements for swaps, over which the CFTC has jurisdiction.<sup>11</sup> Section 763 creates largely parallel requirements for security-based swaps, over which the SEC has authority.<sup>12</sup> Currently, about 75% of swap transactions in the United States are cleared through derivatives clearinghouses,<sup>13</sup> with most of the cleared transactions being interest-rate and credit-default swaps. That figure is up from about 15% of all swaps in 2007.<sup>14</sup>

If a swap or security-based swap is subject to the clearing requirement, the Dodd-Frank Act makes it unlawful for parties to enter into that swap or security-based swap unless the transaction has been submitted for clearing.<sup>15</sup> A swap or security-based swap may become subject to the

<sup>10</sup> Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC), “Further Definition of ‘Swap,’ ‘Security-Based Swap,’ and ‘Security-Based Swap Agreement’; Mixed Swaps; Security-Based Swap Agreement Recordkeeping,” 17 *Federal Register* 48208, August 13, 2012, at <http://www.cftc.gov/ucm/groups/public/@lfederalregister/documents/file/2012-18003a.pdf>.

<sup>11</sup> §723 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203) (codified at 7 U.S.C. §2).

<sup>12</sup> §763(a) of the Dodd-Frank Act (codified at 15 U.S.C. §§78a et seq.).

<sup>13</sup> CFTC, “Testimony of CFTC Chairman Timothy G. Massad before the U.S. House Committee on Financial Services, Washington, DC,” 114<sup>th</sup> Cong., 1<sup>st</sup> sess., December 8, 2015, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-36>.

<sup>14</sup> *Ibid.*

<sup>15</sup> §723(a)(3) of the Dodd-Frank Act (codified at 7 U.S.C. §2(h)(1)) (swaps); §763(a) of the Dodd-Frank Act (codified at 15 U.S.C. §§78a et seq.) (security-based swaps).

clearing requirement in two ways.<sup>16</sup> First, the agency of jurisdiction is required to engage in an ongoing review of the products under its jurisdiction to determine whether a particular swap, security-based swap, group, or class of such contracts should be subject to the clearing requirement. Second, a swap or security-based swap may become subject to the clearing requirement upon submission to the CFTC or the SEC.

Following submission to the agencies, the CFTC and the SEC have 90 days to determine whether the swaps or security-based swaps are subject to the clearing requirement, unless the submitting organization agrees to an extension. When making that determination, the agencies must consider the following:

- (I) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.
- (II) The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms consistent with material terms and trading conventions on which the contract is then traded.
- (III) The effect on the mitigation of systemic risk....
- (IV) The effect on competition, including appropriate fees and charges....
- (V) The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or 1 or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.<sup>17</sup>

In the process of making these determinations, the agencies also are required to allow the public to comment on whether the clearing requirement should apply.

With certain exceptions—for example, if one of the counterparties qualifies for the end-user exception (see “End-User Exception,” below)—counterparties to swaps and security-based swaps that are required to be cleared must execute the transactions either on exchanges or on specialized execution facilities.<sup>18</sup>

## Exchange-Trading Requirement

With certain exceptions, swaps and security-based swaps that are required to be cleared also must be executed on a regulated exchange or on a trading platform defined in the act as either a swap execution facility (SEF) or a security-based swap execution facility (SBSEF). Such facilities must permit multiple market participants to trade by accepting bids or offers made by multiple participants in the facility. As of the end of the first quarter of 2015, 54.5% of all interest-rate and credit-related swaps were traded on SEFs, globally, in terms of gross notional value—a figure that has increased since the passage of Dodd-Frank.<sup>19</sup>

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<sup>16</sup> Section 723(a)(3) of the Dodd-Frank Act (codified at 7 U.S.C. §2(h)(2)) (swaps); Section 763(a) of the Dodd-Frank Act (codified at 15 U.S.C. §78a et seq.) (security-based swaps).

<sup>17</sup> Ibid. Similar considerations were mandated by the Senate-passed version of the bill, but those considerations were to be applied to the agencies’ rulemakings to identify other classes of transactions that should be subject to the clearing requirement that had not been submitted to the agency. §723(a) of H.R. 4173 (as passed by the Senate).

<sup>18</sup> §723(a)(3) of the Dodd-Frank Act (codified at 7 U.S.C. §2(h)(8)); §763(a) of the Dodd-Frank Act (codified at 15 U.S.C. §§78a et seq.) (security-based swaps).

<sup>19</sup> International Swaps and Derivatives Association, Inc., *SwapsInfo First Quarter 2015 Review*, April 2015, at <https://www2.isda.org/>.

The goal of the trading requirement is “to promote pre-trade price transparency in the swaps market.”<sup>20</sup> Because the old OTC market was notably opaque, with complete price information available only to dealers, swaps customers were limited in their ability to shop for the best price or rate. The expectation is that as price information becomes more widely available, competition will produce narrower spreads by lowering prices.

SEFs and SBSEFs must comply with a number of core principles set out in the act. Although these principles are somewhat less prescriptive than the regulation of exchanges in which public customers are allowed to trade,<sup>21</sup> the new trading facilities have regulatory and administrative responsibilities far beyond what applied to OTC trading desks in the past. Among other things, SEFs and SBSEFs must

- establish and enforce rules to prevent trading abuses and to provide impartial access to the trading facility;
- ensure that swap contracts are not readily susceptible to manipulation;
- monitor trading to prevent manipulation, price distortion, and disruptions in the underlying cash market;
- set position limits;
- maintain adequate financial and managerial resources, including safeguards against operational risk;
- maintain an audit trail of all transactions;
- publish timely data on prices and trading volume;
- adopt emergency rules governing liquidation or transfer of trading positions as well as trading halts; and
- employ a chief compliance officer, who will submit an annual report to regulators.

During consideration of Dodd-Frank, a central issue of debate was the extent to which existing OTC derivatives trading platforms and mechanisms could be accommodated under the new regulatory regime. Before Dodd-Frank, OTC trading practices ranged from individual telephone negotiations to electronic systems accessible to multiple participants. One concern was that if SEFs were too much like exchanges, the existing futures and securities exchanges would monopolize trading. However, if the SEF definition were too vague or general, the OTC market might remain opaque.

The bill reported by the Senate Banking, Housing, and Urban Affairs Committee defined an SEF as “an electronic trading system with pre-trade and post-trade transparency.”<sup>22</sup> The explicit reference to “pre-trade” transparency does not appear in the final legislation, in part because of concerns that such a requirement was not compatible with the business models of a number of intermediaries, such as interdealer swap brokers providing anonymous execution services.<sup>23</sup>

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<sup>20</sup> §723 of the Dodd-Frank Act (new §5h(e) of the Commodity Exchange Act to be codified after 7 U.S.C. §7b-2).

<sup>21</sup> Only eligible contract participants will be able to trade on swaps execution facilities and security-based swaps execution facilities.

<sup>22</sup> §720 of S. 3217, 111<sup>th</sup> Cong., as reported by the Senate Committee on Banking, Housing, and Urban Affairs, April 15, 2010.

<sup>23</sup> §720 of the Dodd-Frank Act, P.L. 111-203.

As is the case with the clearing requirement, Dodd-Frank provides exceptions to the exchange-trading mandate. If no exchange, SEF, or SBSEF makes a swap available for trading, the contract may be traded OTC. A swap that meets the end-user clearing exception likewise is exempt from the exchange-trading requirement.

SEFs will provide pre-trade price transparency—the ability for all market participants to see quoted prices before transacting—for (1) trades that must be cleared, (2) all swaps that are made available for trading on an SEF, and (3) trades that are below the size of a block trade.<sup>24</sup> Pre-trade transparency requirements will not apply to block trades, end-user trades, or contracts that are not available for trading on an SEF.

## End-User Exception

Sections 723 and 763 of the Dodd-Frank Act provide exceptions to the clearing requirement for swaps and security-based swaps when one of the counterparties to the transaction (1) is not a financial entity; (2) is using the transaction to hedge or mitigate its own commercial risk; and (3) notifies the relevant agency “how it generally meets its financial obligations associated with entering into non-cleared swaps.”<sup>25</sup> This provision has been widely referred to as the *end-user exception* because it applies only to transactions in which at least one counterparty is “not a financial entity.”<sup>26</sup>

A *financial entity* for the purposes of this section is defined as a swap dealer, security-based swap dealer, an MSP, major security-based swap participant, commodity pool, private fund, employee benefit plan, or person predominantly engaged in activities that are in the business of banking or are financial in nature.<sup>27</sup> To illustrate, a prime example of an entity that would not be a financial entity but that may engage in swaps trading as a necessary part of its business would be an airline that regularly trades in fuel derivatives to offset potential volatility in the market for jet fuel.<sup>28</sup>

Under the Dodd-Frank Act, eligible counterparties also may use an affiliate (“including affiliate entities predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person”) to engage in swaps or security-based swaps under the condition that the affiliate “act on behalf of the person [qualifying for the exception] and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.”<sup>29</sup> Financial entities wholly controlled by the end user and

<sup>24</sup> Block trades are very large securities transactions, which would be expected to move prices if they were executed on a public exchange. Securities markets have developed a number of mechanisms to match large buyers and sellers without revealing the size of the deal to the public markets, which would raise the cost of the transaction to the block traders. These mechanisms include the upstairs market and dark pools, where block trades can be negotiated out of the public eye.

<sup>25</sup> §723(a)(3) of the Dodd-Frank Act (codified at 7 U.S.C. §2(h)(7)) (swaps); §763(a) of the Dodd-Frank Act (codified at 15 U.S.C. §§78a et seq.) (security-based swaps).

<sup>26</sup> *Ibid.*

<sup>27</sup> §723(a)(3) of the Dodd-Frank Act (codified at 7 U.S.C. §2(h)(7)) (swaps); §763(a) of the Dodd-Frank Act (codified at 15 U.S.C. §§78a et seq.) (security-based swaps) (pp. 822 and 1060).

<sup>28</sup> Ben Protess, “In New Rules to Shine Light on Derivatives, Regulators Also Allow Exceptions,” *DealBook NYTimes Blog*, July 10, 2012, at <http://dealbook.nytimes.com/2012/07/10/in-new-rules-to-shine-light-on-derivatives-regulators-also-allow-exceptions/>.

<sup>29</sup> Affiliates of persons qualifying for the end-user exception are not eligible to engage in swaps or security-based swaps on the behalf of qualifying persons if the affiliate is a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, company that would be an investment company under §3 of the Investment Company Act of 1940 but for the exceptions provided in subparagraphs (c)(1) or (c)(7) of that section (15 U.S.C. §80a-3), commodity pool, or bank holding company with over \$50 billion in consolidated assets. §723(a)(3) of (continued...)

whose primary business is hedging the commercial risk of the end user also may qualify for the end-user exception.

Finally, the act allows regulators to exclude depository institutions, farm credit institutions, and credit unions with \$10 billion or less in assets from the definition of financial entity, allowing small financial entities (e.g., small banks) to qualify for the end-user exception as well.<sup>30</sup>

To qualify for the exception from the clearing requirement, it is not enough to be a nonfinancial entity (or, in some circumstances, a financial entity that nonetheless qualifies for the exception). The swaps engaged in by the entity must be for the purpose of hedging or mitigating commercial risk. According to the CFTC's final rule defining the end-user exception, an entity will be engaging in a swap to hedge or mitigate its own commercial risk under the following circumstances:

- First, the swap must meet one of the following three criteria. It must (1) be economically appropriate to the reduction of risks conducted by the company; (2) qualify as a bona fide hedge for purposes of being exempt from position limits under the Commodity Exchange Act (CEA; P.L. 74-675); or (3) qualify for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133) or Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments.
- Second, the swap must not be used either for “a purpose that is in the nature of speculation, investing or trading” or “to hedge or mitigate the risk of another swap or security-based swap position, unless that other position itself is used to hedge or mitigate commercial risk.”<sup>31</sup>

## Major Swap Participant and Swap Dealer Definitions

A basic theme in Dodd-Frank is that systemically important financial institutions should maintain capital cushions above and beyond what specific regulations require to compensate for the risk that their failure would pose to the financial system and the economy. In addition to the margin requirements that apply to individual derivatives contracts, major participants in derivatives markets became subject to prudential regulation in Title VII. Two categories of regulated market participants are enumerated: swap dealers and MSPs (together with their security-based swap equivalents).

Because the OTC dealer market is highly concentrated, the proposal that swap dealers be subject to additional prudential regulation was not controversial. Only a few dozen of the largest financial institutions were presumed to be affected. The question of how many firms should be included in the definition of MSP, however, was contentious. How many non-dealer and nonbank firms should become subject to prudential regulation?

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the Dodd-Frank Act (codified at 7 U.S.C. §2(h)(3)) (swaps); §763(a) of the Dodd-Frank Act (codified at 15 U.S.C. §§78a et seq.) (security-based swaps).

<sup>30</sup> §723(a)(3) of the Dodd-Frank Act (codified at 7 U.S.C. §2(h)(7)) (swaps); §763(a) of the Dodd-Frank Act (codified at 15 U.S.C. §§78a et seq.) (security-based swaps). The CFTC also has issued rules implementing §723, at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012.pdf>.

<sup>31</sup> CFTC, “End-User Exception to the Clearing Requirement for Swaps,” RIN 3038-AD10, September 17, 2012, at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012.pdf>.

On May 23, 2012, the CFTC and SEC released a joint final rule further defining the terms *swap dealer* and *major swap participant*.<sup>32</sup> The final rule defined what constitutes a “substantial” position in swaps, for the purposes of being an MSP. The regulators proposed a two-pronged test for a substantial position. First, *current exposure*, or the current mark-to-market value of a swaps or security-based swaps position, minus the value of collateral posted against the position, constitutes a substantial position if the net uncollateralized exposure exceeds \$1 billion or \$3 billion for interest- or currency-rate swaps. The second test also involves a calculation, this time relating to *future exposure*. This figure is calculated by discounting current notional exposure by a risk factor, by the existence of netting agreements, and according to whether the position is cleared or subject to daily margining. A future exposure is substantial if it exceeds \$2 billion or \$6 billion for interest- or currency-rate swaps. These quantitative tests for substantial position are meant to set a threshold “materially below” the level at which a swaps trader’s default could pose a threat to the financial system.

In the joint final rule, the CFTC and SEC’s definition of a swap dealer closely followed the Dodd-Frank definition of a swap dealer.<sup>33</sup> The final rule defines a swap dealer as any person (a person, in this case, can be an entity) who holds himself out as a dealer in swaps; makes a market in swaps; regularly enters into swaps with counterparties as an ordinary course of business for his own account; or engages in activity causing himself to be commonly known as a dealer or market maker in swaps. The rule also excludes certain swaps used to hedge or mitigate risk, if the risks arise from a potential change in the value of assets a person owns or produces or services the person provides. In addition, it excludes swaps entered into between majority-owned affiliates.

At the same time, the rule includes a de minimis exception. For a person to be regarded as a swap dealer, the aggregate gross notional amount of the swaps the person entered into during the prior 12 months in connection with swap dealing activities must exceed \$8 billion during a phase-in period. The phase-in period would last two and a half years from the time data start being reported to swap data repositories (SDRs). After that time, the CFTC would undertake a study of the swaps markets and may reduce this de minimis amount to \$3 billion or may propose a new rule for a different de minimis threshold. On November 18, 2015, the CFTC published a preliminary study on the swap dealer de minimis threshold, which laid out a number of policy considerations—including reducing systemic risk, providing protections for trading counterparties, and other issues—and asked for additional public input, without making a direct recommendation regarding the final amount of the threshold.<sup>34</sup>

## Reporting of Swaps and Security-Based Swaps

The Dodd-Frank Act requires all swaps to be reported.<sup>35</sup> Swaps must be reported to registered SDRs or to the CFTC.<sup>36</sup> Security-based swaps must be reported to registered security-based SDRs or to the SEC.<sup>37</sup> Whereas, in the fall of 2008, virtually no swaps transactions were reported,

<sup>32</sup> CFTC and SEC, “Further Definition of ‘Swap Dealer,’ ‘Major Swap Participant,’ and ‘Eligible Contract Participant,’” 77 *Federal Register* 30596, May 23, 2012, at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-10562a.pdf>.

<sup>33</sup> §721 of the Dodd-Frank Act.

<sup>34</sup> CFTC, *Swap Dealer De Minimis Exception Preliminary Report*, November 18, 2015, at [http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport\\_sddeminis\\_1115.pdf](http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport_sddeminis_1115.pdf).

<sup>35</sup> §§3103 and 3203 of H.R. 4173 (as passed); §§723(a) and 763 of S. 3217 (as passed).

<sup>36</sup> §723(a)(3) of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(h)(5)).

<sup>37</sup> §763(a) of the Dodd-Frank Act (to be codified at 15 U.S.C. §§78a et seq.).

currently all swaps transactions, whether they are cleared through a clearinghouse or remain uncleared, are reported to SDRs.<sup>38</sup> The CFTC continues to work on standardizing its swap reporting forms and improving its system of effectively analyzing and utilizing the data it now collects.<sup>39</sup>

Section 727 of Dodd-Frank outlines the public availability of swap transaction data.<sup>40</sup> The CFTC is required to promulgate rules regarding the public availability of such data. Swaps that are subject to the clearing requirement—and swaps that are not subject to the clearing requirement but nonetheless are cleared at registered derivatives clearing organizations—must have real-time reporting for such transactions. *Real-time reporting* means reporting data relating to a swap transaction, including price and volume, as soon as technologically practicable after the swap transaction has been executed. For swaps that are not cleared and are reported pursuant to subsection (h)(6) (requiring reporting prior to the implementation of the clearing requirement), real-time reporting is required in a manner that does not disclose the business transactions and market positions of any person. For swaps that are determined to be subject to the clearing requirement under subsection (h)(2) (outlining the two ways in which swaps may become subject to this requirement; see “Clearing Requirement,” above) but are not cleared, real-time public reporting is required as well. The act has no parallel requirement for security-based swaps, presumably because the national securities exchanges upon which these transactions will be executed already provide comparable reporting.<sup>41</sup>

The act also creates reporting obligations for uncleared swaps and security-based swaps (including swaps and security-based swaps that qualify for the end-user exception).<sup>42</sup> Swaps entered into prior to enactment of the act will be subject to reporting and recordkeeping requirements for uncleared swaps and security-based swaps.<sup>43</sup> The purpose of these requirements, presumably, was to give the relevant commissions access to a more complete picture of the derivatives market, even for swaps not required to be cleared.

The SEC proposed its rule on reporting requirements for security-based swaps, which was published on December 2, 2010.<sup>44</sup> Regulation SBSR (for security-based swap reporting) would require security-based SDRs to register with the SEC as securities information processors, an existing category of regulated entity. The data that the repositories receive would fall into two categories: one to be made public and the other to remain nonpublic. Information to be disclosed to the public would include the following:

- information on the asset class and the underlying security;
- the price and notional amount of the security-based swap;
- the time of execution; and
- the effective and expiration dates of the security-based swap.

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<sup>38</sup> CFTC, “Keynote Remarks of Chairman Timothy Massad before the Risk USA Conference,” October 22, 2015, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-31>.

<sup>39</sup> *Ibid.*

<sup>40</sup> §725 of the Dodd-Frank Act (to be codified at 7 U.S.C. §2(a)).

<sup>41</sup> See 15 U.S.C. §78f.

<sup>42</sup> §729 of the Dodd-Frank Act (to be codified at 7 U.S.C. §60-1) and §766 of the Dodd-Frank Act (to be codified at 15 U.S.C. §§78a et seq.).

<sup>43</sup> *Ibid.*

<sup>44</sup> SEC, “Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information,” 75 *Federal Register* 75208, December 2, 2010.

Nonpublic information—to be available to the SEC—would include the following:

- the identity of the swap counterparty, the broker, and the trading desk;
- any up-front payments;
- the title of the master agreement (if any);
- a description of the valuation methods to be used; and
- which counterparty will report the contract to the SDR.

Some market participants expressed concerns that real-time reporting (required by the statute but left to the regulators to define) would be unduly burdensome for large or illiquid trades, where reporting might result in the disclosure of market-sensitive information about holders of large positions and their trading intentions. The SEC, however, proposed a narrow definition of *real-time*—“as soon as technologically practicable after the time at which the ... transaction has been executed.”<sup>45</sup>

The real-time reporting requirement is qualified in only a few circumstances. In the case of contracts that are not required to be cleared and are not cleared, public reporting for such transactions shall not disclose the business transactions or market positions of any person. In addition, the SEC proposal does not address block trades directly, but it notes that the SEC intends to propose a rule for the reporting of block trades at a later date, after considering comments.

On April 3, 2012, the CFTC issued a final rule describing reporting, recordkeeping, and daily trading records obligations for swap dealers and MSPs.<sup>46</sup> The CFTC’s final rule followed a proposed rule released on December 23, 2010.<sup>47</sup> The final rule calls for electronic reporting to an SDR of swap data from each of two important stages of the existence of a swap: the creation of the swap and the continuation of the swap over its existence until its final termination or expiration. The purpose of this requirement appears to be to create an electronic audit trail of all stages of the swap.<sup>48</sup> The final rule requires swap dealers and MSPs to maintain records of all activities related to their business, regardless of whether they also have a prudential, or banking, regulator with separate recordkeeping requirements.

## Legislation in the 114<sup>th</sup> Congress

The two legislative provisions enacted in the 114<sup>th</sup> Congress as part of larger legislation (in one case, a transportation bill, and in the other case, an omnibus appropriations bill) made fairly circumscribed changes to swaps regulation. The other legislation introduced in the 114<sup>th</sup> Congress would, to varying degrees, make broader changes on an array of issues. A number of the provisions discussed below were included in a CFTC reauthorization bill, H.R. 2289, which passed the House on June 9, 2015, and was subsequently referred to the Senate Committee on Agriculture, Nutrition, and Forestry.<sup>49</sup> The CFTC reauthorization process has historically been

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<sup>45</sup> Ibid., p. 75210.

<sup>46</sup> CFTC, “Swap Dealer and Major Swap Participant Recordkeeping, Reporting and Duties Rules,” 77 *Federal Register* 20128, April 3, 2012, at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-5317a.pdf>.

<sup>47</sup> CFTC, “Swap Data Repositories: Registration and Regulatory Requirements,” 75 *Federal Register* 80897, December 23, 2010.

<sup>48</sup> See CFTC, “Swap Dealer and Major Swap Participant Recordkeeping, Reporting and Duties Rules,” 77 *Federal Register* 20128, April 3, 2012, at p. 20212: “Appendix 2: Statement of Chairman Gary Gensler.”

<sup>49</sup> For a more detailed analysis of H.R. 2289 itself, see CRS Report R44231, *Commodity Futures Trading Commission*: (continued...)

used as a vehicle to make additional changes to the Commodity Exchange Act.<sup>50</sup> While authorization of appropriations for the CFTC typically lasts five years, the CFTC reauthorization process has often stretched beyond the expiration date of the previous authorization. The previous CFTC authorization expired on September 30, 2013. This report first analyzes the two provisions enacted in the 114<sup>th</sup> Congress and then turns to analysis of other legislation that has at least been reported by committee if not considered on the floor of either the House or the Senate.

## Swap Data Repository Indemnifications (P.L. 114-94/H.R. 22; H.R. 1847)

A provision in the Fixing America's Surface Transportation (FAST) Act, signed into law as P.L. 114-94 on December 4, 2015, removed a requirement added in the Dodd-Frank Act's Title VII<sup>51</sup> that foreign regulators indemnify a U.S.-based swap data repository (SDR) and the CFTC for any expenses arising from litigation related to a request for market data.<sup>52</sup> Indemnification generally refers to compensating someone for harm or loss. The provision instead required the SDR and the CFTC, prior to sharing information, to receive written agreements from the foreign regulator promising to abide by confidentiality requirements with respect to the data. The provision does the same for security-based swap data repositories (SBSDRs) and for the SEC's information sharing on security-based swaps with foreign regulators.

In an effort to improve transparency in the opaque swaps market, Title VII of Dodd-Frank required all swaps to be reported to SDRs and all security-based swaps to be reported to SBSDRs. Dodd-Frank included provisions requiring foreign regulators to indemnify U.S.-based SDRs, and the CFTC, for expenses arising from litigation related to requests for swaps transactions data. It included a similar indemnification provision for SBSDRs and the SEC.<sup>53</sup> The original purpose of this Dodd-Frank provision appeared to be to encourage foreign regulators to more closely protect any shared information related to swaps by making it potentially more costly for them should any information be leaked.

In subsequent years after Dodd-Frank's passage, however, regulators testified that the indemnification requirement was creating barriers to information sharing with foreign regulators.<sup>54</sup> At a February 12, 2015, House Agriculture Committee hearing, CFTC Chair Timothy Massad, questioned about this indemnification provision, noted that "if the legislation did remove this provision, this indemnification requirement, then it would facilitate the sharing of information ... across borders. Again, that would just make it easier for regulators to work

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*Proposed Reauthorization in the 114th Congress*, by (name redacted)

<sup>50</sup> The CEA, codified at 7 U.S.C. Section 1 et seq. was the statute that was amended by Title VII of the Dodd-Frank Act so as to bring swaps under the jurisdiction of the CFTC, among other changes.

<sup>51</sup> This provision in Title VII of Dodd-Frank is found in §763(i) of P.L. 111-203 for security-based swaps, which are under the jurisdiction of the SEC, and in §§725 and 728 for swaps generally, which are under the jurisdiction of the CFTC.

<sup>52</sup> In addition to P.L. 114-94, the Fixing America's Surface Transportation (FAST) Act, §86001, additional bills on this topic in the 114<sup>th</sup> Congress, largely identical to this provision, include H.R. 37 (§501); S. 1484 (§603); H.R. 1847; S. 1560; S. 1910 (§973); H.R. 2289 (§302); and H.R. 1847, which passed the House on July 14, 2015, on a voice vote.

<sup>53</sup> This provision is found in §763(i) of P.L. 111-203 for security-based swaps and in §725 and §728 for other swaps.

<sup>54</sup> See, for example, Testimony of Ethiopis Tafara, director, Office of International Affairs, SEC, in U.S. Congress, House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, *Testimony Concerning Indemnification of Security-Based Swap Data Repositories*, 112<sup>th</sup> Cong., 2<sup>nd</sup> sess., March 21, 2012, at <http://www.sec.gov/News/Testimony/Detail/Testimony/1365171489346#.VLRamig1OHC>.

together.”<sup>55</sup> Officials from the SEC also have testified that they recommend removing this provision, which they view as a barrier to information sharing.<sup>56</sup>

In the 114<sup>th</sup> Congress, H.R. 1847, which is substantially similar to the provision in P.L. 114-94 repealing the indemnification provision, passed the House on July 14, 2015, on a voice vote. Substantially the same provision also was included in Section 302 of H.R. 2289, the CFTC reauthorization bill, which passed the House on June 9, 2015.

In House floor debate over H.R. 1847, proponents of the bill stated that the concept of indemnification did not exist in some foreign jurisdictions, making it impossible for some foreign regulators to agree to these requirements before sharing information and thus hindering the sharing of market information between U.S. and foreign regulators.<sup>57</sup> The provision in H.R. 2289, as in H.R. 1847, would repeal the indemnification requirement but maintain the existing requirement that confidentiality agreements be signed prior to information sharing.

## Centralized Treasury Units Exemption (P.L. 114-113; H.R. 1317)

The House of Representatives on November 16, 2015, passed H.R. 1317, a bill to allow certain corporate affiliates to use an existing exception from the derivatives regulatory requirements in the Dodd-Frank Act. The bill would provide a more narrowly tailored exception than a number of predecessor bills on a similar topic from the 112<sup>th</sup>, 113<sup>th</sup>, and 114<sup>th</sup> Congresses. A provision identical to H.R. 1317 was included in the Consolidated Appropriations Act 2016 (P.L. 114-113, Division O, Title VII, §705), which passed the House and Senate and was signed into law by President Obama on December 18, 2015.

### Background: Derivatives Trading and Centralized Treasury Units

Dodd-Frank’s Title VII required many swaps to be traded on exchange-like facilities and to be cleared by a clearinghouse, as futures long have been. Clearinghouses monitor trades and require margin, or cash, to be posted by traders as potential losses accumulate. Posting margin incurs costs for market participants. Dodd-Frank’s Section 723 created an exception to these clearing and exchange-trading requirements for swaps traded by nonfinancial commercial companies, known as end users, partly to avoid imposing the cost of posting margin on them. Examples of end users include airlines, oil companies, and agriculture companies, which use derivatives to hedge against commodity price fluctuations. (See “End-User Exception,” above.)

A major issue addressed in H.R. 1317 and Section 705 of P.L. 114-113<sup>58</sup> is the CFTC’s treatment of such end users’ derivatives trading affiliates—known as *centralized treasury units* (CTUs)—and whether CTUs also should be able to use this clearing exception. A 2013 CFTC no-action letter defined CTUs as entities that perform certain limited financial functions on behalf of the larger conglomerate, such as hedging activities, cash management, credit administration, or other

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<sup>55</sup> U.S. Congress, House Committee on Agriculture, *Hearing To Review the 2015 Agenda for the Commodity Futures Trading Commission*, hearing, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., February 12, 2015 (Washington, DC: GPO, 2015), p. 38, at [http://agriculture.house.gov/uploadedfiles/114-02\\_-\\_93960.pdf](http://agriculture.house.gov/uploadedfiles/114-02_-_93960.pdf).

<sup>56</sup> Testimony of Ethiopis Tafara, director, Office of International Affairs, SEC, in U.S. Congress, House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, *Testimony Concerning Indemnification of Security-Based Swap Data Repositories*, 112<sup>th</sup> Cong., 2<sup>nd</sup> sess., March 21, 2012.

<sup>57</sup> See, for example, comments by Rep. Crawford, Rep. Austin Scott, Rep. Maxine Waters, Rep. Gwen Moore, *Congressional Record-House* (July 14, 2015), p. H5145, at <http://www.gpo.gov/fdsys/pkg/CREC-2015-07-14/pdf/CREC-2015-07-14-pt1-PgH5145.pdf#page=1>. No opponents of H.R. 1847 spoke on the House floor prior to the vote.

<sup>58</sup> As the two provisions are identical, hereinafter they will be referred to simply as H.R. 1317.

financial risk management.<sup>59</sup> In a 2012 final rule, the CFTC found that CTUs operating as separate legal entities and whose primary function is financial would be precluded from the end-user exception, but CTUs housed within nonfinancial corporations, and through which the nonfinancial company enters into the swaps in its own name, could be eligible for the end-user exception.<sup>60</sup> This decision gave rise to what some have called the principal-agent issue, meaning the CTU could use the exception only if it were not structured as a separate legal entity—or if it were not trading swaps as a principal but merely as an agent of the conglomerate. Because a number of CTUs reportedly are structured as separate legal entities, however, questions regarding the proper application of the end-user exception to treasury affiliates continued to arise.

In a 2014 “no-action” letter, the CFTC attempted to address these questions.<sup>61</sup> The CFTC indicated that it would not bring enforcement actions for CTUs meeting a number of conditions, including that the CTU neither was affiliated with nor was itself a swap dealer or a major swap participant (MSP). The CFTC also required that the affiliate’s “ultimate parent” was not a financial entity (and defined *ultimate parent* as the topmost, direct or indirect, majority owner of the entity). Some industry participants were not satisfied by the no-action letter, however, expressing concerns that, among other things, a statutory change was needed. They noted that CTUs would still technically be in violation of the statute, with the no-action letter only assuring forbearance from enforcement of that statute.<sup>62</sup>

### Analysis of H.R. 1317

H.R. 1317 shares broad similarities with the 2014 CFTC no-action letter. H.R. 1317 does not use the phrase *centralized treasury unit*, but it excepts affiliates of end users from the clearing and trading requirements as if they were end users themselves, subject to a number of conditions. These conditions are presumably aimed at ensuring that only entities such as CTUs would be excepted, rather than other financial affiliates that might trade derivatives for speculative purposes.

Under H.R. 1317, the affiliate must meet a number of criteria to qualify for the end-user exception. The affiliate must

- be directly and wholly owned by a nonfinancial entity or its affiliate that qualifies for the end-user exception itself and
- enter into the swap to hedge or mitigate the commercial risk of the nonfinancial entity, and the commercial risk that the affiliate is hedging or mitigating must have been transferred to the affiliate.

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<sup>59</sup> CFTC, Division of Clearing and Risk, “No-Action Relief from the Clearing Requirement for Swaps Entered into by Eligible Treasury Affiliates,” CFTC Letter No. 13-22, June 4, 2013, at <http://www.cftc.gov/idc/groups/public/@lrllettergeneral/documents/letter/13-22.pdf>.

<sup>60</sup> See CFTC, “End-User Exception to the Clearing Requirement for Swaps,” 77 *Federal Register* 42560, July 19, 2012, pp. 42561 and 42563, at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-17291a.pdf>.

<sup>61</sup> CFTC, “No Action Relief from the Clearing Requirement for Swaps Entered into by Eligible Treasury Affiliates,” CFTC Letter No. 14-144, November 26, 2014, at <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/14-144.pdf>.

<sup>62</sup> See, for example, Letter from the United State Chamber Of Commerce, June 8, 2015, entered into the *Congressional Record*, daily edition, vol. 161, No. 91 (June 9, 2015), p. H3937, during House Floor Debate on H.R. 2289, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., at <https://www.congress.gov/crec/2015/06/09/CREC-2015-06-09.pdf>, and Letter from the National Association of Manufacturers, June 5, 2015, entered into the *Congressional Record*, daily edition, vol. 161, no. 91 (June 9, 2015), p. H3933, during House floor debate on H.R. 2289, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., at <https://www.congress.gov/crec/2015/06/09/CREC-2015-06-09.pdf>.

In addition, the affiliate cannot

- be indirectly majority-owned by a financial entity;
- be ultimately owned by a parent company that is a financial entity;
- provide any services, financial or otherwise, to any affiliate that is a nonbank financial company supervised by the Federal Reserve;
- be any one of a long list of different types of financial firms, including a hedge fund, bank or bank holding company, swap dealer, MSP (or its securities equivalents), insurance company, pension fund, credit union, commodity pool operator, or several other enumerated financial entities; or
- be affiliated with a swap dealer or MSP.

H.R. 1317 does not restrict the location of the CTU (i.e., domestic or foreign).

Proponents of H.R. 1317 stated that CTUs permit efficient aggregation of the risk of a corporate entity and provide for a single point of contact between the company and financial counterparties.<sup>63</sup> They further contended that because most CTUs act as principals to the trade, a statutory change was needed to permit these CTUs to engage in swaps as principals, not only as agents, on behalf of a conglomerate.<sup>64</sup> Past critics of widening the exemption for affiliates of end users focused on whether the actual wording of bills created broader exemptions permitting more than just CTUs to be exempt from clearing and trading requirements. If such an exemption were too broad, they argued, then firms might use affiliates to circumvent these requirements.<sup>65</sup> One public interest group, Americans for Financial Reform, said it would not oppose the version of H.R. 1317 that passed the House on November 16, 2015, but objected to previous versions.<sup>66</sup> H.R. 1317 was passed by a voice vote.

## CFTC Reauthorization (H.R. 2289)

The Commodity Exchange Act (CEA),<sup>67</sup> the statute governing futures and swaps markets, which the CFTC administers, contains a sunset provision. This provision means Congress must periodically reauthorize appropriations to carry out the CEA.<sup>68</sup> However, if an explicit authorization of appropriations for a program or activity is present—as in the CEA—and it expires, the underlying authority in the statute to administer such a program or to engage in such

<sup>63</sup> See, for example, comments of Rep. Hensarling, Rep. Moore, Rep. Austin Scott, in House Floor Debate over H.R. 1317, *Congressional Record*, November 16, 2015, pp. H8219-H8221, at <https://www.gpo.gov/fdsys/pkg/CREC-2015-11-16/pdf/CREC-2015-11-16-pt1-PgH8219-2.pdf>.

<sup>64</sup> Comments of Rep. Austin Scott, in House Floor Debate over H.R. 1317, *Congressional Record*, November 16, 2015, pp. H8219-H8221.

<sup>65</sup> Letter from Dennis M. Kelleher, President and CEO of Better Markets, Inc., to David Stawick, Secretary, CFTC, “Re. Proposed Clearing Exemption for Swaps Between Certain Affiliated Entities,” September 21, 2012, p. 4, at <http://www.bettermarkets.com/sites/default/files/documents/CFTC-CL-%20Proposed%20Clearing%20Exemption%20for%20Swaps%20Between%20Certain%20Affiliated%20Entities-%202012-12.pdf>.

<sup>66</sup> Americans for Financial Reform, Letter to Congress, July 28, 2015, at <http://ourfinancialsecurity.org/wp-content/uploads/2015/07/HR-1317-Final-7.28.151.pdf>.

<sup>67</sup> 7 U.S.C. §§1 et seq.

<sup>68</sup> An authorization generally may be described as a statutory provision that defines the authority of the government to act. The primary purpose of authorization statutes or provisions is to provide authority for an agency to administer a program or to engage in an activity. For further information, see CRS Report R42098, *Authorization of Appropriations: Procedural and Legal Issues*, by (name redacted) and (name redacted)

an activity does not.<sup>69</sup> In other words, the CFTC continues functioning and administering the CEA even if its authorization has expired—which has been the case since the most recent CFTC reauthorization expired on September 30, 2013. It has not been uncommon for Congress to pass CFTC reauthorization bills several years after the prior authorization expired.<sup>70</sup>

The 114<sup>th</sup> Congress is considering a new CFTC reauthorization bill.<sup>71</sup> Historically, the reauthorization process often has been one of the principal vehicles for modifying the CFTC’s regulatory authority and evaluating the efficacy of its regulatory programs. Congress has used the reauthorization process in the past as a vehicle to consider a wide range of issues related to the regulation of derivatives trading.

The current CFTC reauthorization process is the first since the Dodd-Frank Act’s passage brought the more than \$400 trillion U.S. swaps market<sup>72</sup> under regulatory oversight. For some in Congress, it may be an opportunity to reexamine provisions of Dodd-Frank they feel may have created excessive regulatory burdens or industry costs. Others have been critical of any perceived weakening of derivatives oversight introduced in the wake of the financial crisis. Still others may be using the current CFTC reauthorization process to try to make changes to futures regulation that industry, advocacy groups, or regulators themselves have long sought.

In the 114<sup>th</sup> Congress, the House passed H.R. 2289,<sup>73</sup> the Commodity End-User Relief Act, on June 9, 2015, by a vote of 246 to 171. Among other changes to the CEA, H.R. 2289 as passed would reauthorize appropriations for the CFTC. The bill was referred to the Senate Committee on Agriculture, Nutrition, and Forestry on June 10, 2015. The Obama Administration threatened to veto H.R. 2289, stating that the bill “undermines the efficient functioning of the CFTC by imposing a number of organizational and procedural changes and would undercut efforts taken by the CFTC over the last year to address end-user concerns.”<sup>74</sup>

Among its other changes, H.R. 2289 as passed would amend the short “Authorization of Appropriations” section in the CEA (7 U.S.C. §16(d)). The section currently authorizes the

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<sup>69</sup> The Government Accountability Office (GAO) guidance states that “the existence of a statute (organic legislation) imposing substantive functions upon an agency that require funding for their performance is itself sufficient legal authorization for the necessary appropriations, regardless of whether the statute addresses the question of subsequent appropriations.” (GAO, *Principles of Federal Appropriations Law* [Red Book], Volume I, 3<sup>rd</sup> ed., January 2004, pp. 2-41, 2-69).

<sup>70</sup> For a closer look at some of the past CFTC reauthorizations, see, for example, CRS Report 89-520E *Commodity Futures Trading Commission Reauthorization in 1982 and 1986: Major Issues in Futures Regulations* by (name redacted) (onf-print report; available from the author upon request).

<sup>71</sup> For more details on the current CFTC reauthorization bill, see CRS Report R44231, *Commodity Futures Trading Commission: Proposed Reauthorization in the 114th Congress*, by (name redacted)

<sup>72</sup> The \$400 trillion figure is measured in terms of notional value. See testimony of CFTC Chairman Timothy G. Massad, in U.S. Congress, Senate Committee on Agriculture, Nutrition & Forestry, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., May 14, 2015, which says in part: “In addition to the challenges posed by the growth and increasing complexity of the futures and options market, our responsibilities now include overseeing the swaps market, an over \$400 trillion market in the U.S., measured by notional amount.” Available at CFTC, “Testimony of Chairman Timothy G. Massad before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry,” May 14, 2015, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-22>.

<sup>73</sup> For a comprehensive summary of each of H.R. 2289’s provisions, see CRS Summary, May 29, 2015, at <http://www.lis.gov/cgi-lis/bdquery/D?d114:1:./temp/~bdpQ7D:@@D&summ2=m&:dbs=n:/billsumm/billsumm.php?id=2>.

<sup>74</sup> Executive Office of the President, Office of Management and Budget, *Statement of Administration Policy on H.R. 2289—Commodity End-User Relief Act*, June 2, 2015, at [https://www.whitehouse.gov/sites/default/files/omb/legislative/sap/114/saphr2289r\\_20150602.pdf](https://www.whitehouse.gov/sites/default/files/omb/legislative/sap/114/saphr2289r_20150602.pdf).

appropriation of “such sums as are necessary to carry out” the chapter of the CEA “through 2013,” and H.R. 2289 as passed would amend it to read “through 2019.”<sup>75</sup>

## Cost-Benefit Analysis (H.R. 2289)

The CFTC already is required to conduct cost-benefit analysis in its rulemakings, but H.R. 2289 as passed by the House includes a provision in its Section 202 expanding the number of factors for the CFTC to consider in cost-benefit analysis. This provision also includes a requirement for quantitative as well as qualitative analysis—an apparent change from current practice.

### Existing CFTC Requirements for Cost-Benefit Analysis

The CFTC and other independent regulatory agencies<sup>76</sup> (such as the SEC) are not subject to the general requirements that apply to other government agencies to conduct cost-benefit analysis under Executive Order (E.O.) 12866.<sup>77</sup>

For the CFTC, Section 15(a) of the CEA requires that “before promulgating a regulation under this chapter or issuing an order (except as provided in paragraph (3)), the Commission shall consider the costs and benefits of the action of the Commission.”<sup>78</sup> In addition,

the costs and benefits of the proposed Commission action shall be evaluated in light of:

- (A) considerations of protection of market participants and the public;
- (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;
- (C) considerations of price discovery;
- (D) considerations of sound risk management practices; and
- (E) other public interest considerations.<sup>79</sup>

The CFTC also may have additional required considerations when issuing a particular rule. Section 15(a) of the CEA applies more broadly than E.O. 12866, which applies only to rules deemed to reach a certain “significance” threshold. CEA Section 15(a), by contrast, applies to all rules issued by the CFTC.

In practice, the CFTC relies on guidance provided by the Office of Management and Budget’s (OMB’s) Office of Information and Regulatory Affairs (OIRA) when considering costs and

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<sup>75</sup> 7 U.S.C. §16(d) currently reads as follows:

“(d) Authorization of appropriations

There are authorized to be appropriated such sums as are necessary to carry out this chapter for each of the fiscal years 2008 through 2013.”

<sup>76</sup> As defined in 44 U.S.C. §3502.

<sup>77</sup> Under E.O. 12866, the Office of Management and Budget’s (OMB’s) Office of Information and Regulatory Affairs (OIRA) reviews “significant” proposed and final regulations for agencies that are covered, and those agencies are required to conduct a cost-benefit analysis if they deem a rule to be “economically significant” (e.g., if it has a \$100 million effect on the economy). For a more detailed examination of cost-benefit analysis, see CRS Report R41974, *Cost-Benefit and Other Analysis Requirements in the Rulemaking Process*, coordinated by (name redacted).

<sup>78</sup> 7 U.S.C. §19(a).

<sup>79</sup> 7 U.S.C. §19(a). Subsection (a)(3) in 7 U.S.C. §19(a) also states that these requirements do not apply to “(A) An order that initiates, is part of, or is the result of an adjudicatory or investigative process of the Commission. (B) An emergency action. (C) A finding of fact regarding compliance with a requirement of the Commission.”

benefits under Section 15(a) of the CEA, although it is not required to do so. This practice is documented in a May 2012 memorandum of understanding (MOU) between OIRA and CFTC regarding implementation of the Dodd-Frank Act.<sup>80</sup> OIRA has issued a variety of documents to assist agencies in conducting their cost-benefit analyses, including OMB Circular A-4 and accompanying guidance documents. Thus, although the CFTC is not subject to the E.O. 12866's requirements, the CFTC's analyses conducted pursuant to the CEA likely share some similarities with analyses that are completed pursuant to the executive order.<sup>81</sup>

### Cost-Benefit Provisions in H.R. 2289

Section 202 of H.R. 2289 as passed would expand the CEA's current 5 cost-benefit analysis provisions listed above to 12 considerations. Some of the considerations are similar to requirements to which other agencies are subject under E.O. 12866, and some are currently in Section 15(a) of the CEA.

H.R. 2289 as passed includes the following 12 factors:

- (A) considerations of protection of market participants and the public;
- (B) considerations of the efficiency, competitiveness, and financial integrity of futures and swaps markets;
- (C) considerations of the impact on market liquidity in the futures and swaps markets;
- (D) considerations of price discovery;
- (E) considerations of sound risk-management practices;
- (F) available alternatives to direct regulation;
- (G) the degree and nature of the risks posed by various activities within the scope of its jurisdiction;
- (H) the costs of complying with the proposed regulation or order by all regulated entities, including a methodology for quantifying the costs (recognizing that some costs are difficult to quantify);
- (I) whether the proposed regulation or order is inconsistent, incompatible, or duplicative of other federal regulations or orders;
- (J) the cost to the Commission of implementing the proposed regulation or order by the Commission staff, including a methodology for quantifying the costs;

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<sup>80</sup> *Memorandum of Understanding Between Office of Information and Regulatory Affairs, Executive Office of the President, and U.S. Commodity Futures Trading Commission*, May 9, 2012, at [https://www.whitehouse.gov/sites/default/files/omb/inforeg/regpol/oira\\_cftc\\_mou\\_2012.pdf](https://www.whitehouse.gov/sites/default/files/omb/inforeg/regpol/oira_cftc_mou_2012.pdf).

<sup>81</sup> In September 2010, the CFTC Office of General Counsel and Office of Chief Economist created a template for a uniform cost-benefit analysis methodology to be used in Dodd-Frank Act proposed rules. That template stated, in part, that §15(a) “does not require the Commission to quantify the costs and benefits of a rule or to determine whether the benefits of the order outweigh its costs; rather, it requires that the Commission ‘consider’ the costs and benefits of its actions.” It went on to say that CFTC “could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.” See CFTC, Office of the Inspector General, *A Review of Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act*, June 13, 2011, p. 3, at [http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig\\_investigation\\_061311.pdf](http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig_investigation_061311.pdf).

(K) whether, in choosing among alternative regulatory approaches, those approaches maximize net benefits (including potential economic and other benefits, distributive impacts, and equity); and

(L) other public interest considerations.

Arguably, at least some of these considerations, such as liquidity and market efficiency, incorporate the existing statutory mission of the CFTC.

In addition, Section 202 would add a requirement that the CFTC conduct quantitative as well as qualitative assessments of costs and benefits.<sup>82</sup> The requirement for quantitative cost-benefit analysis appears to mark a change from previous practice.<sup>83</sup> It also raises the question of how to accurately quantify benefits involving economic *externalities*. In economics, an externality refers to a consequence of an economic activity that is experienced by unrelated third parties; it can be either positive or negative. Pollution is often used as an example of a negative externality, in which the effects may be widely dissipated and hard to quantify. Risks to the financial system could be another example of a negative externality.

Quantifications of such externalities may involve judgments or estimates as to the value of intangible or speculative benefits that might be experienced differently by individuals, such as the value of financial stability or, in the case of pollution, the value of avoiding certain diseases.<sup>84</sup> In the realm of financial regulation, benefits are often widely dissipated (for instance, prospective investors broadly benefit from fuller and more accurate corporate disclosures and related investor protections) and are sometimes speculative (e.g., trying to measure the benefit of avoiding potential financial fraud). This, according to critics, can make benefits harder to reliably quantify. Costs of compliance, meanwhile, may be more easily measurable (e.g., through payment hours for accountants, lawyers, and staff).<sup>85</sup>

### How Valuable Is Cost-Benefit Analysis?

Proponents of cost-benefit analysis argue that it can force agencies to focus on and clarify the benefits of their proposed rulemakings and to better weigh the costs they will impose against those benefits.<sup>86</sup> According to this line of reasoning, by putting cost-benefit requirements in statute, such as those in the CEA and those proposed in H.R. 2289 as passed, Congress can have some influence over the considerations and outcomes in agency rulemakings.<sup>87</sup>

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<sup>82</sup> “The Commission, through the Office of the Chief Economist, shall assess and publish in the regulation or order the costs and benefits, both qualitative and quantitative, of the proposed regulation or order, and the proposed regulation or order shall state its statutory justification.” H.R. 2289, the Commodity End-User Relief Act, 114<sup>th</sup> Congress, §202.

<sup>83</sup> See CFTC, Office of the Inspector General, *A Review of Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act*, June 13, 2011, p. 3, at [http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig\\_investigation\\_061311.pdf](http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig_investigation_061311.pdf).

<sup>84</sup> For an analysis of these issues, see Toshihiro Oka, *Effectiveness and Limitations of Cost-benefit Analysis in Policy Appraisal*, p. 26, at [http://report.jbaudit.go.jp/english\\_exchange/volume10/e10d02.pdf](http://report.jbaudit.go.jp/english_exchange/volume10/e10d02.pdf).

<sup>85</sup> For a more detailed discussion of the debate over cost-benefit analysis, see CRS Report R42821, *Independent Regulatory Agencies, Cost-Benefit Analysis, and Presidential Review of Regulations*, by (name redacted) and (name redacted).

<sup>86</sup> See, for example, Robert W. Hahn and Paul C. Tetlock, “Has Economic Analysis Improved Regulatory Decisions?,” *Journal of Economic Perspectives*, vol. 22, no. 1 (Winter 2008), p. 68.

<sup>87</sup> See, for example, Cass R. Sunstein, *The Cost-Benefit State: The Future of Regulatory Protection* (Chicago: American Bar Association, 2002), pp. 6-10.

By contrast, some administrative law scholars have argued that the increased use of cost-benefit analysis has “ossified” the rulemaking process, slowing down the process or causing agencies to issue guidance documents rather than regulations, thereby avoiding rulemaking requirements altogether.<sup>88</sup> Some academics argue that, particularly for financial rulemakings, costs can be easier to quantify than widely dispersed potential benefits (such as “a safer financial system” or “better investor disclosure”) and that this discrepancy may lead to an overstatement of costs relative to benefits.<sup>89</sup> Finally, critics argue that the practice opens the agency’s rules to court challenges by industry groups on the grounds of inadequate cost-benefit analysis, tying up agency resources and at times leading to the invalidation of regulations.<sup>90</sup>

## **Trading by Affiliates: Amendment to the End-User Exception<sup>91</sup> (H.R. 37; S. 876; H.R. 2289)**

As discussed, Section 723 of Dodd-Frank states that the clearing and exchange-trading requirements shall not apply to the swap if one of the counterparties to the swap is “not a financial entity” and is using the swap to hedge or mitigate commercial risk.<sup>92</sup> This exception is commonly referred to as the end-user exception. The exception applies to affiliates of nonfinancial entities when those affiliates are using the swap to hedge or mitigate the commercial risk of the nonfinancial entity. (See “End-User Exception,” above.)

Section 301 of H.R. 2289 as passed by the House would expand the end-user exception by amending the definition of financial entities ineligible to use the exception and by expanding the types of activities in which eligible affiliates may engage while using the exception. H.R. 2289, H.R. 37, and S. 876, which bear general similarities, would create a broader exemption for affiliates than would H.R. 1317, which would apply to a narrower category of affiliates often called centralized treasury units (CTUs; see “Centralized Treasury Units Exemption (P.L. 114-113; H.R. 1317),” above).

### **Who Is an Eligible Affiliate?**

The Dodd-Frank Act currently allows affiliates of end users to use the exception only “if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.”<sup>93</sup> Without further definition, the term *affiliated companies* can loosely refer to companies that are related to each other in some way, including foreign affiliates. However, the Dodd-Frank Act does provide that an affiliate cannot use the exception if the affiliate is a swap dealer; security-based

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<sup>88</sup> For two main proponents of the ossification thesis, see Thomas O. McGarity, “Some Thoughts on ‘Deossifying’ the Rulemaking Process,” *Duke Law Journal*, vol. 41, no. 6 (June 1992), pp. 1385-1462; and Richard J. Pierce, Jr., “Seven Ways to Deossify Agency Rulemaking,” *Administrative Law Review*, vol. 47, no. 1 (Winter 1995), pp. 59-98.

<sup>89</sup> See, for example, Dennis Kelleher, Stephen Hall, and Katelynn Bradley, *Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC*, Better Markets, Inc., July 30, 2012.

<sup>90</sup> Dennis Kelleher, *Cost Benefit Analysis and Financial Reform: Overview*, Better Markets, at <http://ourfinancialsecurity.org/wp-content/uploads/2012/05/DENNIS-KELLEHER-PPT.pdf>.

<sup>91</sup> H.R. 2289, H.R. 37, and S. 876, which bear general similarities, would create a broader exemption for affiliates than would H.R. 1317, which would apply to a narrower category of affiliates often called centralized treasury units. This section focuses on H.R. 2289 as it is the most recently introduced of the three bills.

<sup>92</sup> Codified at 7 U.S.C. §2(h)(7).

<sup>93</sup> §723 of the Dodd-Frank Act (codified at 7 U.S.C. §2).

swap dealer; MSP; major security-based swap participant; hedge fund; commodity pool; or bank holding company with more than \$50 billion in consolidated assets.<sup>94</sup>

Key questions for policymakers in deciding whether to extend any exception for affiliates include the following: How widely should the exception be extended? Would risks be posed to the financial system or to parent companies if the exception from derivatives clearing and exchange-trading requirements were extended to nonfinancial affiliates of financial companies? And under what circumstances should the exception be extended to financial affiliates of nonfinancial companies to minimize such risks?

The CFTC, in its 2012 final rule on the end-user exception, addressed some of the questions involved in deciding which entities to exclude from the end-user exception as financial entities.<sup>95</sup> Among other restrictions, the CFTC found that treasury units that operated as separate legal entities and whose primary function was financial in nature would be precluded from the end-user exception, but treasury units housed within a nonfinancial corporation, and in which the nonfinancial company enters into the swaps in its own name, could be eligible to use the exception.<sup>96</sup> The CFTC also noted that some commenters had argued that the end-user exception “should be narrowly tailored to businesses that produce, refine, process, market, or consume underlying commodities and to counterparties transacting with nonfinancial counterparties”<sup>97</sup> and that a number of form letters had argued that extending the end-user exception to certain financial entities could increase systemic financial risks from derivatives trading.<sup>98</sup>

In a November 26, 2014, no-action letter, the CFTC indicated that it would not bring enforcement actions against certain treasury affiliates that met a number of conditions.<sup>99</sup> The CFTC defined an *eligible treasury affiliate*—which would qualify for the enforcement forbearance—as an entity meeting each of six conditions. The conditions include, among other things, that the affiliate is neither affiliated with nor is itself a swap dealer or an MSP. The CFTC also requires that the affiliate’s ultimate parent is not a financial entity (and defines *ultimate parent* as the topmost, direct or indirect, majority owner of the entity).<sup>100</sup>

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<sup>94</sup> §723 of the Dodd-Frank Act (codified at 7 U.S.C. §2(h)(7)(D)(ii)).

<sup>95</sup> See CFTC, “End-User Exception to the Clearing Requirement for Swaps,” 77 *Federal Register* 42560, July 19, 2012, pp. 42561 and 42563, at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-17291a.pdf>.

<sup>96</sup> See *ibid.*, p. 42563, July 19, 2012:

However, the Commission notes that it is important to distinguish where the treasury function operates in the corporate structure. Treasury affiliates that are separate legal entities and whose sole or primary function is to undertake activities that are financial in nature as defined under Section 4(k) of the Bank Holding Company Act are financial entities as defined in Section 2(h)(7)(C)(VIII) of the CEA because they are ‘predominantly engaged’ in such activities. If, on the other hand, the treasury function through which hedging or mitigating the commercial risks of an entire corporate group is undertaken by the parent or another corporate entity, and that parent or other entity is entering into swaps in its own name, then the application of the end-user exception to those swaps would be analyzed from the perspective of the parent or other corporate entity of the parent or other corporate entity directly.

<sup>97</sup> CFTC citing comment letter from Idaho Petroleum Marketers & Convenience Store Association at *ibid.*, p. 42560.

<sup>98</sup> “We must not broaden this narrow, commonsense exception to include financial and commercial institutions that want to gamble in the derivatives markets. Doing so would allow systemically important companies to enter into risky trades in a market with zero transparency and accountability.” CFTC citing Form Letters received as comments at 77 *Federal Register* 42560 (July 19, 2012).

<sup>99</sup> CFTC, “No Action Relief from the Clearing Requirement for Swaps Entered into by Eligible Treasury Affiliates,” CFTC Letter No. 14-144, November 26, 2014, at <http://www.cftc.gov/ucm/groups/public/@lrflettergeneral/documents/letter/14-144.pdf>.

<sup>100</sup> CFTC Letter No. 14-144, pp. 3-7.

Some industry participants were not satisfied by the no-action letter, however.<sup>101</sup> Treasury affiliates that relied on the no-action letter for swaps that they neither clear nor execute on an exchange were technically in violation of the Dodd-Frank Act's clearing requirement as interpreted by the CFTC. The CFTC's no-action letter, although it assures those that qualify under the letter that they will not face an enforcement action for violating the clearing and exchange-trading requirements, does not actually change the statute. Consequently, proponents of the language in H.R. 2289's Section 301 have argued that a statutory amendment was necessary to provide clarity and certainty to end users that use treasury affiliates to hedge their commercial risk.<sup>102</sup> Sections 301 and 306 of H.R. 2289 appear to attempt to address those concerns, but they may expand the exception beyond those entities covered by the CFTC's no-action letter.

## **Broader Issues**

At issue for Congress in deciding whether to expand the existing exception is whether derivatives trading between affiliates within the same umbrella organization could pose substantial risk of losses, to either the affiliate or the parent, or spread losses outside the organization. Various questions for policymakers to consider include the following:

- Might one affiliate have an incentive to gain through a swaps trade at another affiliate's expense?
- What repercussions could this have within the conglomerate?
- What would be the best way to control risks of excessive losses by a single affiliate from such trades?
- Is any proposed legislative exemption tailored narrowly enough to meet concerns from regulators that large swaps market players might funnel swaps through an affiliate to avoid U.S. derivatives requirements?
- Would a legislative provision allow overseas affiliates to use this exception and, if so, what would be the cross-border regulatory implications?

Proponents of the provision in H.R. 2289 argue that it would prevent the redundant regulation of inter-affiliate transactions and prevent capital from being tied up unnecessarily, such as through the duplicative posting of margin for derivatives trades.<sup>103</sup> The expansion of the exception, they argue, would allow businesses that centralize their hedging activities to reduce costs, simplify financial dealings, and reduce their counterparty credit risk. Proponents contend that the provision would allow affiliates within a corporate entity to trade swaps under the end-user exception to the clearing and exchange-trading requirements both within and outside the umbrella organization.<sup>104</sup>

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<sup>101</sup> See, for example, Letter from the United States Chamber Of Commerce, June 8, 2015, entered into the *Congressional Record*, daily edition, vol. 161, No. 91 (June 9, 2015), p. H3937, during House Floor Debate on H.R. 2289, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., at <https://www.congress.gov/crec/2015/06/09/CREC-2015-06-09.pdf>; and Letter from the National Association of Manufacturers, June 5, 2015, entered into the *Congressional Record*, daily edition, vol. 161, no. 91 (June 9, 2015), p. H3933, during House floor debate on H.R. 2289, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., at <https://www.congress.gov/crec/2015/06/09/CREC-2015-06-09.pdf>.

<sup>102</sup> See, for example, Letter from the United States Chamber Of Commerce, June 8, 2015, entered into the *Congressional Record*, daily edition, and vol. 161, no. 91 (June 9, 2015), p. H3937, during House floor debate on H.R. 2289, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., at <https://www.congress.gov/crec/2015/06/09/CREC-2015-06-09.pdf>. (“Non-financial companies that use centralized treasury units to manage their enterprise-wide risk should not be penalized for adopting this risk reducing structure, and H.R. 2289 acknowledges and would address this issue.”)

<sup>103</sup> See *ibid.*, p. H3937.

<sup>104</sup> Letter from the National Association of Manufacturers, June 5, 2015, entered into the *Congressional Record*, daily (continued...)

Opponents of the provision in H.R. 2289 argue that it would allow financial firms with commercial business affiliates to “take advantage of exemptions from key Dodd-Frank risk controls that were meant to apply only to commercial end users.”<sup>105</sup> Opponents of widening the exception as it applies to affiliates from the Dodd-Frank requirements also have stated that “the potential for affiliates to cause massive losses to their parent companies cannot be denied.”<sup>106</sup> They cite examples such as the derivatives losses incurred by AIG’s overseas affiliate in London and by JPMorgan’s so-called London Whale trading losses in its London affiliate.<sup>107</sup> They argue that any expansions of the exception should be restricted to 100%-owned subsidiaries of a parent company and be subject to strict risk-management controls.<sup>108</sup>

## **Analysis**

Section 301 of H.R. 2289 as passed by the House seemingly would expand the hedging activities in which affiliates of nonfinancial entities could engage while being able to use the end-user exception. Under current statutory language, affiliates may use the end-user exception “only if the affiliate, acting on behalf of the [non-financial entity] and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate.”<sup>109</sup> Section 301 would expand that language by allowing affiliates to engage in more hedging activities while using the exception.

Specifically, Section 301 would permit an affiliate to use the end-user exception

only if the affiliate enters into the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity, provided that if the hedge or mitigation of such commercial risk is addressed by entering into a swap with a swap dealer or major swap participant, an appropriate credit support measure or other mechanism must be utilized.<sup>110</sup>

Removing the requirement that the affiliate act on behalf of the nonfinancial entity and as an agent could permit the affiliate to act in its own capacity as an independent entity while hedging the commercial risk of the nonfinancial entity.

As noted above, affiliates of end users cannot use the end-user exception if they are swap dealers, security-based swap dealers, MSPs, major security-based swap participants, hedge funds, commodity pool operators, or large bank holding companies with more than \$50 billion in assets.

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(...continued)

edition, vol. 161, no. 91 (June 9, 2015), p. H3933, during House floor debate on H.R. 2289, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., at <https://www.congress.gov/crec/2015/06/09/CREC-2015-06-09.pdf>.

<sup>105</sup> Americans for Financial Reform, Letter to Congress, June 3, 2015, at <http://ourfinancialsecurity.org/2015/06/letter-to-congress-afr-urges-congress-to-keep-our-markets-safe-reject-hr-2289/>.

<sup>106</sup> Letter from Dennis M. Kelleher, President and CEO of Better Markets, Inc., to David Stawick, Secretary, CFTC, “Re. Proposed Clearing Exemption for Swaps Between Certain Affiliated Entities,” September 21, 2012, p. 4, at <http://www.bettermarkets.com/sites/default/files/documents/CFTC-CL-%20Proposed%20Clearing%20Exemption%20for%20Swaps%20Between%20Certain%20Affiliated%20Entities-%209-21-12.pdf>.

<sup>107</sup> The “London Whale” trading incident refers to roughly \$6.2 billion in derivatives trading losses incurred by J.P. Morgan in 2012 through trades booked in its London office by a J.P. Morgan trader, Bruno Iksil, dubbed the “London Whale” due to the hefty size of his positions in credit derivatives. The incident raised questions about the extent and reliability of U.S. banking regulators’ oversight of JP Morgan’s overseas activities, among other issues, and resulted in congressional hearings.

<sup>108</sup> Better Markets, p. 5.

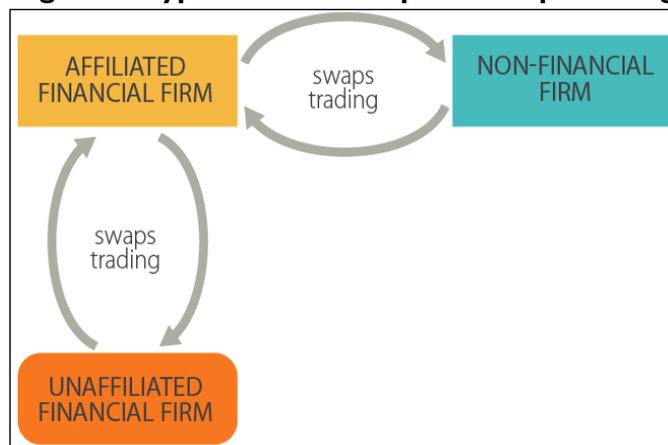
<sup>109</sup> 7 U.S.C. §2(h)(7)(D).

<sup>110</sup> §301 of H.R. 2289 has a similar provision for security-based swaps, which fall under the jurisdiction of the SEC.

This portion of the statute appears to prevent large bank holding companies, swap dealers, MSPs, hedge funds, and commodity pool operators affiliated with a nonfinancial firm from using the end-user exception even if H.R. 2289 became law.<sup>111</sup> However, barring further action from the regulators, this part of the statute would not appear to prevent affiliated financial firms with less than \$50 billion in assets, or that did not otherwise fall into these categories, from using this end-user exception from the derivatives requirements.

Section 301 apparently would not restrict with whom the affiliate may trade. It states only that the affiliate of the nonfinancial firm or end user may qualify for the end-user exception itself “only if the affiliate enters into the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.” H.R. 2289 as passed by the House does not specify that such trades must occur within an umbrella organization.

**Figure 4. Hypothetical Example of Swaps Trading**



Source: CRS.

The hypothetical scenario in **Figure 4** illustrates the issues: If a nonfinancial firm, such as an energy or metals business, had an affiliate that was a financial firm, could that financial firm engage in swaps trading with an unaffiliated large financial firm and still use the end-user exception under Section 301? Although no restriction appears in Section 301 to prevent this scenario so long as the financial affiliate engaged in the swap “to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity,” the prohibition on certain affiliates in Section 723 of Dodd-Frank would appear to preclude affiliates that were large banks with more than \$50 billion in assets—or were swap dealers, MSPs, hedge funds,<sup>112</sup> or commodity pool operators—from using the end-user exception as an affiliate, even if H.R. 2289 is enacted. Financial firms with fewer assets (and that are not swap dealers, MSPs, hedge funds, or commodity pool operators), however, apparently would not be prohibited from using the exception, so long as the standard for hedging or mitigating the commercial risk of the nonfinancial affiliate was met.

<sup>111</sup> Again, using the end-user exception means the entity would not be required to clear its swaps through a derivatives clearinghouse nor trade the swaps on an exchange or swap execution facility, which is similar to an exchange.

<sup>112</sup> As per the Commodity Exchange Act’s Prohibition on Affiliates, in 7 U.S.C. §2(h)(7)(D)(ii), what would commonly be referred to as a hedge fund is defined as, “an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3), but for paragraph (1) or (7) of subsection (c) of that Act [8] (15 U.S.C. §80a–3(c)).”

## Which Companies Are Financial Entities? (H.R. 2289)

Section 306 of H.R. 2289 as passed by the House would modify the definition of a financial entity, potentially enabling a wider range of companies to claim the end-user exception to the clearing requirement in the Dodd-Frank Act. As discussed above, the end-user exception is limited to a company that “is not a financial entity,”<sup>113</sup> as the term financial entity is defined by H.R. 2289. Section 306 of H.R. 2289 would potentially allow certain nonbank financial entities to use the end-user exception even when trading on behalf of another financial entity, so long as neither entity has a prudential regulator.

Section 306 would exclude from the definition of financial entity one “who is not supervised by a prudential regulator, and is not described in any of subclauses (I) through (VII)<sup>114</sup> ... and is a commercial market participant, or enters into swaps, contracts for future delivery, and other derivatives on behalf of, or to hedge or mitigate the commercial risk of, whether directly or in the aggregate, affiliates that are not so supervised or described.”<sup>115</sup> Section 306 would define a *commercial market participant* as “any producer, processor, merchant, or commercial user of an exempt or agricultural commodity, or the products or byproducts of such a commodity.”<sup>116</sup>

Under this language, entities that are not supervised by a prudential regulator and are not swap dealers, MSPs, hedge funds, large banks, or other enumerated financial entities that enter into swaps to hedge the commercial risk of other affiliates that also are not supervised by a prudential regulator and are not among the types of entities listed in subclauses I-VII of the Commodity Exchange Act (Section 2(h)(7)(C)) are not considered financial entities for the purposes of qualifying for the end-user exception. If these entities are not financial entities, then they may use the end-user exception in their own right and need not meet the affiliate requirements of Section 723 of the Dodd-Frank Act, as it would be amended by Section 301 of H.R. 2289. To use the clearing and exchange-trading exceptions, these entities would only need to use the swaps to hedge or mitigate commercial risk of other qualifying nonfinancial entities and to notify the CFTC in accordance with agency regulations.

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<sup>113</sup> 7 U.S.C. §2(h) (7) (A).

<sup>114</sup> The Commodity Exchange Act (7 U.S.C. §2(h)(7)(C)) currently reads as follows:

(C) Financial entity definition

(i) In general. For the purposes of this paragraph, the term “financial entity” means—

(I) a swap dealer;

(II) a security-based swap dealer;

(III) a major swap participant;

(IV) a major security-based swap participant;

(V) a commodity pool;

(VI) a private fund as defined in section 80b–2(a) of title 15;

(VII) an employee benefit plan as defined in paragraphs (3) and (32) of section 1002 of title 29;

(VIII) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 1843(k) of title 12.

§306 of H.R. 2289, however, does not include the last of these items, item VIII, in its limitation on which entities are excluded from the definition of a financial entity. This difference could effectively limit the application of subclause VIII to a large extent, potentially permitting certain nonbank financial entities to no longer be considered financial entities for the purposes of determining which entities may use the end-user exception in their own right.

<sup>115</sup> §306 of H.R. 2289.

<sup>116</sup> H.R. 2289 §306.

H.R. 2289 would create a broader, statutory exception from the Dodd-Frank clearing and exchange-trading requirements. It potentially would allow certain nonbank financial entities that do not have banking regulators to be eligible for the exception if these entities could show that they were “commercial market participants” or that they met the requirements for trading on behalf of other non-prudentially supervised affiliates. The bill leaves to the CFTC to further clarify who would be a commercial market participant and to determine which types of nonbank financial firms would qualify for the end-user exception.

## Changes to Definition of Bona Fide Hedging (H.R. 2289)

Section 313 of H.R. 2289 as passed by the House also would make changes to the definition of *bona fide hedging* in the CEA.<sup>117</sup> The concept of bona fide hedging refers to transactions that in some way genuinely offset commercial risks. The CFTC relies on its established rules and guidance on what constitutes a bona fide hedge to help determine which types of swaps count toward the requirement to register as a swap dealer or MSP. The agency also uses the concept to determine which derivatives count toward limits on position size, referred to as *position limits*, and, similarly, which transactions count toward *large trader reporting*.<sup>118</sup>

Large trader reporting requirements refer to a system the CFTC uses to monitor how large any one trading party’s position size is. The broad purpose of this system is to ensure that no one entity wields excessive market power.<sup>119</sup> The CFTC has the discretion to raise or lower the large trader reporting levels in specific markets to strike a balance between collecting sufficient information to oversee the markets and minimizing the reporting burden on market participants.<sup>120</sup> Similarly, a position limit broadly refers to the maximum position in any one type of future, option, or swap for one commodity that may be held or controlled by one person.<sup>121</sup>

The current definition of a bona fide hedge in the CEA specifies, among other factors, that

(2) For the purposes of implementation of subsection (a)(2) for contracts of sale for future delivery or options on the contracts or commodities, the Commission shall define what constitutes a bona fide hedging transaction or position as a transaction or position that—

(A) (i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel;

(ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and...<sup>122</sup>

Among other changes, H.R. 2289’s Section 313 would change (A)(ii) above so as to read:

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<sup>117</sup> Specifically, H.R. 2289 would change portions of 7 U.S.C. §6a(c).

<sup>118</sup> A *position limit*, which can be set either by the CFTC or by an exchange, refers to the maximum position size in any one future or option contract type the exchange makes available to trade, or in all futures or options of one commodity combined, that may be held or controlled by one person or one entity. See CFTC Glossary, “Speculative Position Limits,” at <http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm#S>.

<sup>119</sup> See CFTC, “Large Trader Reporting Program,” at <http://www.cftc.gov/IndustryOversight/MarketSurveillance/LargeTraderReportingProgram/ltrp>.

<sup>120</sup> *Ibid.*

<sup>121</sup> For a more detailed definition, see CFTC Glossary, “Speculative Position Limits,” at <http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm#S>.

<sup>122</sup> 7 U.S.C. §6a(c)(2).

(ii) is economically appropriate to the reduction *or management of current or anticipated risks* in the conduct and management of a commercial enterprise; and... [emphasis added].

This change could potentially broaden the bona fide hedging definition so as to allow anticipated, as well as current, risks. In addition, it could potentially allow trades that were needed not only to reduce risks but also simply to manage risks. This change could potentially enable many more types of trades to be permitted under this bona fide hedging definition, in which case more swap trades potentially would not count toward the registration requirements or restrictions on position size.

## Global Cross-Border Swaps (H.R. 2289)

The topic of cross-border swaps broadly relates to the question of to what degree Congress intended, and the Dodd-Frank Act authorized, the CFTC to regulate swaps that may extend beyond U.S. borders or be transacted between U.S. and non-U.S. persons. Because the swaps market is international in nature, with considerable cross-border trading, this question is material. Section 722(d) of the Dodd-Frank Act stated that swaps reforms shall not apply to activities outside the United States unless the activities have “a direct and significant connection with activities in, or effect on, commerce of the United States.”

This mandate left much discretion to the CFTC as to how to interpret it. Former CFTC chair Gary Gensler, under whom the CFTC first issued rules and interpretations implementing Section 722, stated, “Failing to bring swaps market reform to transactions with overseas branches and overseas affiliates guaranteed by U.S. entities would mean American jobs and markets would likely move offshore, but, particularly in times of crisis, risk would come crashing back to our economy.” Gensler and others have noted that derivatives trading by overseas affiliates of U.S. financial conglomerates can and has resulted in significant losses to U.S.-based entities. They cite examples such as AIG’s London-based Financial Products Group, which sold credit-default swap derivatives related to mortgage-backed securities that incurred losses during the financial crisis, or the more recent J.P. Morgan London Whale derivatives trading losses of roughly \$6 billion.<sup>123</sup>

By contrast, industry participants have warned that if CFTC rules are too burdensome or out of sync with other countries’ rules—putting in place requirements that other jurisdictions lacked—then “swap business will migrate, in the short term, away from U.S. financial institutions to other jurisdictions that are putting in place similar regulatory reform initiatives but are not as far advanced in doing so as the United States.” These industry participants have warned that, once gone, such business would be unlikely to return to U.S. companies.<sup>124</sup>

## Past CFTC Action

The CFTC issued proposed guidance<sup>125</sup> on the cross-border application of Title VII of Dodd-Frank. In it, the agency sought to clarify who would count as a U.S. person for the purposes of

<sup>123</sup> Testimony of CFTC Chairman Gary Gensler before the U.S. House Committee on Financial Services, June 19, 2012, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-117>.

<sup>124</sup> Testimony of Samara Cohen, Goldman, Sachs & Co., in U.S. Congress, House Financial Services Committee, Subcommittee on Capital Markets and Government Sponsored Enterprises, December 12, 2012, p. 3, at <http://financialservices.house.gov/uploadedfiles/hhrg-112-ba16-wstate-scohen-20121212.pdf>.

<sup>125</sup> CFTC Proposed Interpretive Guidance and Policy Statement Regarding Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 78 *Federal Register* 45292, at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062912.pdf>.

meeting the requirements of Dodd-Frank, such as the clearing requirement for swaps, among other questions. Subsequently, on December 21, 2012, the agency issued a temporary exemption, extending the deadline for meeting all the requirements for cross-border swaps, while it continued to work with foreign regulators to create a more uniform system of requirements.<sup>126</sup> Then, on May 1, 2013, the SEC proposed a rule and interpretive guidance on cross-border security-based swaps—swaps related to a security, such as an equity—which the SEC regulates. The SEC’s proposed rule has been widely interpreted as taking a narrower approach to defining who is a U.S. person than did the CFTC—and thus restricting the reach of Dodd-Frank requirements on security-based swaps to fewer overseas transactions or entities.<sup>127</sup>

The CFTC issued its final guidance on July 26, 2013, setting out the scope of the term *U.S. person*, the general framework for determining which entities had to register as swap dealers and MSPs, and which swaps involving non-U.S. persons who were guaranteed by U.S. persons were subject to U.S. requirements.<sup>128</sup> On November 14, 2013, the CFTC issued a staff advisory<sup>129</sup> aimed at determining when to apply U.S. derivatives requirements to trades that were booked in an offshore affiliate but in which the non-U.S. affiliate used U.S. personnel to arrange, negotiate, or execute the swap.

The CFTC continues to issue rules aimed at clarifying how to apply Dodd-Frank derivatives requirements to cross-border trades. Other issues that have arisen more recently include the need for U.S. and foreign regulators to recognize one another’s derivatives clearinghouses, trading exchanges, and data repositories for reporting trades as “equivalent,” so that one trade spanning multiple jurisdictions need only be cleared, traded, and reported one time. This issue has proven challenging, as, among other things, the European Union has thus far not granted such an equivalence determination to U.S. clearinghouses and trading facilities.<sup>130</sup>

## H.R. 2289 on Cross-Border Swaps

Section 314 of H.R. 2289 as passed by the House bears some similarities to H.R. 1256 in the 113<sup>th</sup> Congress.<sup>131</sup> H.R. 2289 drops the earlier bill’s requirement that the CFTC and SEC must

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<sup>126</sup> See CFTC, “CFTC Approves Exemptive Order on Cross-Border Application of the Swaps Provisions of Dodd-Frank,” press release, December 21, 2012, at <http://www.cftc.gov/PressRoom/PressReleases/pr6478-12>.

<sup>127</sup> Peter Madigan, “SEC cross-border rules an improvement on CFTC proposals, say lawyers,” *Risk Magazine*, May 2, 2013, at <http://www.risk.net/risk-magazine/news/2265545/sec-crossborder-rules-are-an-improvement-on-cftc-proposals-say-lawyers>.

<sup>128</sup> CFTC, “Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations,” 78 *Federal Register* 45292, July 26, 2013.

<sup>129</sup> CFTC, “Division of Swap Dealer and Intermediary Oversight Advisory: Applicability of Transaction-Level Requirements to Activity in the United States,” CFTC Staff Advisory 13-69, November 14, 2013, at <http://www.cftc.gov/ucm/groups/public/@llettergeneral/documents/letter/13-69.pdf>.

<sup>130</sup> For additional details, see CFTC, “Remarks of Chairman Timothy G. Massad before the FIA International Derivatives Conference (London),” June 9, 2015, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-25>.

<sup>131</sup> In the 113<sup>th</sup> Congress, legislation was passed by the House (H.R. 1256) on June 12, 2013, by a roll call vote of 301 to 124, which would have mandated that the CFTC and SEC issue joint, identical rules “relating to cross-border swaps and security-based swaps transactions involving U.S. persons or non-U.S. persons.” The legislation, had it been enacted, likely would have superseded the proposed CFTC and SEC rules on cross-border swaps. Instead, the CFTC and SEC would have been required to jointly introduce a new proposed rule on cross-border swaps. In addition, H.R. 1256 would have required the CFTC and SEC to allow non-U.S. persons in compliance with the laws of any countries with one of the nine largest swaps markets to be exempt from U.S. regulatory requirements on swaps, unless the two agencies issued a joint rule finding that the regulatory requirements of any of those nine countries or administrative regions “are not broadly equivalent to U.S. swaps requirements.”

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jointly issue a cross-border rule. However, similarly to H.R. 1256, the current bill would mandate that, starting 18 months from its enactment, the swaps regulatory requirements of the eight largest foreign swaps markets<sup>132</sup> must be considered comparable to those of the United States—unless the CFTC issues a rule or order finding that any of those foreign jurisdictions’ requirements are not comparable to or as comprehensive as those of the United States.<sup>133</sup>

However, listing those eight largest jurisdictions is not entirely straightforward. For one thing, selecting the jurisdictions would depend on how regulators treated the member countries of the European Union for purposes of the statute. For another, the total notional value of swaps traded in a jurisdiction fluctuates over time, so how the 12-month period was drawn likely would impact the results. Further, regulators would have to determine where a swap is traded—that is, in whose jurisdiction it would fall—when a large portion of the market is considered cross-border in nature. This problem is essentially the same one U.S. regulators are already facing in deciding when a swap qualifies as a U.S. transaction.

Under H.R. 2289, absent a CFTC determination of noncomparability, “a non-United States person or a transaction between two non-United States persons [would] be exempt from United States swaps requirements” as long as the transaction was in compliance with the regulations of any of the eight permitted foreign jurisdictions.<sup>134</sup> Effectively, the bill would substitute as a default, for trades that involved a non-U.S. person, the swaps requirements of the eight largest foreign swaps markets (which would encompass most of the world of swaps trading, particularly if countries in the European Union were treated as one swaps jurisdiction) for U.S. requirements—unless the CFTC found a foreign jurisdiction to be lacking.

One question that presumably would be left to the CFTC to determine in a rulemaking would be how widely to apply this provision to “a non-United States person or a transaction between two non-United States persons,” were the bill enacted. For instance, would the provision potentially encompass any swap in which a non-U.S. person was at least one counterparty? If so, the provision could apply to a large majority of swaps, the bulk of which appear to be transacted in some way between a U.S. and non-U.S. person.<sup>135</sup> It would presumably be left to the regulator to interpret and clarify the provision’s application.

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In House floor debate, opponents of H.R. 1256 asserted that it would weaken the Dodd-Frank requirements on swaps by allowing foreign banks and overseas affiliates of large U.S. conglomerates to escape these requirements and that it would slow the pace of agency rulemakings and implementation of the Dodd-Frank derivatives reforms. Supporters stated that it would subject U.S. and foreign businesses to harmonized U.S.-swaps requirements and avoid potentially conflicting regulations between U.S. and overseas jurisdictions, thereby reducing the regulatory burden on U.S. businesses.

<sup>132</sup> As calculated by notional value during the 12-month period ending with H.R. 2289’s date of enactment. See §314(c)(2) of H.R. 2289. The notional value of a derivative is the nominal or face amount of the assets that are used to calculate payments made on the derivative. This notional amount generally does not change hands, however.

<sup>133</sup> §314(c)(2) of H.R. 2289.

<sup>134</sup> §314(c)(2)(B) of H.R. 2289.

<sup>135</sup> For instance,

According to data analyzed by SEC staff, a majority of transactions involving single-name credit default swaps on U.S. reference entities involve one or more counterparties located abroad. Based on staff estimates, only 12 percent of global notional volume between 2008 and 2014 was between two U.S.-domiciled counterparties. This compares to 48 percent entered into between one U.S.-domiciled counterparty and one foreign-domiciled counterparty, and 40 percent entered into between two foreign-domiciled counterparties.

SEC, “SEC Proposes Cross-Border Security-Based Swap Rules Regarding Activity in the U.S.,” press release, April (continued...)

A definition of a U.S. person in Section 314 includes, among other factors, “any other person as the Commission may further define to more effectively carry out the purposes of this section”—thereby apparently giving the CFTC some leeway.<sup>136</sup> However, Section 314 also specifies that, in developing its cross-border rules, the CFTC “shall not take into account, for the purposes of determining the applicability of United States swaps requirements, the location of personnel that arrange, negotiate, or execute swaps.”<sup>137</sup> This requirement drew some criticism in congressional debate over the bill.<sup>138</sup>

The provision would appear to overturn CFTC Advisory 13-69,<sup>139</sup> which has drawn much industry opposition.<sup>140</sup> The advisory was aimed at resolving questions regarding the precise conditions in which swaps between U.S. and non-U.S. persons would be subject to Dodd-Frank requirements. The advisory, which technically represented the opinion of only one division of the CFTC, held that the Dodd-Frank requirements would apply to a swap between a non-U.S. swap dealer—even if it were an affiliate of a U.S. swap dealer—and a non-U.S. person, as long as the foreign swap dealer used “personnel or agents located in the U.S. to arrange, negotiate, or execute such swap.”<sup>141</sup> The advisory proved controversial and drew strong industry opposition.<sup>142</sup> The CFTC has delayed its actual implementation several times. Presumably, H.R. 2289 would overturn it.

## Residual Interest (S. 1560, H.R. 2289)

The term *residual interest* generally refers to capital from a futures commission merchant (FCM) committed to temporarily make up the difference for insufficient margin in a customer’s

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(...continued)

29, 2015, at <http://www.sec.gov/news/pressrelease/2015-77.html>.

<sup>136</sup> §314(f) of H.R. 2289.

<sup>137</sup> §314(b)(4) of H.R. 2289.

<sup>138</sup> “There is even a provision in this bill that absurdly directs the CFTC to ignore the physical location of a bank’s swap trader when determining whether the derivative was conducted inside the United States for purposes of applying U.S. law.” Rep. Maxine Waters, during House floor debate on H.R. 2289, *Congressional Record*, daily edition, vol. 161, no. 91 (June 9, 2015), p. H3940, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., at <https://www.congress.gov/crec/2015/06/09/CREC-2015-06-09.pdf>.

<sup>139</sup> CFTC, “Division of Swap Dealer and Intermediary Oversight Advisory: Applicability of Transaction-Level Requirements to Activity in the United States,” CFTC Staff Advisory 13-69, November 14, 2013, at <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-69.pdf>.

<sup>140</sup> See, for example, Letter from Securities Industry and Financial Markets Association (SIFMA), Futures Industry Association (FIA), and Financial Services Roundtable (FSR), to Melissa D. Jurgens, Secretary of the Commission, CFTC, “Comment Letter on the Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non-U.S. Swap Dealers Located in the United States,” March 10, 2014, at <http://www.sifma.org/comment-letters/2014/sifma,-fia-and-fsr-submit-comments-to-the-cftc-on-regulation-of-swaps-between-non-us-swap-dealers-and-non-us-counterparties/>. This letter argued, among other things, that “the location of personnel involved in a swap transaction does not alter the risk posed by the swap transaction.”

<sup>141</sup> CFTC, “Division of Swap Dealer and Intermediary Oversight Advisory: Applicability of Transaction-Level Requirements to Activity in the United States,” CFTC Staff Advisory 13-69, November 14, 2013.

<sup>142</sup> See, for example, Letter from SIFMA, FIA, and FSR, to Melissa D. Jurgens, Secretary of the Commission, CFTC, “Comment Letter on the Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non-U.S. Swap Dealers Located in the United States,” March 10, 2014, at <http://www.sifma.org/comment-letters/2014/sifma,-fia-and-fsr-submit-comments-to-the-cftc-on-regulation-of-swaps-between-non-us-swap-dealers-and-non-us-counterparties/>.

account.<sup>143</sup> A Senate bill, S. 1560, and H.R. 2289's Section 104 would essentially both codify the deadline for FCMs to deposit any capital to cover residual interest as no earlier than 6:00 p.m. on the following business day.<sup>144</sup> This move is broadly in line with the CFTC's March 17, 2015, final rule on residual interest.

The CFTC's Regulation 1.22 sets the deadline for posting residual interest.<sup>145</sup> That deadline then affects when customers are required to post their collateral to cover insufficient margin amounts. Regulation 1.22 provided that the deadline, which is currently set for 6:00 p.m. on the following day, would automatically become earlier in a couple of years, without further CFTC action.<sup>146</sup> The CFTC's final rule on March 17, 2015, amended Regulation 1.22 so that the FCM's deadline to post residual interest would not become earlier than 6:00 p.m. the following day without an affirmative CFTC action or rulemaking that included an opportunity for public comment.<sup>147</sup>

CFTC Chair Massad noted in a statement on this rule that an earlier deadline could help to ensure that FCMs always held sufficient margin and did not use one customer's margin to support another customer. But such a practice also could impose costs on customers who must deliver margin sooner.<sup>148</sup> The March 17, 2015, final rule included a plan for the CFTC to conduct a study of how well the current rule and deadline function, the practicability of changing the deadline, and the costs and benefits of any change.

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<sup>143</sup> CFTC, "Residual Interest Deadline for Futures Commission Merchants, Final Rule," 80 *Federal Register* 15507, March 24, 2015.

<sup>144</sup> Substantially similar provisions regarding residual interest appear in §104 of H.R. 2289 and in S. 1560.

<sup>145</sup> CFTC, "Statement of CFTC Chairman Timothy G. Massad in Support of Adoption of Amendments to CFTC Regulation 1.22 (Residual Interest Deadline for Futures Commission Merchants)," March 17, 2015, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement031715>.

<sup>146</sup> Statement of CFTC Chairman Timothy G. Massad in Support of Adoption of Amendments to CFTC Regulation 1.22 (Residual Interest Deadline for Futures Commission Merchants), March 17, 2015.

<sup>147</sup> *Ibid.*, Statement of CFTC Chairman Timothy G. Massad.

<sup>148</sup> *Ibid.*, Statement of CFTC Chairman Timothy G. Massad.

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