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H.R. 37 Derivatives Provision May Create Broader Exemption

The 114th Congress has debated the pros and cons of financial reform in H.R. 37, the Promoting Job Creation and Reducing Small Business Burdens Act (commonly referred to as the financial reform bill). It was passed by the House on January 14, 2015, and includes several provisions on securities, derivatives, and banking. Title II, Section 201 of H.R. 37 ("Treatment of Affiliate Transactions") includes a derivatives provision that would revise the treatment of transactions that may be exempt from Dodd-Frank requirements for *swaps*—a type of derivative—when traded between an affiliate of a nonfinancial firm and another company.

Swap: The exchange of one asset or liability for a similar asset or liability for the purpose of lengthening or shortening maturities, or otherwise shifting risks. Swaps also may involve exchanging income flows—for example, exchanging the fixed rate bond coupon for a variable rate payment stream or vice versa.

The Dodd-Frank Act (P.L. 111-203) requires certain swap deals to be cleared through a clearinghouse and traded on an electronic exchange, but it exempts nonfinancial firms from these two requirements in what is commonly referred to as the *end-user exemption.* Section 723 of P.L. 111-203 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. H.R. 37 may potentially enable certain financial affiliates of nonfinancial companies to trade swaps with unaffiliated companies without having to clear or exchange-trade these swaps.

Background: Swaps Between Corporate Affiliates

There have been industry calls to broaden the exemption from clearing and exchange-trading requirements, which were designed to prevent large losses from accumulating and to increase transparency. At issue was whether derivatives trading between affiliates within the same umbrella organization could pose substantial risk of losses to either affiliate or spread losses outside the organization. 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 one affiliate from such trades? Proponents of more exemptions argue that losses within a parent organization from trading between affiliates would pose little or no risk outside the organization (see http://www.cq.com/doc/congressionaltranscripts-4271483?0). They further contend that gains and losses stop inside the same conglomerate and that it would be unduly costly for affiliates to be forced to clear, and thereby post margin for, swaps transacted between affiliates.

The Commodity Futures Trading Commission (CFTC) issued a proposed rule on August 16, 2012 (see http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2012-20508), exempting certain inter-affiliate swaps from the requirements of Title VII of the Dodd-Frank Act. It issued a final rule on April 1, 2013 (see http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-07970a.pdf). The CFTC argued in its final rule that it "is not persuaded by comments suggesting that inter-affiliate swaps pose no risk to the financial system" because entities that are affiliated with each other remain separate legal entities notwithstanding that affiliation and, as such, are not legally responsible for one another's debts or losses. To address such risks, the CFTC's final rule limits the inter-affiliate exemption to cases in which the affiliates are majority owned and their financial statements are consolidated. In addition, the affiliates must be subject to a centralized risk-management program. Further, the swaps and the trading relationship between the affiliates must be documented, and any outward-facing swaps (i.e., with parties not affiliated) must be cleared or else qualify for an exemption from the clearing requirement under the rule.

Action Last Congress

In the 113th Congress, H.R. 677 and H.R. 5471 were introduced to create statutory exemptions from these Dodd-Frank requirements for certain swaps between affiliates. H.R. 5471, which is identical to Section 201 of H.R. 37, was passed by the House on December 2, 2014. H.R. 677 was ordered to be reported by the House Agriculture Committee and the House Financial Services Committee. No further action was taken.

Debate Over H.R. 37, Title II

Proponents of H.R. 37 in House floor debate argued that Title II would prevent the redundant regulation of inter-affiliate transactions and prevent capital from being tied up unnecessarily. This exemption, they argued, 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—sometimes called *centralized treasury units*—within a corporate entity to trade swaps under the end-user exemption to the clearing and exchange-trading requirements.

During House floor debate, opponents of H.R. 37's Title II argued that this provision would allow banks with commercial business to trade derivatives privately rather than on clearinghouses, increasing risks and reducing transparency for these transactions. They also noted that a proposed amendment, which had not been accepted, would have prohibited systemically important financial institutions from claiming the exemption. They cited a *New York Times* article stating that "the bill's changes in derivatives would reduce transparency and increase risks in this arena by allowing Wall Street firms with commercial businesses—like oil and gas or other commodities operations—to trade derivatives privately and not on clearinghouses" (see http://www.nytimes.com/2015/01/11/business/kicking-dodd-frank-in-the-teeth.html?_r=0).

Analysis of the Provision and Related CFTC Actions

Section 201 of H.R. 37 states that "an affiliate of a person that qualifies for" the end-user exemption

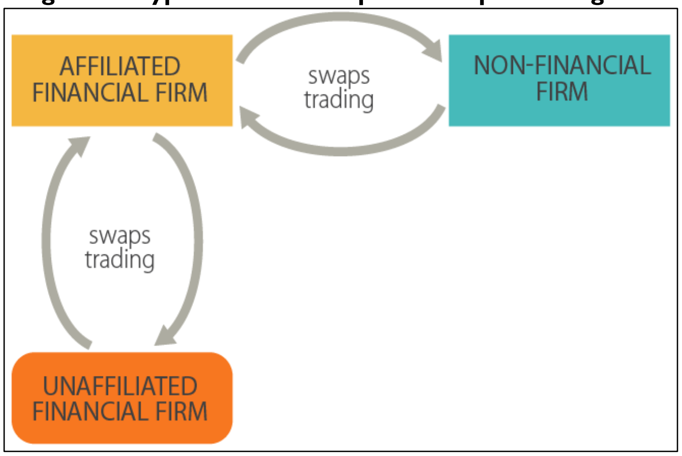
> may qualify for the exception only if the affiliate enters into the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity, provided that if the hedge or mitigation of such commercial risk is addressed by entering into a swap with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

It has a similar provision for security-based swaps, which fall under the jurisdiction of the Securities and Exchange Commission.

The bill does not further define what type of company or entity could be considered "an affiliate." This contrasts with the approach taken by the CFTC in its November 26, 2014, related no-action letter on centralized treasury units (see http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-144.pdf). The CFTC defines an "eligible treasury affiliate"—qualifying for the exemption—as 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 a major swap participant. The CFTC also requires that the affiliate's "ultimate parent" is not a financial entity (and defines this as the topmost, direct or indirect, majority owner of the entity.) The CFTC no-action letter, which would be overturned by H.R. 37, thus appears to preclude most financial firms from qualifying as affiliates of commercial end users. Section 201 does not contain such restrictions. However, Section 723 of the Dodd-Frank Act, which amended the Commodity Exchange Act (CEA), contains a prohibition on certain affiliates, which states that an affiliate of an end user cannot claim the end user exemption if the affiliate is a swap dealer, MSP, bank holding company with more than $50 billion in assets, hedge fund, or commodity pool. This restriction in Dodd-Frank would appear to preclude certain financial affiliates, such as those with more than $50 billion in assets, from using the end-user exemption even if H.R. 37 were to be enacted.

It is unclear whether the exemption in Section 201 would apply only to swaps traded within the umbrella organization (i.e., between the commercial end user and the affiliate) or whether it could also apply to outward-facing swaps—that is, swaps traded between the affiliate and an external firm not associated with the parent company. Section 201 does not appear to restrict with whom the affiliate trades. It states only that the affiliate of the nonfinancial firm (the end user) may qualify for the end user exemption 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. 37 does not specify that such trades must occur within an umbrella organization.

Figure 1. Hypothetical Example of Swaps Trading



Source: Congressional Research Service.

A hypothetical scenario in **Figure 1** 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 exemption under Section 201? While no restriction appears in Section 201 preventing this scenario, the prohibition on certain affiliates in Section 723 of Dodd-Frank would appear to preclude any affiliates that were large banks with more than $50 billion in assets, swap dealers or MSPs, hedge funds, or commodity pool operators, from using the end-user exemption as an affiliate even if H.R. 37 passed. Financial firms with less assets, however, (and who are not swap dealers, MSPs, hedge funds, or commodity pools) would not appear to be prohibited. Without further definition of what qualifies as hedging or mitigating commercial risk, it would be left to the regulators to attempt to impose any further restrictions.

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