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HOUSE OF REPRESENTATIVES
REPT. 112–344
Part 1

TO EXEMPT INTER-AFFILIATE SWAPS FROM CERTAIN REGULATORY REQUIREMENTS PUT IN PLACE BY THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

DECEMBER 23, 2011.—Ordered to be printed

Mr. BACHUS, from the Committee on Financial Services, submitted the following

# R E P O R T

[To accompany H.R. 2779]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 2779) to exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike all after the enacting clause and insert the following:

**SECTION 1. TREATMENT OF AFFILIATE TRANSACTIONS.**

(a) COMMODITY EXCHANGE ACT AMENDMENTS.—Section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1(a)(47)), as added by section 721(a)(21) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, is amended by adding at the end the following:

"(G) TREATMENT OF AFFILIATE TRANSACTIONS.—

"(i) IN GENERAL.—The term 'swap' does not include any agreement, contract, or transaction that—

"(I) would otherwise be included as a 'swap' under subparagraph (A); and

"(II) is entered into by a party that is controlling, controlled by, or under common control with its counterparty.

"(ii) REPORTING.—All agreements, contracts, or transactions described in clause (i) shall be reported to either a swap data repository, or, if there is no swap data repository that would accept such swaps, to the Commission pursuant to section 4r within such time period as the Commission may by rule or regulation prescribe.".

(b) SECURITIES EXCHANGE ACT OF 1934 AMENDMENTS.—Section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(3)(a)(68)), as added by section 761(a)(6) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, is amended by adding at the end the following:

"(F) TREATMENT OF AFFILIATE TRANSACTIONS.—

"(i) IN GENERAL.—For the purposes of any clearing and execution requirements under sections 3C and any applicable margin and capital requirements of section 15F(e), and for purposes of defining a security-

based swap dealer or a major security-based swap participant, and reporting requirements other than those set forth in clause (ii), the term 'security-based swap' does not include any agreement, contract, or transaction that—

"(I) would otherwise be included as a 'security-based swap' under subparagraph (A); and

"(II) is entered into by parties that report information or prepare financial statements on a consolidated basis, or for which an affiliated company reports information or prepares financial statements on a consolidated basis for both parties.

"(ii) REPORTING.—All agreements, contracts, or transactions described in clause (i) shall be reported to either a security-based swap data repository, or, if there is no security-based swap data repository that would accept such security-based swaps, to the Commission pursuant to section 13A within such time period as the Commission may by rule or regulation prescribe.

"(iii) PRESERVATION OF FEDERAL RESERVE ACT AUTHORITY.—Nothing in this subparagraph shall exempt a transaction described in this subparagraph from sections 23A or 23B of the Federal Reserve Act or implementing regulations thereunder.

"(iv) PROTECTION OF INSURANCE FUNDS.—Nothing in this subparagraph shall be construed to prevent the regulator of a Federal or State insurance fund or guaranty fund from exercising its other existing authority to protect the integrity of such a fund, except that such regulator shall not subject security-based swap transactions between affiliated companies to clearing and execution requirements under section 3C, to any applicable margin and capital requirements of section 15F(e), or to reporting requirements other than those set forth in clause (ii).

"(v) PREVENTION OF EVASION.—The Commission may prescribe rules under this subparagraph (and issue interpretations of rules prescribed under this subparagraph) as determined by the Commission to be necessary to include in the definition of security-based swap under this paragraph any agreement, contract, or transaction that has been structured as an affiliate transaction to evade the requirements of this Act applicable to security-based swaps.".

## PURPOSE AND SUMMARY

Inter-affiliate swaps are swaps and security-based swaps executed between entities under common corporate ownership. H.R. 2779 exempts inter-affiliate swaps and security-based swap trades from many of the regulations in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111–203) that are designed to mitigate risks associated with so-called "market-facing trades," where a corporation executes a derivatives transaction with an investment bank or other entity, which may be either a swap dealer or security-based swap dealer.

Under H.R. 2779, inter-affiliate swap trades must still be reported to a swap data repository and to the appropriate regulators. While the bill does not exempt security-based swap trades from all of Title VII's requirements, the bill does exempt such transactions from the margin, capital, clearing and execution, and real-time reporting requirements of Title VII. The bill would also prohibit affiliate transactions from being used as a factor in defining a security-based swap dealer or major security-based swap participant.

## BACKGROUND AND NEED FOR LEGISLATION

Inter-affiliate swaps allow a company with subsidiaries and affiliates to better manage risk by transferring the risk of its affiliates to a single affiliate and then executing swaps through that affiliate. Inter-affiliate swaps do not pose a systemic risk because

they do not create additional counterparty exposures or increase the interconnectedness between parties outside the corporate group. Currently, companies use inter-affiliate swaps to combine positions and centrally hedge risk. This is accomplished by executing most or all of its external swaps or security-based swaps through a single or limited number of affiliates.

Despite the significant differences between inter-affiliate swaps and swaps between unrelated parties, the Dodd-Frank Act treats these swaps the same, which needlessly increases the cost of hedging risk for end-users.

At an October 14, 2011, hearing of the Capital Markets and Government Sponsored Enterprises Subcommittee, Ms. Brenda Boultwood of Constellation Energy testified on behalf of the Coalition for Derivatives End-Users that:

> Constellation Energy, like many other companies, uses a business model through which we limit the number of affiliates within our corporation that enters into derivatives transactions with external and other swap dealer counterparties. Rather than having each corporate subsidiary transact individually with external counterparties, a single or limited number of corporate entities face dealers and other counterparties in the market. This helps our company centralize risk taking, accountability and performance management. These entities then allocate transactions to those affiliates seeking to mitigate the underlying risk. This allocation is done by way of "interaffiliate swaps"—or swaps between commonly controlled entities. This structure allows us to more effectively manage our corporate risk on an enterprise basis and to secure better pricing on our derivatives transactions. The transactions are largely "bookkeeping" in nature and do not create systemic risk. Using affiliates to transact has always been a healthy part of the way many companies internally centralize risk and manage overall performance.

Further, Ms. Boultwood testified that H.R. 2779 "would exempt a category of swaps, not a particular type of entity from regulation. That is precisely what the Administration did in exempting foreign exchange swaps and forwards and it is the right approach here as well."

## HEARINGS

On October 14, 2011, the Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing entitled "Legislative Proposals to Bring Certainty to the Over-the-Counter Derivatives Market," to consider H.R. 2779, and four other bills. The following witnesses testified:

- Mr. Keith Bailey, Managing Director, Fixed Income, Currencies and Commodities, Barclays Capital, on behalf of the Institute of International Bankers
- Mr. Shawn Bernardo, Senior Managing Director, Tullett Prebon, on behalf of the Wholesale Market Brokers' Association Americas

• Ms. Brenda Boultwood, Chief Risk Officer and Senior Vice President, CE Risk Management Division Office, Constellation Energy, on behalf of the Coalition of Derivatives End-Users
• Mr. James Cawley, CEO, Javelin Capital Markets LLC
• Mr. Kent Mason, Davis & Harman LLP, on behalf of the American Benefits Council and the Committee on the Investment of Employee Benefit Assets
• Mr. Conrad Voldstad, Chief Executive Officer, International Swaps and Derivatives Association

## COMMITTEE CONSIDERATION

The Subcommittee on Capital Markets and Government Sponsored Enterprises met in open session on November 15, 2011, and ordered H.R. 2779 favorably reported to the full Committee by a record vote of 23 yeas, 6 nays and 1 present (Record vote no. CM–42).

The Committee on Financial Services met in open session on November 30, 2011, and ordered H.R. 2779, as amended, favorably reported to the House by a record vote of 53 yeas and 0 nays (Record vote no. FC–53).

## COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. A motion by Chairman Bachus to report the bill, as amended, to the House with a favorable recommendation was agreed to by a record vote of 53 yeas and 0 nays (Record vote no. FC–53). The names of Members voting for and against follow:

RECORD VOTE NO. FC–53

| Representative | Aye | Nay | Present | Representative | Aye | Nay | Present |
|---|---|---|---|---|---|---|---|
| Mr. Bachus | X | | | Mr. Frank (MA) | X | | |
| Mr. Hensarling | X | | | Ms. Waters | X | | |
| Mr. King (NY) | X | | | Mrs. Maloney | X | | |
| Mr. Royce | X | | | Mr. Gutierrez | | | |
| Mr. Lucas | X | | | Ms. Velázquez | | | |
| Mr. Paul | | | | Mr. Watt | X | | |
| Mr. Manzullo | X | | | Mr. Ackerman | X | | |
| Mr. Jones | X | | | Mr. Sherman | X | | |
| Mrs. Biggert | X | | | Mr. Meeks | X | | |
| Mr. Gary G. Miller (CA) | X | | | Mr. Capuano | X | | |
| Mrs. Capito | X | | | Mr. Hinojosa | X | | |
| Mr. Garrett | X | | | Mr. Clay | X | | |
| Mr. Neugebauer | X | | | Mrs. McCarthy (NY) | X | | |
| Mr. McHenry | X | | | Mr. Baca | X | | |
| Mr. Campbell | X | | | Mr. Lynch | X | | |
| Mrs. Bachmann | | | | Mr. Miller (NC) | X | | |
| Mr. McCotter | X | | | Mr. David Scott (GA) | X | | |
| Mr. McCarthy (CA) | X | | | Mr. Al Green (TX) | | | |
| Mr. Pearce | X | | | Mr. Cleaver | X | | |
| Mr. Posey | X | | | Ms. Moore | | | |
| Mr. Fitzpatrick | X | | | Mr. Ellison | X | | |
| Mr. Westmoreland | X | | | Mr. Perlmutter | X | | |
| Mr. Luetkemeyer | X | | | Mr. Donnelly | X | | |
| Mr. Huizenga | X | | | Mr. Carson | | | |
| Mr. Duffy | X | | | Mr. Himes | X | | |
| Ms. Hayworth | X | | | Mr. Peters | X | | |
| Mr. Renacci | X | | | Mr. Carney | | | |

RECORD VOTE NO. FC–53—Continued

| Representative | Aye | Nay | Present | Representative | Aye | Nay | Present |
|---|---|---|---|---|---|---|---|
| Mr. Hurt | X | | | | | | |
| Mr. Dold | X | | | | | | |
| Mr. Schweikert | X | | | | | | |
| Mr. Grimm | X | | | | | | |
| Mr. Canseco | X | | | | | | |
| Mr. Stivers | X | | | | | | |
| Mr. Fincher | X | | | | | | |

During the Committee consideration of H.R. 2779, the following amendment and motion were considered:

1. An amendment offered by Ms. Moore and Mr. Stivers, no. 1, to narrow the scope of the affiliate exemption, provide a new definition of "affiliate," preserve the Federal Reserve Act's authority, protect insurance and guaranty funds, and allow the Securities and Exchange Commission (SEC) to prescribe rules to prevent evasion of the requirements of the Act, was agreed to by voice vote.

2. A motion offered by Mr. Bachus to move the previous question on H.R. 2779 was agreed to by voice vote.

## COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the Committee has held hearings and made findings that are reflected in this report.

## PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee establishes the following performance related goals and objectives for this legislation:

The objective of H.R. 2779 is to exempt inter-affiliate swaps and security-based swap trades from the margin, clearing, and reporting requirements of the Dodd-Frank Act. Inter-affiliate swaps are swaps and security-based swaps executed between entities under common corporate ownership. Inter-affiliate swaps allow a company with subsidiaries and affiliates to better manage risk by transferring the risk of its affiliates to a single affiliate and then executing swaps through that affiliate. Inter-affiliate swaps do not pose a systemic risk because they do not create additional counterparty exposures or increase the interconnectedness between parties outside the corporate group. Currently, companies use inter-affiliate swaps to combine positions and centrally hedge risk. This is accomplished by executing most or all of its external swaps or security-based swap trades through a single or limited number of affiliates.

## NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

## COMMITTEE COST ESTIMATE

The Committee adopts as its own the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

## CONGRESSIONAL BUDGET OFFICE ESTIMATE

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

DECEMBER 14, 2011.

Hon. SPENCER BACHUS,
*Chairman, Committee on Financial Services,*
*House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 2779, a bill to exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Susan Willie.

Sincerely,

DOUGLAS W. ELMENDORF.

Enclosure.

*H.R. 2779—A bill to exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act*

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111–203) requires that participants in swap transactions meet certain clearing, reporting, and margin requirements as well as certain business conduct standards. (A swap is a contract that calls for an exchange of cash between two participants, based on an underlying rate or index or the performance of an asset). H.R. 2779 would exempt from the definition of a swap those transactions in which the parties are affiliates as defined in the bill; thus, affiliated parties that enter into swap transactions would be exempt from those clearing, reporting, margin and business conduct requirements.

Neither the Commodity Futures Trading Commission nor the Securities and Exchange Commission (the agencies required to develop and enforce regulations related to swap transactions) has finalized regulations related to swap transactions. Based on information from the two agencies, CBO expects that incorporating the provisions of H.R. 2779 at this point in the regulatory process would not require a significant increase in the workload of either agency. Therefore, CBO estimates that any change in discretionary spending to implement the legislation, which would be subject to the availability of appropriated funds, would not be significant. Enacting H.R. 2779 would not affect direct spending or revenues; therefore, pay-as-you-go procedures do not apply.

H.R. 2779 would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA) by prohib-

iting state regulators from requiring insurance companies to report their holdings of inter-affiliate swaps on their annual statements. Because the limit on state authority would not require the expenditure of funds, CBO estimates that the bill would impose no costs on state, local, or tribal governments.

The bill contains no private-sector mandates as defined in UMRA.

The CBO staff contact for this estimate is Susan Willie. The estimate was approved by Theresa Gullo, Deputy Assistant Director for Budget Analysis.

## FEDERAL MANDATES STATEMENT

The Committee adopts as its own the estimate of Federal mandates prepared by the Director of the Congressional Budget Office pursuant to section 423 of the Unfunded Mandates Reform Act.

## ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

## APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

## EARMARK IDENTIFICATION

H.R. 2779 does not contain any congressional earmarks, limited tax benefits, or limited tariff benefits as defined in clause 9 of rule XXI.

## SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

*Section 1. Treatment of affiliate transactions*

This section amends Section 1(a)(47) of the Commodity Exchange Act, as added by Section 721(a)(21) of the Dodd-Frank Act, by stating that the term "swap" is not considered a "swap" as defined under Dodd-Frank so long as the transaction is between a party that is controlling, controlled by, or under common control with its counterparty. This section also requires that all swaps defined under the section shall be reported to a swap data repository, or if one does not exist, to the Commodity Futures Trading Commission within a time period to be prescribed by the Commission.

This section also amends Section 3(a)(68) of the Securities Exchange Act of 1934, as added by Section 761(a)(6) of the Dodd-Frank Act, by stating that the term "security-based swap" is not considered a "security-based swap" for purposes of clearing and execution requirements; any applicable margin and capital requirements; defining a security-based swap dealer or a major security-based swap participant; and reporting requirements other than the requirement that all transactions be reported to a security-based swap data repository or to the Securities and Exchange Commission within a time period to be prescribed by the Commission.

This section also preserves the power to regulate security-based swap transactions under Sections 23A and 23B of the Federal Reserve Act. This section also provides for protection of federal and state regulators of insurance and guaranty funds to exercise their existing authority to protect the integrity of a fund, except that such regulator shall not have the ability to subject security-based swaps to clearing and execution requirements, any applicable margin and capital requirements, or any reporting requirements established under the Dodd-Frank Act other than the reporting requirements already set forth in this section. Additionally, this section allows the SEC to prescribe rules to govern security-based swaps to prevent transactions from being structured as an affiliate transaction for the purposes of avoiding regulation under the Dodd-Frank Act.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italic and existing law in which no change is proposed is shown in roman):

## COMMODITY EXCHANGE ACT

* * * * * * *

**SEC. 1a. DEFINITIONS.**

As used in this Act:

(1) * * *

* * * * * * *

(47) SWAP.—

(A) * * *

* * * * * * *

*(G) TREATMENT OF AFFILIATE TRANSACTIONS.—*

*(i) IN GENERAL.—The term "swap" does not include any agreement, contract, or transaction that—*

*(I) would otherwise be included as a "swap" under subparagraph (A); and*

*(II) is entered into by a party that is controlling, controlled by, or under common control with its counterparty.*

*(ii) REPORTING.—All agreements, contracts, or transactions described in clause (i) shall be reported to either a swap data repository, or, if there is no swap data repository that would accept such swaps, to the Commission pursuant to section 4r within such time period as the Commission may by rule or regulation prescribe.*

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## SECURITIES EXCHANGE ACT OF 1934

### TITLE I—REGULATION OF SECURITIES EXCHANGES

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DEFINITIONS AND APPLICATION OF TITLE

SEC. 3. (a) When used in this title, unless the context otherwise requires—

(1) * * *

* * * * * * *

(68) SECURITY-BASED SWAP.—

(A) * * *

* * * * * * *

*(F) TREATMENT OF AFFILIATE TRANSACTIONS.—*

*(i) IN GENERAL.—For the purposes of any clearing and execution requirements under sections 3C and any applicable margin and capital requirements of section 15F(e), and for purposes of defining a security-based swap dealer or a major security-based swap participant, and reporting requirements other than those set forth in clause (ii), the term "security-based swap" does not include any agreement, contract, or transaction that—*

*(I) would otherwise be included as a "security-based swap" under subparagraph (A); and*

*(II) is entered into by parties that report information or prepare financial statements on a consolidated basis, or for which an affiliated company reports information or prepares financial statements on a consolidated basis for both parties.*

*(ii) REPORTING.—All agreements, contracts, or transactions described in clause (i) shall be reported to either a security-based swap data repository, or, if there is no security-based swap data repository that would accept such security-based swaps, to the Commission pursuant to section 13A within such time period as the Commission may by rule or regulation prescribe.*

*(iii) PRESERVATION OF FEDERAL RESERVE ACT AUTHORITY.—Nothing in this subparagraph shall exempt a transaction described in this subparagraph from sections 23A or 23B of the Federal Reserve Act or implementing regulations thereunder.*

*(iv) PROTECTION OF INSURANCE FUNDS.—Nothing in this subparagraph shall be construed to prevent the regulator of a Federal or State insurance fund or guaranty fund from exercising its other existing authority to protect the integrity of such a fund, except that such regulator shall not subject security-based swap transactions between affiliated companies to clearing and execution requirements under section 3C, to any applicable margin and capital requirements of section 15F(e), or to reporting requirements other than those set forth in clause (ii).*

*(v) PREVENTION OF EVASION.—The Commission may prescribe rules under this subparagraph (and issue interpretations of rules prescribed under this subparagraph) as determined by the Commission to be necessary to include in the definition of security-based swap under this paragraph any agreement, contract, or transaction that has been structured as an affiliate transaction to evade the requirements of this Act applicable to security-based swaps.*

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