V. Congress's Rollback of the Dodd-Frank Swaps Push-Out Rule

A. Introduction

In December of 2014, as part of the mandatory government spending bill, Congress amended Section 716 of the Dodd-Frank Act.[1] The section that Congress amended is known as the "swaps push out rule."[2] The original purpose of this rule was to forbid banks that bought or sold "swaps" from receiving certain types of federal assistance, especially any kind of government bailout.[3] The amended version of Section 716 relaxes many of these restrictions on banks' swaps activities.[4]

This Article explains the swaps that Section 716 regulated before the amendment, and the effects of the amendments. Part B covers some basic information concerning swaps. Part C discusses the old rule's advantages and disadvantages, as well as the reasoning behind its implementation. Part D goes on to explain Congress's recent amendment to Section 716. Finally, Part E analyzes the broader implications of this rule change and what it might mean looking forward.

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[1] Consolidated and Further Continuing Appropriations Act of 2015, Pub. L. No. 113-235, 128 Stat. 2130 (codified as amended in scattered sections of U.S.C.); *see also* Jim Hamilton, *Spending Bill Funds SEC and CFTC, Amends Dodd-Frank Swaps Push-Out Provision*, WOLTERS KLUWER (Dec. 12, 2014), http://www.dailyreportingsuite.com/securities/news/spending_bill_funds_sec_and_cftc_amends_dodd_frank_swaps_push_out_provision, *archived at* http://perma.cc/LK2A-VUKV.

[2] Christopher T. Fowler, Note, *The Swaps Push-Out Rule: An Impact Assessment*, 15 N.C. BANKING INST. 205, 205 (2011).

[3] *Id.*

[4] *Swaps Pushout Provision Amended: Pushout Requirement in Section 716 Now Limited to Certain ABS Swaps*, DAVIS POLK & WARDWELL LLP 2 (Dec. 17, 2014), http://www.davispolk.com/sites/default/files/2014-12-17_Swaps_Pushout_Provision_Amended.pdf, *archived at* http://perma.cc/Y33N-Q6VH.

B. Swaps Basics

In order to better understand the effect of Congress's amendment to Section 716, a basic understanding of the transactions Section 716 regulates is necessary. "Swaps" are financial transactions wherein two entities agree to "exchange sequences of cash flows for a set period of time."[5] They are often a form of derivative contract, as the value of a swap is often tied to an instrument unrelated to the actual swap transaction.[6] Many swap agreements are aimed primarily at risk management.[7] Some swaps have purposes aside from risk management, such as exchanging cash flows in different currencies in order to gain reserves of that currency, or better matching assets to liabilities by exchanging cash flows for shorter or longer termed cash flows.[8] A "credit default swap" ("CDS") is a particular type of swap agreement that is of special concern to regulators because financial institutions might use them for financial "gambling."[9] In a CDS, a "protection seller" receives continuous payments from a "protection buyer," in exchange for an agreement to pay off a third-party debt owed to the protection buyer in the event that the third-party defaults on that debt.[10] Institutions can "gamble" by using swaps to "bet" on whether risky debts will default.[11]

C. Original Section 716

As originally enacted, Dodd-Frank Section 716 forbid banks and bank holding companies from participating in regulated swap transactions, and instead forced them to "push-out" the swaps to

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[5] Michael McCaffrey, *An Introduction to Swaps*, INVESTOPEDIA, http://www.investopedia.com/articles/optioninvestor/07/swaps.asp (last visited Jan. 29, 2015), *archived at* http://perma.cc/K89Z-PSGX.
[6] *Id*.
[7] *See id.*
[8] *Id*.
[9] *See* Robert S. Bloink, *Does the Dodd-Frank Wall Street Reform Act Rein in Credit Default Swaps? An EU Comparative Analysis*, 89 NEB. L. REV. 587, 591 (2011).
[10] Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 52 (2011).
[11] *See* Bloink, *supra* note 9, at 591.

outside "satellite companies."[12] If the banks and bank holding companies failed to "push-out" their swaps, they would forfeit any chance of receiving government bailout funds, including Federal Deposit Insurance Corporation ("FDIC") money.[13] Congress enacted Section 716 in response to the 2008 financial crisis, in order to ensure that future federal bailouts did not protect unnecessarily risky financial activities.[14] Section 716, as originally enacted, had the effect of pushing the vast majority of swaps out of federally insured depository institutions.[15]

1. Purpose and Benefits of the "Swaps Push-Out" Rule

The originally enacted form of Section 716 was supposed to reduce the risk that swap transactions posed to banks and taxpayers and theoretically increase the overall health of the financial system by isolating major sources of financial risk.[16] Section 716 protected taxpayers by preventing them from footing the bill of a government bailout in the event that a bank became insolvent due to swaps activities.[17] Before the enactment of Section 716, federal protections for banks created a potential for banks to enter into "no-lose transactions," where banks would benefit if a risky swap bet paid off or simply take advantage of FDIC insurance or federal bailout money if the swap didn't pay off.[18] Section 716 ensured that banks would be responsible for paying for their own risk-taking financial behaviors.[19] Finally, original Section 716 was part of a broader attempt by Congress to prevent a new financial crisis by more clearly separating banking

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[12] Ben Protess, *Wall Street Seeks to Tuck Dodd-Frank Changes in Budget Bill*, N.Y. TIMES DEALBOOK (Dec. 9, 2014, 4:38 PM), http://dealbook.nytimes.com/2014/12/09/wall-street-seeks-to-tuck-dodd-frank-changes-in-budget-bill/, *archived at* http://perma.cc/4PY8-AXFR.
[13] *Id.*
[14] *See id.*
[15] Hamilton, *supra* note 1.
[16] *See* Protess, *supra* note 12.
[17] *See id.*
[18] *See id.*; Jonathan Weisman, *Furor over Move to Aid Big Banks in Funding Bill*, N.Y. TIMES, Dec. 12, 2014, at B1.
[19] Weisman, *supra* note 18.

activities, like taking deposits and lending money, from riskier financial activities like swap transactions.[20]

2. Criticisms of Original Section 716

Critics of the original Section 716 noted that, by pushing swaps to less regulated satellite entities, their potential effect in a financial disaster might actually be worse.[21] Because Section 716 forbid Congress from bailing out these banks and satellite entities, if a financial crisis did occur, the government would have its hands tied in providing the assistance necessary to stem the "domino effect" of financial collapse.[22] Furthermore, pushing swaps out to entities less regulated than the banks themselves could actually increase the banks' exposure to risk.[23]

Other commenters saw the original Section 716 as not having any large effect at all.[24] Section 716 did not prevent banks from investing in swaps; it merely changed where they were held.[25] Furthermore, Section 716 did nothing on its own to reduce the amount of assets the financial market committed to investing in swaps.[26] Some analysts say the rule is unnecessary because the market as a whole has

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[20] Fowler, *supra* note 2, at 214-15.

[21] *See* Jill Priluck, *Don't Sweat the Dodd-Frank Rollback*, SLATE (Dec. 19, 2014, 5:07 PM), http://www.slate.com/articles/business/moneybox/2014/12/dodd_frank_rollback_congress_gave_wall_street_a_win_but_now_should_regulate.html, *archived at* http://perma.cc/3H2F-8DAM.

[22] *See* Ed Skyler, *Why Citi—and Banks Large and Small—Support the Swaps Push-Out Fix*, CITI BLOG (Dec. 12, 2014, 2:10 PM), http://blog.citigroup.com//2014/12/-much-has-been-said.shtml, *archived at* http://perma.cc/QEQ5-VM8J.

[23] *See* Matt Levine, *Levine on Wall Street: Swaps Pushed Back In, Harvard Gets in Trouble*, BLOOMBERG VIEW (Dec. 11, 2014, 7:53 AM), http://www.bloombergview.com/articles/2014-12-11/levine-on-wall-street-swaps-pushed-back-in-harvard-gets-in-trouble, *archived at* http://perma.cc/A8GP-LKRZ.

[24] *See* Levine, *supra* note 23; Victoria McGrane, *Swap Talk: Why Are People Fighting Over Dodd-Frank and Derivatives?*, WALL ST. J. BLOG (Dec. 10, 2014, 4:38 PM), http://blogs.wsj.com/washwire/2014/12/10/swap-talk-why-are-people-fighting-over-dodd-frank-and-derivatives/, *archived at* http://perma.cc/Q4DH-3QDP.

[25] Levine, *supra* note 23.

[26] *Id.*

been moving away from the risker types of swaps on its own, regardless of any regulatory or statutory intervention.[27]

D. Congress's Amendment to Section 716

Whether or not original Section 716 actually had a large effect on the financial system, Congress's recent amendment to Section 716 greatly reduced its effect by "exempt[ing] a wider array of derivatives from the push out plan."[28] As amended, Section 716 now allows banks to hold, buy, or sell most types of swaps—including swaps referencing commodities, equity swaps, and CDSs—without forfeiting federal protection.[29] This amendment has the primary effect of allowing banks and bank holding companies to take their swap activities back from their satellite companies, thus ensuring that those swap transactions are "federal insured."[30] Under amended Section 716, banks are still forbidden from participating in "asset backed securities" ("ABS") swaps, which Section 716 refers to as "structured finance swaps."[31] However, banks may enter into these structured finance swaps directly if they use them for the purpose of "hedging or risk management," or if banks are otherwise allowed by "prudential regulators" to enter these transactions.[32]

Advocates of the amendment point out several benefits of the amended rule. First, allowing banks to hold their own swap investments removes unnecessary transaction and compliance costs as well as unnecessary complexity from the financial system, easing future regulation and increasing transparency.[33] Second, the amendment allows more "one-stop shopping" for businesses and investors alike who seek to buy or sell swaps in the American market, by allowing financial institutions and banks to more directly provide access to the swaps market without a satellite company intermediary.[34] Other advocates suggest the amendment provides greater security to

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[27] *See* Priluck, *supra* note 21.
[28] Protess, *supra* note 12.
[29] *Id.*; *Swaps Pushout Provision Amended: Pushout Requirement in Section 716 Now Limited to Certain ABS Swaps*, *supra* note 4, at 2.
[30] *See* Protess, *supra* note 12.
[31] *Swaps Pushout Provision Amended: Pushout Requirement in Section 716 Now Limited to Certain ABS Swaps*, *supra* note 4, at 2.
[32] *Id.*
[33] *See* Skyler, *supra* note 22.
[34] Weisman, *supra* note 18.

FDIC insured institutions invested in or relying on swaps in the event that there is a financial catastrophe, because the amendment allows those institutions to take advantage of the supposed "risk-mitigating" effects of swaps.[35] Finally, some point out that the rule allows American banks to compete more easily with foreign banks that do not have to push out these transactions to other entities, which increases the overall value and health of the American financial system.[36]

Critics emphasize that the amendment to Section 716 increases banks' risk exposure, which may result in a similar level of vulnerability that was one of the causes of the 2008 crisis in the first place.[37] Those against the amendment argue that nearly all of the swaps trading newly allowed by this amendment currently takes place exclusively at the four largest banks in the United States, and that this amendment exclusively benefits those already enormous banks.[38] Many critics of the amendment argue that Congress has failed to acknowledge the lessons of history concerning financial deregulation.[39] These critics suggest that the amendment to Section 716 exemplifies the type of lax regulation that led to the 2008 financial crisis.[40]

E. Broader Implications for Financial Regulation in General

Some commentators are concerned, not with the specific language or effect of the amendment to Section 716, but rather with what they see as an overall move towards the federal deregulation of banking and financial activities.[41] Commentators and politicians alike point to the fact that Citigroup lobbyists *originally penned* the language of the amendment to Section 716.[42] Analysts have expressed concern and even outrage with banks and financial firms writing the very

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[35] *Id*.
[36] McGrane, *supra* note 24.
[37] Steve Denning, *With Dodd-Frank Rollback, The Big Bad Banks Are Back*, FORBES (Dec. 12, 2014, 10:46 AM), http://www.forbes.com/sites/stevedenning/2014/12/12/with-dodd-frank-rollback-the-big-bad-banks-are-back/.
[38] Weisman, *supra* note 18.
[39] *See* Denning, *supra* note 37.
[40] *Id*.
[41] *See id*. ("With big banks once again on the rampage, another major financial crisis is inexorably in the making.")
[42] Weisman, *supra* note 18.

legislation that is supposed to restrain their risker activities.[43] Senator Elizabeth Warren has been vocal about lobbyist-drafted regulations, and has argued that this practice is a breakdown of Congressional independence.[44]

Other critics have complained that Congress tried to "hide" the amendment by "sneaking" it into the mandatory spending bill needed to fund the U.S. government.[45] These critics argue that Congress should not be substantially deregulating the banking and financial sectors in eleventh hour legislation.[46]

Others suggest that this amendment does not presage future deregulation of banking and finance, but rather provides an opportunity for Congress to pass more meaningful restrictions on risky financial activities.[47] These commentators see this amendment as providing an opportunity for more meaningful regulation by creating room for more effective forward-looking regulations, rather than ineffective reactionary regulations like the original Section 716.[48] In essence, these commenters argue that original Section 716 was ineffective at protecting the financial system, so Congress was correct to amend Section 716 and clear the path for newer, more effective regulations.[49] Of course, this view depends on whether Congress will in fact pass more restrictive bank regulations in the future, which remains to be seen.

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[43] Michael Corkery, *Citigroup Becomes the Fall Guy in the Spending Bill Battle*, N.Y. TIMES DEALBOOK (Dec. 12, 2014, 1:57 PM), http://dealbook.nytimes.com/2014/12/12/citigroup-becomes-the-fall-guy-in-the-spending-bill-battle/, *archived at* http://perma.cc/49YE-NKSX; Protess, *supra* note 12.
[44] *See* Corkery, *supra* note 43.
[45] Weisman, *supra* note 18.
[46] Protess, *supra* note 12.
[47] *See* Priluck, *supra* note 21.
[48] *See id.*
[49] *Id.*

F. Conclusion

The Dodd-Frank Act was at the heart of the Congressional response to the 2008 financial crisis. Congress's recent amendment to Section 716 affects a fairly narrow area of Dodd-Frank, but has still proven controversial enough to polarize analysts and politicians.[50] Ideologues and experts are sharply divided on whether financial institutions and banks should play a role in drafting regulations, and also on the degree to which taxpayers should protect the financial institutions on which they rely.[51] Fundamental disagreements between regulators and financial actors on the best approach towards further regulation will no doubt continue to spark conflict along the same lines going forward. When deciding whether to increase, decrease, or maintain the level of regulation now in place, Congress must balance on a razors edge between inviting history to repeat itself and restraining the financial activity necessary for our economy to function.

Daniel R. Warren[52]

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50 *See supra* text accompanying notes 33-49.
51 *See supra* text accompanying notes 16-19, 42-44.
52 Student, Boston University School of Law (J.D. 2016).