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Commodity Futures Trading Commission: Proposed Reauthorization in the 115th Congress

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Summary

The Commodity Futures Trading Commission (CFTC), created in 1974, regulates futures, most options, and swaps markets. The CFTC administers the Commodity Exchange Act (CEA; P.L. 74-765, 7 U.S.C. §§1 et seq.), enacted in 1936, to monitor trading in certain derivatives markets. The CFTC was last reauthorized in 2008 as part of the Food, Conservation, and Energy Act (P.L. 110-246), which included authorization of appropriations through FY2013. Although the underlying authority in the statute to administer programs does not have an explicit expiration, the authorization of appropriations only applied through FY2013. As a consequence, the authorization of appropriations assumes Congress will periodically act to authorize future appropriations. It has not been uncommon, however, for Congress to continue to fund the CFTC for several years beyond the expiration of previous authorizations of appropriations.

The current CFTC reauthorization process is the first since the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203) brought the roughly \$400 trillion U.S. swaps market under regulatory oversight. Historically, the reauthorization process has often been one of the principal vehicles for modifying the CFTC’s regulatory authority and evaluating the efficacy of its regulatory programs.

In the 115th Congress, a CFTC reauthorization bill—H.R. 238, the Commodity End-User Relief Act—that also would make changes to the CEA passed the House on January 12, 2017, and was referred to the Senate Committee on Agriculture, Nutrition, and Forestry on January 17, 2017. H.R. 238 shares substantial similarities with the 114th Congress CFTC reauthorization bill, H.R. 2289, that the House passed, but differs in some respects from the Senate Agriculture Committee reauthorization bill, S. 2917, which did not see Senate floor action in the 114th Congress.

This report examines selected major H.R. 238 provisions that would

- authorize appropriations for the CFTC of \$250 million for each of FY2017 through FY2021. Both prior reauthorization bills introduced in the 114th Congress would have authorized “such sums as are necessary” to carry out the CEA, rather than a specific amount. The CFTC requested \$330 million for FY2017 and received \$250 million.
- expand the current 5 cost-benefit analysis provisions in the CEA to 12 considerations. It would add a requirement that the CFTC conduct quantitative as well as qualitative assessments, which appears to mark a change from previous practice.
- modify the definition of a *financial entity*, potentially enabling a wider range of companies to claim certain exemptions from the Dodd-Frank derivatives requirements.
- potentially broaden the bona fide hedging definition to allow anticipated, as well as current, risks to be hedged, which might increase the number of swaps that qualify as hedges. Bona fide hedging is often used to determine which swaps count toward registration requirements, position limits, large trader reporting, and other regulatory requirements.
- mandate that, starting 18 months from enactment, the regulatory requirements of the eight largest foreign swaps markets be considered comparable to those of the United States—unless the CFTC issued a rule finding that any of those foreign jurisdictions’ requirements were not comparable to U.S. requirements.

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Background on the CFTC

The Commodity Futures Trading Commission (CFTC) was created in 1974 through the enactment of the Commodity Futures Trading Commission Act to regulate commodities futures and options markets.¹ At the time, these markets were poised to expand beyond their traditional base in agricultural commodities to encompass contracts based on financial variables, such as interest rates and stock indexes. The CFTC's mission is to prevent excessive speculation, manipulation of commodity prices, and fraud. The agency administers the Commodity Exchange Act (CEA), which was passed in 1936.² Prior to the CFTC's creation, trading in agricultural commodities regulated by the CEA was overseen by the Commodity Exchange Administration, an office within the U.S. Department of Agriculture that also formed in 1936.

What is a Derivative?

Derivatives are financial instruments with one feature in common: their value is linked to changes in some underlying variable, such as the price of a physical commodity, a stock index, or an interest rate. Derivatives contracts—which are mostly in the form of futures, options, and swaps—gain or lose value as the underlying rates or prices change, even though the holder may not actually own the underlying asset.

The CFTC oversees industry self-regulatory organizations (SROs)—such as the futures exchanges and the National Futures Association—and requires the registration of a range of industry firms and personnel, including futures commission merchants (or brokers), floor traders, commodity pool operators, and commodity trading advisers. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) significantly expanded the CFTC's

jurisdiction to include over-the-counter (OTC) derivatives, also called swaps.³ As a result of Dodd-Frank, major participants in the swaps markets must register with the CFTC, and certain swaps must be cleared by clearinghouses and traded on electronic trading platforms similar to exchanges.⁴ Newly regulated swap market participants include swap dealers, major swap participants, swap clearing organizations, swap execution facilities, and swap data repositories.

These entities are subject to new business conduct standards contained in the statute or promulgated as CFTC rules. Similar to the Securities and Exchange Commission (SEC), the CFTC generally does not regulate the safety and soundness of individual firms, with the exception of newly regulated swap dealers and major swap participants, for which it was instructed to set up capital standards pursuant to the Dodd-Frank Act.

Although most derivatives trading in today's market relates to financial variables (e.g., interest rates, currency prices, and stock indexes), congressional oversight remains vested in the House and Senate Agriculture Committees in part because of the market's historical origins in

What is a Swap?

A swap is an exchange of one asset or liability for a similar asset or liability for the general purpose of shifting risks. The basic terms of a swap often require two counterparties to exchange payments periodically for a prearranged duration of time. For instance, one party may pay a fixed-rate payment stream and receive in return a variable-rate payment stream from its swap counterparty (or vice versa) for a certain time period.

¹ P.L. 93-463.

² P.L. 74-765, 7 U.S.C. §§1 et seq.

³ P.L. 111-203.

⁴ These platforms are called swap execution facilities.

agricultural commerce. Appropriations for the CFTC are under the jurisdiction of the House Agriculture Appropriations Subcommittee and the Senate Financial Services and General Government Appropriations Subcommittee.

Organizationally, the CFTC is led by five commissioners appointed by the President, with the advice and consent of the Senate, to serve staggered five-year terms. No more than three commissioners at any one time may be from the same political party. The President designates one commissioner to serve as chair. The agency is organized around four divisions:⁵

- **Clearing and Risk**, which oversees derivatives clearing organizations and other major market participants;
- **Enforcement**, which investigates and prosecutes alleged violations of the CEA and CFTC regulations;
- **Market Oversight**, which conducts trade surveillance and oversees trading facilities, such as futures exchanges and swap execution facilities, and swap data repositories; and
- **Swap Dealer and Intermediary Oversight**, which oversees registration and compliance by SROs, such as the futures exchanges (e.g., the Chicago Mercantile Exchange), the National Futures Association, and the registration of swap dealers and major swap participants.

The CFTC Reauthorization Process

The CFTC was last reauthorized in 2008 as part of the Food, Conservation, and Energy Act (P.L. 110-246), which included authorization of appropriations through FY2013.⁶ Although the underlying authority in the statute to administer programs does not have an explicit expiration,⁷ the authorization of appropriations only applied through FY2013. As a consequence, the authorization of appropriations assumes Congress will periodically act to authorize future appropriations. It has not been uncommon, however, for Congress to continue to fund the CFTC for several years beyond the expiration of previous authorizations of appropriations.⁸

The 115th Congress is considering a new CFTC reauthorization bill, H.R. 238, the Commodity End-User Relief Act, which was passed by the House on January 12, 2017, and referred to the Senate Committee on Agriculture, Nutrition, and Forestry on January 17, 2017. H.R. 238 shares substantial similarities with the 114th Congress CFTC reauthorization bill, H.R. 2289, that the House passed, but differs in some respects from the Senate Agriculture Committee

⁵ See Commodity Futures Trading Commission (CFTC), “CFTC Organization,” at <http://www.cftc.gov/About/CFTCOrganization/index.htm>.

⁶ An authorization may generally 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 engage in an activity. For further information, see CRS Report R42098, *Authorization of Appropriations: Procedural and Legal Issues*, by (name redacted) and (name redacted)

⁷ 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 Red Book, Volume I, at 2-41, 2-69 [3d ed. 2004]).

⁸ 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) (out-of-print report; available from the author upon request).

reauthorization bill, S. 2917, which did not see Senate floor action in the 114th Congress. Key similarities and differences are described throughout this report.

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 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 under regulatory oversight.⁹ For some in Congress, the reauthorization process may be an opportunity to reexamine Dodd-Frank provisions 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, or regulators themselves, have long sought.

The Commodity End-User Relief Act (H.R. 238): Selected Provisions

The next sections examine more closely selected major provisions of the House CFTC reauthorization bill, H.R. 238, as passed by the House on January 12, 2017.

Authorization of Appropriations

Section 201 of H.R. 238 would authorize to be appropriated \$250 million per year for each of FY2017 through FY2021 for the CFTC. Although Congress remains free to determine the level of funding provided in future appropriations legislation, the addition of language authorizing \$250 million for each of FY2017 through FY2021 provides a specific procedural guideline of subsequent appropriations action over this period.¹⁰

H.R. 238's approach differs from that of the previous proposed CFTC reauthorization bills, H.R. 2289 and S. 2917, in the 114th Congress. Like H.R. 238, both H.R. 2289 and S. 2917 would have amended the short Authorization of Appropriations section in the CEA (7 U.S.C. §16(d)). The section currently authorizes the appropriation of "such sums as are necessary to carry out" the chapter of the CEA "through 2013."¹¹ Both H.R. 2289 and S. 2917 would have amended the section to extend such authorization through FY2019. H.R. 238, however, replaces the "such

⁹ The \$400 trillion figure is measured in terms of notional value. See "Testimony of Chairman Timothy G. Massad before the U.S. Senate Committee on Agriculture, Nutrition & Forestry," 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." See <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-22>. Since the Dodd-Frank Act, oversight of the swaps market has been divided between the CFTC, which oversees the vast majority of swaps, and the Securities and Exchange Commission (SEC), which regulates a smaller subset of swaps called security-based swaps (SBS). SBS are swaps based on a single security or loan or a narrow-based group or index of securities (or events relating to a single issuer or issuers of securities in a narrow-based security). See U.S. Securities and Exchange Commission, *Derivatives, Background*, at <https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml>.

¹⁰ For further information, see CRS Report R42098, *Authorization of Appropriations: Procedural and Legal Issues*, by (name redacted) and (name redacted)

¹¹ 7 U.S.C. §16(d) currently reads "(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."

sums as are necessary” language with a fixed flat amount of \$250 million per year. CFTC funding levels have been a contentious issue. Some might argue the change to a flat amount per year could diminish the flexibility of congressional appropriators to adjust CFTC funding levels through annual appropriations in line with agency needs, whereas others might view a flat, fixed budgetary amount as indicative of fiscal restraint.

House Majority Leader Protocol for Authorization of Appropriations¹²

The House Majority Leader’s webpage lists a series of protocols that identify requirements for consideration in the House.¹³ These protocols are intended to guide the majority leadership in the scheduling and consideration of legislation on the House floor. Although the protocols do not govern the introduction of legislation, good-faith compliance with protocols is expected for such legislation to be scheduled for floor consideration. One of the protocols stipulates that “Any bill or joint resolution authorizing discretionary appropriations shall specify the actual amount of funds being authorized. Authorizations shall not utilize terms such as ‘such sums as may be necessary’ or similar language that fails to specify the actual amount of funding being authorized.” This protocol is intended “to improve transparency and accountability in the authorization of discretionary programs.”¹⁴ In addition, since 2011, Republican leadership has required that bills authorizing funding for new or increased government programs, activities, or benefits be offset by the termination or reduction of a current program of equal or greater size, but that a bill or joint resolution that provides an authorization at the level most recently appropriated shall be considered in compliance with this protocol.

Recent CFTC Appropriations

The 2010 Dodd-Frank Act (P.L. 111-203) brought the bulk of the previously unregulated OTC swaps markets under CFTC jurisdiction as well as the previously regulated futures and options markets. Because the swaps market is much larger than the futures market, a lingering question is whether CFTC has sufficient resources to meet the agency’s newly added responsibilities.¹⁵ The question of appropriate CFTC-funding levels has grown somewhat contentious.

For FY2018, the Trump Administration requested \$250 million for the CFTC, the same amount the agency received for FY2017.¹⁶ However, the CFTC’s Budget Justification submitted to Congress under CFTC Chair Giancarlo, a Trump appointee, requested \$281.5 million. In his May 23, 2017, transmittal letter accompanying the CFTC budget request, then-acting CFTC Chair Giancarlo did not specifically address the divergence from the Trump Administration’s budget request. However, he did say, “The \$31.5 million in additional funds over FY 2017 is not a formulaic or superficial number, but a thorough and informed assessment of what the CFTC needs to execute its mission in FY 2018.”¹⁷ He noted that the \$31.5 million in additional funding would help the agency particularly with its examinations, including stress testing for large

¹² This section was authored by (name redacted), specialist on Congress and the Legislative Process.

¹³ House Majority Leader, *Floor Protocols*, at <https://www.majorityleader.gov/protocols/>.

¹⁴ Ibid.

¹⁵ “The CFTC does not have the resources to fulfill our new responsibilities as well as all the responsibilities it had prior to the passage of Dodd-Frank in a way that most Americans would expect. Our staff, for example, is no larger than it was when Dodd-Frank was enacted in 2010.” CFTC, “Testimony of CFTC Chairman Timothy G. Massad before the Senate Agriculture Committee,” May 14, 2015, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-22>.

¹⁶ For further detail, see CRS Insight IN10715, *When an Agency’s Budget Request Does Not Match the President’s Request: The FY2018 CFTC Request and “Budget Bypass”*, by (name redacted), (name redacted), and (name redacted)

¹⁷ CFTC Chairman’s Transmittal Letter, *Commodity Futures Trading Commission Budget Request, Fiscal Year 2018*, May 23, 2017, at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/cftcbudget2018.pdf>.

derivatives clearinghouses and resources to address financial technology innovation, among other purposes.

To meet the additional responsibilities for oversight of swaps stemming from the Dodd-Frank Act, the Obama Administration had requested additional funding for the CFTC. For FY2017, the Obama Administration requested \$330 million. However, the CFTC was appropriated \$250 million for FY2017, the same as for FY2015 and FY2016.

Following the enactment of the FY2016 appropriation, former CFTC Chairman Timothy Massad issued a statement criticizing the lack of any increase for the agency despite its expanded oversight over the swaps market: “The failure to provide the CFTC even a modest increase in the fiscal year 2016 budget agreement sends a clear message that meaningful oversight of the derivatives markets, and the very types of products that exacerbated the global financial crisis, is not a priority.”¹⁸ He added that the flat appropriation failed to take into account the need for added resources to enforce oversight of the expanded, technologically complex swaps markets.¹⁹ This view was reiterated in the former President’s FY2017 budget request, which stated that “rules are meaningless without the resources available to implement and enforce them. Although the CFTC’s budget has increased since the passage of the Dodd-Frank Act, the increase has not been commensurate with the Commission’s expanded responsibilities and market growth. Funding levels have limited the Commission’s ability to fulfill both its new and traditional responsibilities.”²⁰

A 2015 International Monetary Fund assessment of the U.S. financial system, evaluating both the CFTC and SEC, noted that, in the wake of the 2008 financial crisis,

Funding limitations have impacted the timely delivery of new rules and the implementation of registration programs for the new categories of participants. These are transitory challenges. However, the markets under the agencies’ supervision have become larger and more complex. In this context, the number of expert staff in the SEC and CFTC does not appear to be sufficient to ensure a robust level of hands-on supervision.²¹

Critics of increased CFTC spending, however, argue, among other things, that “access to more funding does not necessarily ensure that an agency will successfully achieve its mission, or spend that funding responsibly.”²² Others have questioned whether more spending on the CFTC will demonstrably reduce the risk of another financial crisis, with one Member, in addressing former CFTC Chair Timothy Massad, stating,

¹⁸ CFTC, “Statement of Chairman Timothy Massad on the Fiscal Year 2016 Budget Agreement,” December 21, 2015, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement122115>.

¹⁹ For FY2016, the CFTC requested \$322 million and 895 full-time equivalent employees (FTEs). This request represented an increase of \$72 million (or 29%) and 149 FTEs over the FY2015 enacted appropriations amount of \$250 million for the CFTC. See CFTC, *President’s Budget Fiscal Year 2016*, p. 3, at <http://www.cftc.gov/About/CFTCReports/ssLINK/cftcbudget2016>.

²⁰ CFTC, *President’s Budget Fiscal Year 2017*, prepared for the Committee on Appropriations, February, 2016, p. 2, at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/cftcbudget2017.pdf>.

²¹ International Monetary Fund (IMF), Evaluation of the United States, *Financial Sector Assessment Program Detailed Assessment Of Implementation On The Iosco Objectives And Principles Of Securities Regulation*, (April 2015), Executive Summary, p. 8, at <https://www.treasury.gov/resource-center/international/Documents/cr1591.pdf>.

²² U.S. Congress, Senate Committee on Appropriations, Subcommittee on Financial Services and General Government, *Hearing on the Fiscal 2018 Budget for the Securities Exchange Commission and Commodity Futures Trading Commission*, Opening Remarks of Subcommittee Chair Senator Shelley Moore Capito, 115th Cong., 1st sess., June 27, 2017.

I would challenge the CFTC to show where this increase in taxpayer money has reduced risk in the marketplace. How do we know that even more cops on the beat will prevent another ‘too big to fail’? It is difficult to see a direct correlation between CFTC’s repeated increase and reduced risk. Can you provide any assurance that a 188 percent increase will guarantee there will not be another financial crisis?²³

Cost-Benefit Analysis

H.R. 238 would expand a number of factors for the CFTC to consider in cost-benefit analysis and would include the need for quantitative as well as qualitative analysis, among other changes. This section of the report first examines the existing requirements for the CFTC to conduct cost-benefit analysis. It then surveys the changes in H.R. 238. Lastly, it discusses the academic research on cost-benefit analysis. S. 2917, the 114th Congress’s Senate CFTC bill, did not have a similar provision on cost-benefit analysis.

Existing CFTC Requirements for Cost-Benefit Analysis

The CFTC already has certain requirements to perform cost-benefit analysis in its rulemakings under the CEA. The CFTC and other independent regulatory agencies²⁴ (such as the SEC) are not subject, however, to the general requirements that apply to other government agencies to conduct cost-benefit analysis under Executive Order (E.O.) 12866.²⁵

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.”²⁶ 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.²⁷

²³ U.S. Congress, House Committee on Appropriations, Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, *Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations for 2016*, Opening statement of House Agriculture Appropriations Subcommittee Chair Robert Aderholt, 114th Cong., 1st sess., February 11, 2015, p. 164.

²⁴ As defined in 44 U.S.C. §3502.

²⁵ Under Executive Order 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).

²⁶ 7 U.S.C. §19(a).

²⁷ 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.”

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; Section 15(a) 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 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 between OIRA and CFTC regarding implementation of the Dodd-Frank Act.²⁸ 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 E.O. 12866’s requirements, the CFTC’s analyses conducted pursuant to the CEA likely share some similarities with analyses completed pursuant to the executive order.²⁹

Cost-Benefit Provisions in H.R. 238

Section 202 of H.R. 238 would expand the CEA’s current 5 cost-benefit analysis provisions listed above to 12 considerations. Some of the considerations are similar to requirements other agencies are subject to under E.O. 12866, and some are currently in Section 15(a) of the CEA.

H.R. 238 includes the following 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);

²⁸ 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.

²⁹ 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 the Dodd-Frank Act proposed rules. That template stated, in part, that Section 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 Office of the Inspector General, U.S. Commodity Futures Trading Commission, “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.

- (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;
- (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, would incorporate the CFTC existing statutory mission.

In addition, Section 202 would add a requirement that the CFTC conduct quantitative as well as qualitative assessments of costs and benefits.³⁰ The requirement for quantitative cost-benefit analysis appears to mark a change from previous practice.³¹ It also raises the question of how accurately one may quantify benefits, or costs, 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.³² In the realm of financial regulation, benefits are often widely dissipated (e.g., prospective investors broadly benefit from fuller and more accurate corporate disclosures and investor-related 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).³³

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 better weigh the costs they will impose against those benefits.³⁴ According to this line of reasoning, by putting cost-benefit requirements in statute,

³⁰ “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. 238, the Commodity End User Relief Act, 115th Congress, §202.

³¹ See Office of the Inspector General, CFTC, “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.

³² For an analysis of these issues, see Toshihiro Oka, *Effectiveness and Limitations of Cost-benefit Analysis in Policy Appraisal*, p. 26, at <http://www.jbaudit.go.jp/english/exchange/pdf/e10d02.pdf>.

³³ Costs can also involve negative externalities, such as the effect of reduced credit on economic growth, and such externalities may also be difficult to quantify. For a more detailed discussion of the cost-benefit-analysis debate, see CRS Report R42821, *Independent Regulatory Agencies, Cost-Benefit Analysis, and Presidential Review of Regulations*, by (name redacted) and (name redacted); and CRS Report R44813, *Cost-Benefit Analysis and Financial Regulator Rulemaking*, by (name redacted) and (name redacted).

³⁴ 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.

such as those in the CEA and those proposed in H.R. 238, Congress can have some influence over the considerations and outcomes in agency rulemakings.³⁵

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.³⁶ Ossified rulemaking could lead to beneficial regulation being blocked or delayed. Some financial reform advocates 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 may lead to an overstatement of costs over benefits.³⁷ 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 potentially beneficial regulations.³⁸

Which Companies Are “Financial Entities?”

Section 304 of H.R. 238 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. The end-user exception is limited to a company that “is not a financial entity,” as the term is redefined by H.R. 238.³⁹ Section 304 would potentially allow certain nonbank entities that primarily engage in financial activities to use the end-user exception even when trading on behalf of another nonbank entity that engages in activities that are financial in nature, so long as the entities do not have a prudential regulator and do not qualify as one of an enumerated list of companies designated as always falling under the definition of financial entity.

What is the End-User Exception in the Dodd-Frank Act?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203) requires many swaps to be cleared through a clearinghouse and traded on an electronic exchange. But the act provided an exception from these two requirements to nonfinancial firms when certain conditions are met. The exception is commonly referred to as the *end-user exception*. Section 723 of the Dodd-Frank Act 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,” is using swaps to hedge or mitigate commercial risk, and properly notifies the CFTC regarding how it meets its financial obligations.⁴⁰ 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. Examples of “end users” might include commercial companies such as airlines, manufacturers, agricultural companies, or others whose business models are not primarily financial in nature.

³⁵ See, for example, Cass R. Sunstein, *The Cost-Benefit State: The Future of Regulatory Protection* (Chicago: American Bar Association, 2002), pp. 6-10.

³⁶ 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.

³⁷ 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.

³⁸ Dennis Kelleher, “Cost Benefit Analysis and Financial Reform: Overview,” Better Markets, at <http://ourfinancialsecurity.org/wp-content/uploads/2012/05/DENNIS-KELLEHER-PPT.pdf>.

³⁹ 7 U.S.C. §2(h) (7) (A).

⁴⁰ 7 U.S.C. §2(h)(7)(D).

Section 304 of H.R. 238 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)⁴¹ ... 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.”⁴² Section 304 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.”⁴³ Under this language, entities that are not supervised by a prudential regulator and are not swap dealers, major swap participants (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 CEA (Section 2(h)(7)(C)) are not considered financial entities for the purposes of qualifying for the end-user exception.

In this respect, H.R. 238 could broaden the end-user exception from the Dodd-Frank clearing and exchange-trading requirements. It could 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.⁴⁴

Changes to Definition of Bona Fide Hedging

The concept of bona fide hedging refers to transactions that in some way genuinely offset commercial risks. The CFTC uses the concept to determine which derivatives count toward limits on position size, referred to as *position limits*.⁴⁵ The CFTC also relies on its established rules and

⁴¹ 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.

§304 of H.R. 238, 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.

⁴² H.R. 2289 §306.

⁴³ *Ibid.*

⁴⁴ In the 114th Congress, S. 2917 took a different approach to modifying the definition of a financial entity. For further details, see CRS Report R44231, *Commodity Futures Trading Commission: Proposed Reauthorization in the 114th Congress*, by (name redacted)

⁴⁵ A *position limit*, which can be set either by the CFTC or by an exchange, refers to the maximum position size in any (continued...)

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.⁴⁶ Section 311 of H.R. 238 would make changes to the definition of *bona fide hedging* in the CEA, discussed below, in a way that is substantially similar to the CFTC reauthorization bills passed by the House and reported by the Senate Agriculture Committee in the 114th Congress (H.R. 2289 and S. 2917).⁴⁷

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....⁴⁸

Among other changes, H.R. 238's Section 311 would change (A)(ii) above so as to read:

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

This change could potentially broaden the bona fide hedging definition so as to allow trades that were needed either to reduce risks or, alternatively, to manage commercial risks.⁴⁹ This change could potentially enable more types of trades to be permitted under this bona fide hedging definition, in which case more trades would not count toward restrictions on position size for futures, options, and swaps or toward the registration requirements for swap dealers.⁵⁰ The CFTC considered somewhat similar industry proposals for a broadening of the definition of

(...continued)

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. *Position size* broadly refers to how many futures, options or swaps contracts one entity is permitted to own or trade in any given time period. See CFTC Glossary, "Speculative Position Limits," at <http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm#S>.

⁴⁶ The CFTC defines the term *swap dealer* in 17 C.F.R. 1.3(ggg), that incorporates a definition of swaps entered into for the purpose of hedging physical positions (17 C.F.R. 1.3(ggg)(6)), that generally incorporates the criteria for bona fide hedging in 7 U.S.C. §6a(c)(2).

The CFTC defines the term *major swap participants* in 17 C.F.R. (hhh), and excludes positions held for "hedging or mitigating commercial risk"; the term *hedging or mitigating commercial risk* is defined in 17 C.F.R. (kkk), and generally incorporates: (1) the criteria for bona fide hedging in 7 U.S.C. §6a(c)(2); and (2) additional flexibility for "mitigating commercial risk." The term hedge or mitigate commercial risk is also used in 7 U.S.C. 2(h)(7)(A) (providing criteria for an exception to clearing of a swap that is otherwise required to be cleared).

⁴⁷ Specifically, H.R. 238 would modify portions of 7 U.S.C. §6a(c).

⁴⁸ 7 U.S.C. §6a(c)(2).

⁴⁹ *Anticipated or current* risks are within the current standards for defining bona fide hedging position in 7 U.S.C. §4a(c)(2)(A)(iii) which states, for example, "assets that a person owns...or anticipates owning...."

The term *management* would be added to the existing term *reduction* and, thus, management is presumed to mean something other than reduction of current or anticipated risks. Compare, the term hedge or mitigate commercial risk used in 7 U.S.C. 2(h)(7)(A) (providing criteria for an exception to clearing of a swap that is otherwise required to be cleared).

⁵⁰ Registration requirements for MSPs already exclude positions for "mitigating commercial risk" as noted above. Any such change to swap dealer registration, could potentially necessitate new CFTC rulemaking under 7 U.S.C. 6a(c)(2).

economically appropriate risks in their December 30, 2016, position limits rule reproposal,⁵¹ which requested the agency

consider as economically appropriate any derivative position that a business can reasonably demonstrate reduces or mitigates one or more specific, identifiable risks related to individual or aggregated positions or transactions, based on its own business judgment and risk management policies, whether risk is managed enterprise-wide or by legal entity, line of business, or profit center.⁵²

However, in their 2016 position limits rule reproposal, the CFTC opted against such changes, explaining, among other things, that it “would permit an enterprise to cherry pick cash market exposures to justify exceeding position limits, with either a long or short derivative position, even though such derivative position increases the enterprise’s risk.”⁵³ The comment period closed February 28, 2017, for the repropose rule, and a number of industry associations complained in comment letters that the repropose rule was too restrictive in its view of bona fide hedging.⁵⁴ Since then, the CFTC’s Division of Market Oversight on August 10, 2017, issued a no-action letter providing time-limited relief from certain aspects of the aggregation requirements for position limits. Aggregation requirements involve the degree to which an individual or entity is required to aggregate together all of their trading positions for the purposes of meeting position limits. This no-action relief indirectly impacts issues surrounding bona fide hedging requirements, as both the bona fide hedging definition and the aggregation requirements determine how strict position limits requirements prove practically speaking.

Global Cross-Border Swaps

Background: Cross-Border Swaps and Extra-Territoriality

The topic of cross-border swaps broadly relates to the question of to what degree did Congress intend, and did the Dodd-Frank Act authorize, the CFTC to have regulatory authority over swaps that may extend beyond U.S. borders or are transacted between U.S. and non-U.S. persons or two 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 interpretive discretion to the CFTC. Former CFTC Chair Gary Gensler, under whom the CFTC first issued rules and interpretations implementing Section 722, stated that “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.”⁵⁵

⁵¹ CFTC, “Position Limits for Derivative,” 81 *Federal Register* 96747, December 30, 2016.

⁵² CFTC, “Position Limits for Derivative,” 81 *Federal Register* 96747, December 30, 2016. See footnote 444, which cites, e.g., the following comment letters: CL-API-59694 at 4, CL-IEC Assn-59679 at 10–11, CL-APGA-59722 at 9–10, CL-NCFC-59942 at 5, CL-EEI-EPSA-59602 at 15, and CL-EEI-Sup-60386 at 7.

⁵³ CFTC, “Position Limits for Derivative,” 81 *Federal Register* 96747, December 30, 2016.

⁵⁴ See, e.g., Futures Industry Association, “Re: Reproposal – Position Limits for Derivatives” (February 28, 2017), RIN 3038-AD99, at https://commodities.fia.org/sites/default/files/content_attachments/2017-02-28_Reproposal_Position_Limits.pdf.

⁵⁵ Gary Gensler, “Statement of Support by Chairman Gary Gensler on Final Exemptive Order Regarding Compliance with Certain Swap Regulations and Further Proposed Guidance (Final Order),” CFTC, December 22, 2012, at <http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement122112>.

Gensler and other financial experts noted that derivatives trading by overseas affiliates of U.S. financial conglomerates 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, and the J.P. Morgan "London Whale" derivatives trading losses of roughly \$6 billion.⁵⁶

By contrast, industry participants have warned that if CFTC rules were too burdensome or not harmonized with other countries' regulations—putting in place requirements that other jurisdictions lacked—then "swap business [would] 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."⁵⁷ Industry participants also have warned that, once gone, such business would be unlikely to return to U.S. companies.⁵⁸

Past CFTC Action

The CFTC issued proposed guidance on the cross-border application of Title VII of the Dodd-Frank Act in 2012.⁵⁹ In this guidance, the agency sought to clarify who would count as a "U.S. person" for the purposes of meeting the requirements of Dodd-Frank, such as the clearing requirement for swaps, among other cross-border issues. 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.⁶⁰ 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.⁶¹

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.⁶² On November 14, 2013, the CFTC issued a staff advisory 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

⁵⁶ See, e.g., Chairman Gary Gensler's Keynote Address on the Cross-border Application of Swaps Market Reform at Sandler O'Neill Conference (June 6, 2013) at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-141>.

⁵⁷ 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>.

⁵⁸ *Ibid.*

⁵⁹ CFTC Proposed Interpretive Guidance and Policy Statement Regarding Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062912.pdf>.

⁶⁰ See "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>.

⁶¹ 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>.

⁶² 78 *Federal Register* 45292 (July 26, 2013).

execute the swap.⁶³ On December 4, 2013, three financial industry trade associations sued the CFTC, challenging the July 26, 2013, final guidance as well as the extraterritorial application of 14 Dodd-Frank swaps rules.⁶⁴ In a decision issued September 16, 2014, the U.S. District Court for the District of Columbia (1) upheld the final guidance and (2) remanded, without vacating, some of the challenged rules for the CFTC to further consider extraterritorial costs and benefits and to determine whether changes were needed in the rules' substantive requirements.⁶⁵ On remand, the CFTC solicited comments on differences between foreign and domestic costs and benefits, and concluded that any differences identified by the commenters did not establish a need to change the substantive requirements of the rules.⁶⁶

The CFTC continues to issue rules aimed at clarifying how to apply Dodd-Frank derivatives requirements to cross-border trades. In regard to the CFTC's cross-border rulemakings and substituted compliance determinations, in March 2016, the CFTC approved a substituted compliance framework for dually registered central counterparties, located in both the United States and European Union. This permits European CCPs registered with the CFTC to comply with the CFTC's rules by meeting corresponding European requirements.⁶⁷ In May 2016, the CFTC approved its cross-border rules on margin for uncleared swaps. In the final rule, among other things, the CFTC set out its process for determining substituted compliance for its margin requirements for uncleared swaps.⁶⁸ In September 2016, the CFTC determined that Japan's margin requirements for uncleared swaps were, with one exception regarding interaffiliate trades, comparable to the CFTC's margin requirements.⁶⁹ In addition, in October 2016, the CFTC proposed certain cross-border rules on its swap dealer and MSP registration thresholds and the applicability of its external business conduct standards.⁷⁰

H.R. 238 on Cross-Border Swaps

H.R. 238 would mandate that, starting 18 months from its enactment, the swaps regulatory requirements of the eight largest foreign swaps markets must be considered comparable to those of the United States⁷¹—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.⁷² Section 312 of H.R. 238 bears some similarities to H.R. 1256 in the 113th Congress⁷³ and is identical to H.R. 2289 in the 114th Congress.

⁶³ CFTC Staff Advisory 13-69, Division of Swap Dealer and Intermediary Oversight, November 14, 2013, at <http://www.cftc.gov/ucm/groups/public/@lrlattergeneral/documents/letter/13-69.pdf>.

⁶⁴ *Sec. Indus. & Fin. Markets Ass'n v. US CFTC*, 67 F. Supp. 3d 373 (D.D.C. 2014).

⁶⁵ *Ibid.*

⁶⁶ Final Response to District Court Remand Order in Securities Industry and Financial Markets Association, et al. v. United States Commodity Futures Trading Commission, 81 *Federal Register* 54478 (August 16, 2016).

⁶⁷ The European requirements are set out in the European Market Infrastructure Regulation (EMIR), enacted in 2013. See 81 *Federal Register* 15260.

⁶⁸ 81 *Federal Register* 34818.

⁶⁹ 81 *Federal Register* 63376.

⁷⁰ 81 *Federal Register* 71946. For additional details, see "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>.

⁷¹ As calculated by notional value during the 12-month period ending with H.R. 238's date of enactment. 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.

⁷² H.R. 238 §312.

It is not, however, immediately straightforward to list what those eight largest jurisdictions would be. For one thing, the list would depend on how regulators treated the European Union’s member countries, 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.⁷⁴ 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 is essentially the same problem U.S. regulators face in deciding when a swap qualifies as a “U.S. transaction.”

Under H.R. 238, if the CFTC were not to make such a determination (of noncomparability), then “a non-United States person or a transaction between two non-United States persons shall be exempt from United States swaps requirements” as long as it is in compliance with any of the eight permitted foreign jurisdictions.⁷⁵ Effectively, the bill appears to 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 would presumably 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 provision enacted. For instance, would any swap in which a non-U.S. person was at least one counterparty potentially be encompassed? If so, that would potentially encompass a large majority of swaps, the bulk of which appear to be transacted in some way between a U.S. and a non-U.S. person.⁷⁶ H.R. 238 would presumably leave it to the regulator to interpret and clarify the application of this provision.

Section 312 also includes a definition of a U.S. person, which, among other factors, includes “any other person as the Commission may further define to more effectively carry out the purposes of

(...continued)

⁷³ In the 113th Congress, the House passed legislation (H.R. 1256) on June 12, 2013, 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.”

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 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.

⁷⁴ The provision does not specify what data source Congress intends the CFTC to use to make these determinations.

⁷⁵ H.R. 238 §312.

⁷⁶ 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 29, 2015, at <http://www.sec.gov/news/pressrelease/2015-77.html>.

this section”—thereby apparently giving the CFTC some leeway.⁷⁷ However, Section 312 would also specify 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.”⁷⁸ This requirement drew some criticism in the 114th Congress congressional debate over H.R. 2289.⁷⁹

The provision would appear to overturn CFTC Advisory 13-69,⁸⁰ which drew much industry opposition.⁸¹ 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.”⁸² The CFTC has delayed the advisory’s actual implementation several times.⁸³

Residual Interest

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 account.⁸⁴ H.R. 238 would essentially 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.⁸⁵ 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.⁸⁶ That deadline then affects when customers are required to post their collateral to cover insufficient margin amounts.

⁷⁷ H.R. 238 §312.

⁷⁸ H.R. 238 §312(b)(4).

⁷⁹ “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, 114th Cong., 1st sess., at <https://www.congress.gov/crec/2015/06/09/CREC-2015-06-09.pdf>.

⁸⁰ CFTC Staff Advisory 13-69, “Division of Swap Dealer and Intermediary Oversight Advisory: Applicability of Transaction-Level Requirements to Activity in the United States,” November 14, 2013, at <http://www.cftc.gov/idc/groups/public/@lrllettergeneral/documents/letter/13-69.pdf>.

⁸¹ See, for example, *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, from SIFMA, FIA and Financial Services Round Table at <http://www.sifma.org/issues/item.aspx?id=8589947959>. 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.”

⁸² CFTC Staff Advisory 13-69, “Division of Swap Dealer and Intermediary Oversight Advisory: Applicability of Transaction-Level Requirements to Activity in the United States,” November 14, 2013, at <http://www.cftc.gov/idc/groups/public/@lrllettergeneral/documents/letter/13-69.pdf>.

⁸³ In October 2016, the commission issued a proposed rulemaking, which among other things, addressed the circumstances under which the use of U.S. personnel may trigger the application of Dodd-Frank swap requirements. 81 *Federal Register* 71946.

⁸⁴ CFTC, “Residual Interest Deadline for Futures Commission Merchants, Final Rule,” 80 *Federal Register* 15507, March 24, 2015.

⁸⁵ Substantially similar provisions regarding residual interest appear in §104 of H.R. 2289, S. 1560 and §104 of S. 2917.

⁸⁶ 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 (continued...)

Regulation 1.22 provided that the deadline, set for 6:00 p.m. on the following day, would automatically become earlier in several years, barring further CFTC action.⁸⁷ 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.⁸⁸

Former CFTC Chair Timothy Massad noted in a statement on the CFTC 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's. But such a practice also could impose costs on customers who must deliver margin sooner.⁸⁹ 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. In May 2016, the CFTC published its study, recommending that no change to the residual interest deadline be made.⁹⁰

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(...continued)

<http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement031715>.

⁸⁷ Ibid.

⁸⁸ Ibid.

⁸⁹ Ibid.

⁹⁰ *Residual Interest Deadline For Futures Commission Merchants: A Report By Staff Of The U.S. Commodity Futures Trading Commission Pursuant To Regulation 1.22(C)(5)* (May 13, 2016) at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/residualinterestreport050616.pdf>.

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