Derivatives Legislation in the 112th Congress

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December 27, 2011

Congressional Research Service
7-....
www.crs.gov
R42129

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

In the wake of the 2008 financial crisis, amid the perception that the unregulated over-the-counter (OTC) derivatives market contributed to systemic risk, the Dodd-Frank Act (P.L. 111-203) sought to remake the OTC market in the image of the regulated futures exchanges. Reforms included a requirement that swap contracts be cleared through a clearinghouse regulated by one or more federal agencies. Clearinghouses require traders to put down cash (called initial margin) at the time they open a contract to cover potential losses, and they require subsequent deposits (called maintenance margin) to cover actual losses to the position. The intended effect of margin requirements is to prevent firms from building up uncapitalized exposures so large that default would have systemic consequences.

While addressing systemic concerns, the clearing of derivatives also imposes the cost of posting margin on those trading derivatives. Many nonfinancial firms argued during the debate over the Dodd-Frank Act that their use of derivatives posed no systemic threat and thus they should not be subjected to the cost of clearing these OTC derivatives. This particular debate came to be known as "the end user debate." As a result of these concerns, the Dodd-Frank Act included a broad exemption from the clearing requirement for firms that are primarily nonfinancial in nature. Nevertheless, such firms have continued to be concerned that Dodd-Frank could impose indirect costs on them, or that the rulemaking process by the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) could do so. As such, some legislation in the 112th Congress, such as **H.R. 1610**, **S. 947**, **S.Amdt. 814 to H.R. 2112**, **S. 1650**, **H.R. 2779**, and **H.R. 2682**, addresses potential indirect costs to "end users."

In addition, concern about derivatives has been fueled by sharp rises in commodity prices—particularly oil—in 2008 and early 2011. Such steep jumps, along with high price volatility in a range of commodities, have fostered apprehension that financial speculation in derivatives might be creating such volatility in commodity prices. For instance, during the course of 2008, oil prices doubled to more than $145 per barrel and then fell by 80% before rebounding, while there was little evidence suggesting disruption of physical supplies. In early 2011, there was again a run-up of about 20%, sending gasoline prices to near 2008 highs. Such severe fluctuations tend to anger consumers, and thus can become an issue for Congress. In the 112th Congress, a number of bills, such as **H.R. 2328**, **S. 1200**, **H.R. 3006**, **S. 1598**, **H.R. 2003**, **H.R. 3313**, and **S. 1787** seek to address the impact financial speculation and derivatives may have on spot commodity prices. Other bills introduced in the 112th Congress aim to either tighten or loosen other aspects of derivatives regulation, in the wake of the Dodd-Frank Act, such as **H.R. 2586**, **H.R. 3045**, **H.R. 3283**, and **H.R. 1573**.

This report focuses primarily on legislation introduced in the 112th Congress. Additional background on how derivatives work, their role in the financial crisis, and the impact of the Dodd-Frank Act on their regulation can be found in another CRS report cited below. This report will be updated as events warrant.

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Background

In the wake of the 2008 financial crisis and the perception that the unregulated over-the-counter (OTC) derivatives market contributed to systemic risk, the Dodd-Frank Act (P.L. 111-203) sought to remake the OTC market in the image of the regulated futures exchanges.[1] Derivative contracts are an array of financial instruments with one feature in common: their value is linked to, or derives from, changes in some underlying variable, such as the price of a physical commodity, a stock index, or an interest rate. Derivatives contracts—futures contracts, options, and swaps[2]—gain or lose value as the underlying rates or prices change, even though the holder may not actually own the underlying asset.

In the Dodd-Frank Act, some of the crucial reforms included a requirement that swap contracts be cleared through a central counterparty regulated by one or more federal agencies. Clearinghouses require traders to put down cash (called initial margin) at the time they open a contract to cover potential losses, and they require subsequent deposits (called maintenance margin) to cover actual losses to the position. The intended effect of margin requirements is to eliminate the possibility that any firm can build up an uncapitalized exposure so large that default would have systemic consequences. One well-known example of such an uncapitalized exposure includes the case of AIG, which sold about $1.8 trillion worth of credit default swaps guaranteeing payment if certain mortgage-backed securities defaulted or experienced other "credit events."[3] When derivatives are cleared, the size of a cleared position is limited by the firm's ability to post capital to cover its potential losses. That capital protects its trading partners and the system as a whole.

While the clearing of derivatives helps to address systemic concerns, it also imposes the cost of posting margin on those who trade derivatives. For example, if a grain farmer uses a futures position to hedge against the possibility that grain prices might eventually fall, then for the duration of the time that his futures position is open, he may be required to post additional cash or liquid securities to cover unrealized losses in that position. This is true even if the futures position ultimately makes him a profit when it is closed out. In this case, any excess margin is returned to the grain farmer—but he still incurs temporary borrowing costs in order to come up with margin, and these costs can potentially be high. Many nonfinancial firms complained during the debate over the Dodd-Frank Act that their use of derivatives posed no systemic threat and thus they should not be subjected to the cost of clearing these OTC derivatives.

This particular debate came to be known as "the end user debate," as it referred to so-called "end users" of derivatives. As a result of these concerns, the Dodd-Frank Act in Section 723 includes a broad exemption from the clearing requirement for firms that are primarily nonfinancial in nature. Nevertheless, such firms have continued to be concerned that the act could impose indirect costs on them, or that the rulemaking process by the Commodity Futures Trading Commission (CFTC)

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[1] For further background on derivatives, how they work, and their role in the financial crisis, please see CRS Report R40646, *Derivatives Regulation and Recent Legislation*, by (name redacted) and (name redacted); and CRS Report R40965, *Key Issues in Derivatives Reform*, by (name redacted) (archived). For details on how the Dodd-Frank Act changed regulation of the OTC derivatives market, please see CRS Report R41398, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title VII, Derivatives*, by (name redacted) and (name redacted).

[2] For a description of the mechanics of these contracts, see CRS Report R40646, *Derivatives Regulation and Recent Legislation*, by (name redacted) and (name redacted).

[3] For further details on credit default swaps, a type of OTC derivative, and how they work, please see CRS Report RS22932, *Credit Default Swaps: Frequently Asked Questions*, by (name redacted) and (name redacted).

and Securities and Exchange Commission (SEC) could do so. Thus, some of the bills in the 112th Congress discussed below try to address these "end user" concerns.

In addition, under the Dodd-Frank Act swap dealers and major swap participants—firms with substantial derivatives positions—are subject to margin and capital requirements above and beyond what the clearinghouses mandate. Swaps that are cleared are also subject to trading on an exchange, or an exchange-like "swap execution facility" (SEF) regulated by either the CFTC or the SEC, in the case of security-based swaps. All trades must be reported to data repositories so that regulators will have complete information about all derivatives positions. Data on swap prices and trading volumes must be made public. Some bills in the 112th Congress, discussed below, seek to expand the definition of what would constitute an SEF.

In addition, concern about derivatives has been fueled by sharp rises in commodity prices—particularly oil—in 2008 and early 2011. Such steep jumps, along with unexplained price volatility in a range of commodities, have fostered apprehension that financial speculation in derivatives might be creating such volatility in commodity prices.[4] For instance, during the course of 2008 oil prices doubled to more than $145 per barrel and then fell by 80%, before rebounding again, while there was little actual interruption of physical supplies. In early 2011, there was again a run-up of about 20%, sending gasoline prices to near 2008 highs. Such severe fluctuations tend to anger consumers and thus are relevant for Congress.

Indeed, the role of speculators in oil and other commodity markets has attracted congressional interest. For example, in 2009 the staff of the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs found that excessive speculation has had "undue" influence on wheat price movements[5] and in the natural gas market.[6] A 2011 report by the minority staff of the House Committee on Oversight and Government Reform argued that "addressing excessive speculation offers the single most significant opportunity to reduce the price of gas for American consumers."[7] In the 112th Congress, several bills, discussed below, address the impact of financial speculation and derivatives on spot commodity prices.

[4] For a further examination of the role financial speculation may play in commodity prices, please see CRS Report R41986, *Speculation, Fundamentals, and Oil Prices*, by (name redacted), (name redacted), and (name redacted).

[5] U.S. Senate, Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, *Excessive Speculation in the Wheat Market*, Majority and Minority Staff Report, June 24, 2009, available at http://hsgac.senate.gov/public/_files/REPORTExcessiveSpecullationintheWheatMarketwoexhibitschartsJune2409.pdf.

[6] U.S. Senate, Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, *Excessive Speculation in the Natural Gas Market*, Staff Report with Additional Minority Staff Views, June 25, 2007, available at http://hsgac.senate.gov/public/index.cfm?FuseAction=Subcommittees.Investigations.

[7] *Real Help for American Consumers: Who's Profiting at the Pump?* May 23, 2011, p. 13, http://democrats.oversight.house.gov/images/stories/FULLCOM/524%20oil%20products/COOGR%20Democratic%20Oil%20Report%2005-23-11.pdf.

Bills on Dodd-Frank Act Title VII Implementation

End-User Concerns

A number of bills propose to clarify or expand the exemptions provided in Dodd-Frank for commercial end users, primarily nonfinancial firms that use swaps to hedge business risk.

H.R. 1610 (Representative Grimm) and **S. 947 (Senator Johanns)** would create an exemption to the requirements that regulators impose margin and capital requirements on swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants. Those requirements would not apply to contracts where one of the counterparties was not a swap dealer or major swap participant (or the security-based swap equivalents), an issuer of equity securities to more than five unaffiliated persons, a hedge fund, an entity that invests primarily in physical assets, a commodity pool, or Fannie Mae or Freddie Mac. Similar provisions are contained in **S.Amdt. 814 to H.R. 2112 (Senator Crapo)** and **S. 1650 (Senator Crapo)**.

H.R. 2682 (Representative Grimm) would exempt swap and security-based swap transactions in which one of the counterparties was a nonfinancial end user from the requirements that regulators impose capital and margin requirements on the uncleared swap positions of dealers and major swap participants.

Inter-Affiliate Transactions

H.R. 2779 (Representative Stivers) would exempt from the definition of "swap" any contract between a counterparty that controls, is controlled by, or is under common control with the other counterparty. Such contracts would be exempt from all the regulatory requirements that apply to swaps, except that they would still be required to be reported to a swap data repository or to the CFTC. The bill was marked up and referred to the full Committee on Financial Services by the Subcommittee on Capital Markets and Government Sponsored Enterprises on November 15, 2011.

S. 1650 (Senator Crapo) would exempt swaps between affiliates from the margin and capital requirements that apply to swap dealers and major swap participants.

How Swaps Are Traded and What Duties Are Owed

H.R. 2586 (Representative Garrett) amends the definitions of "swap execution facility" (SEF) and "security-based swap execution facility" (SBSEF). The bill addresses several features of proposed agency rules setting out the requirements for these trading facilities that some market participants find onerous. Under the bill, SEFs and SBSEFs could not require (1) that bids and offers be made available to any minimum number of traders, (2) that bids or offers be displayed or delayed for any particular period of time, (3) that all bids and offers be available on multiple trading facilities operated by the same SEF or SBSEF, and (4) would have to permit bids and offers to be transmitted and executed by "any means of interstate commerce." For more on the SEF issue, see the CFTC's proposed rule "Core Principles and Other Requirements for Swap Execution Facilities," issued on January 7, 2011, which is available together with comments received on the CFTC's website (http://www.cftc.gov).

H.R. 3045 (Representative Canseco) amends the provision of Dodd-Frank that defines certain counterparties as "special entities," to whom swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants owe a higher standard of care. Special entities include units of government (federal, state, and municipal), employee benefit plans, and endowments. H.R. 3045 would remove ERISA plans from the definition of special entity, and it specifies that the duty of a swap dealer to act in the best interests of a special entity shall not be construed as a fiduciary duty.

Controlling Speculation

A number of bills seek to reduce excessive speculation in commodities, which is thought to harm consumers by causing price fluctuations that are not justified by the fundamental forces of supply and demand. (For more on speculation, see CRS Report R41986, *Speculation, Fundamentals, and Oil Prices*, by (name redacted), (name redacted), and (name redacted); and CRS Report R41902, *Hedge Fund Speculation and Oil Prices*, by (name redacted) and (name redacted).)

H.R. 2328 (Representative Hinchey) and **S. 1200 (Senator Sanders)** include a number of measures intended to reduce speculation in crude oil, gasoline, diesel fuel, jet fuel, and heating oil. The bill directs the CFTC to impose limits on the size of speculative positions in those commodities, to apply to both swaps and futures markets. The CFTC is also directed to impose a margin requirement of 12% for those commodities. Margin is the amount of cash required to be deposited with one's broker to open a futures or swaps position. The current margin for crude oil futures is about 8%. The increase represents a rise in trading costs, which would be expected to reduce the volume of trading. The provisions of the bill will expire when the CFTC establishes position limits for commodities in accordance with the Dodd-Frank Act.

H.R. 3006 (Representative Welch) and **S. 1598 (Senator Nelson** of Florida) create a presumption that excessive speculation is occurring if the volume of speculative trading exceeds by more than 10% the average over the past 25 years. The CFTC is then directed to establish limits on the aggregate percentage of all energy commodity contracts that are held by speculators as a class—the limits must be no higher than the average over the previous 25 years. The bills also require foreign futures exchanges whose contracts are available for trading electronically in the United States to have rules to control excessive speculation.

Several other bills seek to reduce speculation by imposing taxes on speculators' trades. **H.R. 2003 (Representative DeFazio)** would impose a tax of 0.01% of the value of each oil future, option, and swap contract traded. Commercial traders (those who use derivatives to hedge the risk of their physical commodity business) and financial institutions trading on behalf of commercial traders would be exempt from the tax. Monies collected would be dedicated to the cost of federal regulation of these markets, that is, the CFTC's budget.

Two other bills—**H.R. 3313 (Representative DeFazio)** and **S. 1787 (Senator Harkin)**—would impose a tax on a broad range of financial transactions, including derivatives trades.

International Aspects

H.R. 3283 (Representative Himes) limits the extraterritorial reach of Dodd-Frank by exempting swaps and security-based swaps between U.S. and non-U.S. persons (except from reporting

requirements). Foreign registrants as swap or security-based swap dealers will only be subject to the requirements of Title VII with respect to contracts with nonaffiliated U.S. counterparties.

Repeal of Dodd-Frank

Several bills would repeal Dodd-Frank in its entirety, which would have the effect of returning swap regulation to the Commodity Futures Modernization Act (CFMA) of 2000, which exempts swaps from most of the provisions of federal commodities laws. The repeal bills include **H.R. 87 (Representative Bachmann)**, **S. 712 (Senator DeMint)**, **S. 746 (Senator Shelby)**, **S. 1720 (Senator McCain)**, and **S.Amdt. 394 to S. 782 (Senator DeMint)**.

Postponing Effective Dates

Several bills would delay implementation of Title VII of Dodd-Frank and require regulators to conduct studies, public hearings, or roundtables before issuing final rules.

Under **H.R. 1573 (Representative Lucas, et. al.)**, reported by the House Financial Services and Agriculture committees on June 16, 2011, the provisions of Title VII and any implementing regulations would not take effect earlier than December 31, 2012, with the exception of provisions and rules relating to (1) swap reporting and data repositories, (2) certain clearing provisions, (3) authorities relating to speculation, and (4) the prohibition on federal bailouts of swap dealers contained in Dodd-Frank Section 716. H.R. 1573 also requires the CFTC and SEC to conduct public hearings to determine the amount of time and resources that would be needed by market participants to comply with proposed or contemplated regulations, and to consider alternate regulatory approaches. Finally, the bill authorizes U.S. regulators to exempt persons who are subject to foreign regulation that is comparable to U.S. regulation.

H.Amdt. 465 to H.R. 2112 (Representative Garrett) would postpone the effective date of rules pursuant to Dodd-Frank Section 727, which deals with public reporting of swap trading data, until 12 months after the adoption of such rules. This amendment was approved by the House on June 16, 2011, but was not included in the enacted version of H.R. 2112, the Consolidated and Further Continuing Appropriations Act, 2012 (P.L. 112-55).

S.Amdt. 814 to H.R. 2112 (Senator Crapo) would require the CFTC, before adopting final rules under Title VII of Dodd-Frank, to adopt an implementation schedule and to complete and submit to Congress a study of the effects of Title VII on (1) U.S. economic growth and job creation, (2) the international competitiveness of U.S. financial markets, (3) derivatives market depth and liquidity, as well as an assessment of the degree of harmonization among U.S. regulators and an analysis of the progress of members of the Group of 20 and other countries toward implementing derivatives regulatory reform. The amendment was withdrawn during Senate floor consideration of H.R. 2112.

S. 1650 (Senator Crapo) extends the Title VII rulemaking deadline for one year, meaning that most rules are due in July 2012 rather than July 2011. The bill requires the CFTC and SEC to adopt an orderly implementation schedule by December 31, 2011, taking into account the impact on U.S. economic growth, the international competitiveness of U.S. financial markets, the effect on derivatives market depth and liquidity, and the degree of cooperation among U.S. regulators.

Cost-Benefit Analysis

H.R. 1840 (Representative Conaway) amends the section of the Commodity Exchange Act that requires the CFTC to consider the costs and benefits of its regulations. Under the bill, the CFTC would be permitted to propose or adopt a regulation only on a reasoned determination that the benefits of the intended regulation justify the costs. The bill sets out a number of factors the CFTC must consider, such as the impact on the efficiency, competitiveness, and financial integrity of futures and swaps markets, and whether, consistent with obtaining regulatory objectives, the regulation is tailored to impose the least burden on society.

Other Dodd-Frank Amendments

H.R. 1838 (Representative Hayworth) would repeal Section 716 of Dodd-Frank, which contains restrictions on certain forms of federal assistance to "swaps entities," or swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants. Section 716 also sets certain limitations on insured depository institutions' swap dealings and requires that any FDIC-insured swaps entities that become insolvent due to swaps activities must be liquidated. The bill was marked up and referred to the full Committee on Financial Services by the Subcommittee on Capital Markets and Government Sponsored Enterprises on November 15, 2011.

H.R. 2483 (Representative Grimm, et. al.) amends the Dodd-Frank whistleblower provisions that apply to both the CFTC and SEC. Under Dodd-Frank, the agencies are required to establish reward programs for whistleblowers who provide information that leads to enforcement actions resulting in recovery of ill-gotten gains from securities or commodities fraud. H.R. 2483, among other things, would require whistleblowers to report violations internally (to their employers) before reporting to regulators, in order to be eligible for an award. The bill also eliminates the minimum award provisions of Dodd-Frank, leaving the size of the whistleblower payment to the discretion of the agencies.

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