AMERICANS FOR FINANCIAL REFORM
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June 6, 2011

Mary J. Miller
Assistant Secretary for Financial Markets
Office of Financial Institutions Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW.
Washington, DC 20220

Re: Determination of Foreign Exchange Swaps and Forwards under the Commodity Exchange Act.

Dear Assistant Secretary Miller:

Thank you for the opportunity to comment on the Notice of Proposed Determination[1] issued by the Department of the Treasury ("Treasury") regarding the treatment of foreign exchange swaps and forwards under the Commodity Exchange Act. These comments are submitted on behalf of both Americans for Financial Reform ("AFR") and Professor Michael Greenberger of the University of Maryland School of Law. Americans for Financial Reform is an unprecedented coalition of over 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, religious and business groups as well as prominent economists and other experts.

I. General Comments

The Commodity Exchange Act[2] ("CEA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] ("Dodd-Frank"), requires that foreign exchange swaps and foreign exchange forwards (collectively "forex derivatives") be regulated in the same manner as all other swaps, *i.e.* subject to clearing and exchange or exchange-like trading, unless the Secretary of the Treasury determines, after considering the statutorily mandated five factors listed below, that forex derivatives are qualitatively and objectively different from all other

[1] 76 Fed. Reg. 25774 (May 5, 2011) [hereinafter "Proposed Determination"].

[2] 7 U.S.C. 1 *et seq.*

[3] Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter "Dodd-Frank Act"].

swaps.[4] The critical importance to the regulatory status of forex derivatives is premised on the fact that this is presently about $ 4 trillion a day at risk – soon likely to grow to $ 10 trillion – which has the capacity (indeed, has had the capacity) to create a capital shortage in the world wide economy, causing a return to the crisis atmosphere experienced in the fall of 2008.[5]

In reaching its proposed determination, however, the Treasury did not adequately consider the statutorily mandated factors, relying predominately on the summary assertions and assumptions proffered by financial industry stakeholders, who sell these swaps in the second largest derivatives markets in the world at tremendous profit – profit that would be substantially diminished in a mandatory clearing/exchange-like trading environment.

In order to satisfy its obligation under Dodd-Frank, only after the Treasury has conducted its own *independent* analysis and data collection sufficient to support each of the five statutory findings in the Proposed Determination and, correspondingly meaningfully addresses significant arguments made by participants in this proceeding that are in direct conflict with the Treasury's proposed findings, will the final determination about forex derivatives be able to withstand legal scrutiny.

During the legislative process, Congress actively debated and negotiated the terms of Dodd-Frank's forex provisions.[6] Members of congress were highly skeptical that a blanket

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[4] Under administrative law principles, this determination process is one of informal agency adjudication and therefore subject to judicial review, examining whether Treasury's findings are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," including the agency's obligation to explain its rejection of significant arguments made during the proceedings. *Clark County v. FAA*, 522 F.3d 437, 441 (D.C. Cir. 2008) (citing *see* 5 U.S.C. § 706(2)(A); *see also Pension Benefit Guar. Corp. v. LTV Corp*., 496 U.S. 633, 653-56, 110 S. Ct. 2668, 110 L. Ed. 2d 579 (1990)).

[5] According to the Office of the Comptroller of the Currency, the total notional value of forex derivatives held by commercial banks is approximately $21 billion for the fourth quarter of 2010, which is the second largest, followed by interest rate contract. *See* Comptroller of the Currency, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES FOURTH QUARTER 2010, *available at* http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq410.pdf. *see also* Anchalee Worrachate, *Global Currency Trading Will Grow to $10 Trillion a Day by 2020, UBS Says*, BLOOMBERG.COM (October 26, 2010), *available at* http://www.bloomberg.com/news/2010-10-27/global-currency-trading-will-grow-to-10-trillion-a-day-by-2020-ubs-says.html (stating that "Foreign-exchange trading will more than double to $10 trillion a day on average a decade from now, driven by portfolio diversification from central banks, pension funds, hedge funds and insurance companies, according to UBS AG.").

[6] The details of the deliberation of forex language are provided in my previous comment letter dated November 29, 2010, which is incorporated by reference. *See* Comment Letter by Michael Greenberger, Professor, University of Maryland School of Law, to Mary Miller, Assistant Secretary for Financial Markets, Office of Financial Institutions Policy, Department of the Treasury (November 29, 2010), *available at* http://www.michaelgreenberger.com/files/Greenberger_FX_comment_letter.pdf [hereinafter "Greenberger Letter"].

exemption of forex derivatives from the definition of "swap" was justified.[7] In light of this and because, in drafting Dodd-Frank, Congress sought to bring *all (except those by commercial end users) under the mandatory clearing and exchange-trading requirements*,[8] Congress chose to place the highest burden on the Secretary to choose to disregard clearing, exchange-like trading and capital/collateral requirements for such a huge part of the derivatives market.

That Treasury must conduct its own thorough independent analysis can be gleaned from the text of the statute itself. Section 721 of Dodd Frank requires that, in reaching its final determination, Treasury must identify "the *objective* differences of foreign exchange swaps and foreign exchange forwards[.]"[9] In specifically requiring that the Treasury's findings be *objective*, Congress wanted to ensure that any data and analysis on which Treasury relied would not be biased or influenced by the highly self interested views of swaps dealer/banks that derives substantial from uncleared swaps and therefore have much to gain from continued deregulation.

Even the Treasury itself acknowledges that it is required to conduct an independent analysis. Assistant Secretary of the Treasury, Mary Miller, recently testified: "Treasury staff has … *conducted its own, independent analysis of the issue*, including extensive discussions with a range of regulators, end users, dealers, and other interested parties."[10] However, this claim of objectivity in reaching the proposed determination does not withstand even the most cursory scrutiny since the data required to conduct independent analysis has never been available under the current deregulatory regime; nor has the Treasury called for that data in reaching the determination at issue; nor does Treasury make any such data available in its proposal.

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[7] *See* e.g., Greenberger Letter ("Chairmen Frank and Peterson, leaders of the two committees of jurisdiction on this legislation in the House of Representatives, challenged the Treasury's proposed exclusion of FX derivatives, claiming that it would eliminate from the exchange trading and clearing requirements over $50 trillion in swaps.") (citing Shahien Nasiripour and Ryan Grim, *Two Leading House Dems Will Close $50 Trillion Loophole in Derivatives Reform Bills*, HUFFINGTON POST, (Nov. 18, 2009), *available at* http://www.huffingtonpost.com/2009/11/18/exclusive-two-leading-hou_n_362154.html); *see also* Greenberger Letter ("Senator Maria Cantwell, an active legislative participant in the crafting of Dodd-Frank, publicly said: 'The Treasury Department should be ashamed of themselves,' referring to, inter alia, the exclusion of foreign currency swaps.") (citing Jason Linkins, Sen. Maria Cantwell Savages Derivative Reform Legislation: "The Treasury Department Should Be Ashamed Of Themselves," Huffington Post (October 16, 2009) (updated on March 18, 2010), *available at* http://www.huffingtonpost.com/2009/10/16/sen-maria-cantwell-savage_n_323868.html).

[8] *See* e.g., S. REP. 111-176, at 32–35 (2010) (noting that draft provisions concerning OTC derivatives were designed to minimize non-cleared, off-exchange trades).

[9] §721 of the Dodd-Frank Act, *supra* note 3.

[10] *See* Written Testimony of Mary J. Miller, Assistant Secretary of the Treasury, *Before the Senate Committee on Banking, Housing, and Urban Affairs on Building the New Derivatives Regulatory Framework: Oversight of Title VII of the Dodd-Frank Act* at 6 (April 12, 2011), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=6f4b1354-6b72-4c0f-a98c-ee5c431d00dd.

For example, the recent report by the Committee on the Global Financial System/Markets Committee concludes: "Information about off-balance sheet foreign exchange activities is vital for forming a complete picture. These data are not available from the BIS banking statistics or other collections of international data."[11] It follows that, only after collecting *all* necessary data and conducting its own thorough independent analysis, would Treasury meet the burden placed by Congress. The data necessary to consider adequately all five factors include, *inter alia*, the size of the forex market, including the off-balance sheet transactions, the interrelationship among forex market participants, and the quantifiable costs and benefits analysis for exempting forex.

In fact, Congress provided Treasury the necessary tools and ample time to collect independent data and analyze that data by imposing mandatory reporting requirement for all forex transactions and by not imposing a hard deadline by which the Treasury would be required to make a final determination

However, on May 5, 2011, the Treasury proposed that forex derivatives not be regulated as swaps with only the most general conclusions and assumptions. The Treasury summarily determined without independent underlying support or analysis that since forex derivatives have fixed payment obligations, are physically settled, and are predominantly short-term instruments, their risk profile is different from other derivatives, as they are centered on settlement risk, rather than counterparty credit risk.

Contrary to these highly generalized conclusions are the wholly unanswered analyses of many experts,[12] market observers,[13] and other interested stakeholders[14] that the Secretary must support its final determination to exempt forex derivatives by *fully and adequately justifying* all statutorily mandated considerations.

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[11] Guy Debelle, Chair, Joint Committee on the Global Financial System/Markets Committee Study Group, *The functioning and resilience of cross-border funding markets*, Bank for International Settlements, 11 (March 2010), *available at* http://www.bis.org/publ/cgfs37.pdf.

[12] *See* Greenberger Letter, *supra* note 5; *see also* Comment Letter by Darrell Duffie, Professor, Graduate School of Business, Stanford University, to Inc to Mary Miller, Assistant Secretary for Financial Markets, Department of the Treasury, *On The Clearing of Foreign Exchange Derivatives* (May 12, 2011), *available at* http://www.darrellduffie.com/uploads/policy/DuffieClearingFXDerivatives2011.pdf.

[13] *See* Editorial, *Mr. Geithner's Loophole*, N.Y. TIMES (April 30, 2011), *available at* http://www.nytimes.com/2011/05/01/opinion/01sun2.html?_r=3; *see also* Zach Carter, *Treasury Blocks Regulation of Market That Sparked $5.4 Trillion Fed Bailout*, HUFFINGTONPOST.COM (April 29, 2011), *available at* http://www.huffingtonpost.com/2011/04/29/geithner-blocks-regulatio_n_855634.html.

[14] *See* Comment Letter by Dennis M. Kelleher, President & CEO, Better Markets, Inc., and Wallace C. Turbeville, Derivatives Specialist, Better Markets, Inc., to Mary Miller, Assistant Secretary for Financial Markets, Department of the Treasury (November 29, 2010); *see also* Comment Letter by Americans for Financial Reform to Mary Miller, Assistant Secretary for Financial Markets, Department of the Treasury (November 29, 2010).

Treasury's proposed exemption is flawed as a matter of law and is otherwise arbitrary and capricious: (1) by relying almost completely on summary assertions by major financial institutions with a direct financial stake in the issue, most of whom are themselves forex dealers who want to be free of capital requirements and transparency; (2) by providing no detailed independent data collection and analysis of its own; and (3) by refusing to address the many detailed and substantiated arguments for the full regulation of forex derivatives by interested stake holders, including many commercial end users of these products.

We incorporate by reference herein the November 29, 2010 prior comment letters of the signatories hereto.

II. Statutorily Mandated Consideration

In making a determination pursuant to sections 1a(47)(E) and 1b of the CEA, Congress explicitly directed the Secretary to consider five factors. As shown below, the Secretary did not fully consider all of these factors; nor did it supply data to support those factors it did address.

i. *Consider whether the required trading and clearing of forex derivatives would create systemic risk, lower transparency, or threaten the financial stability of the United States*.

a. <u>The required exchange trading and central clearing of forex derivatives would address the systemic risk created by the large uncollateralized positions and interconnectedness of forex market participants, thereby promoting the financial stability of the United States.</u>

Dodd-Frank is designed to reduce systemic risk in the over-the-counter derivatives markets by, *inter alia*, requiring that all swaps (except those of commercial end users) be cleared through a clearinghouse. A clearinghouse interposes itself between counterparties to a swap transaction by taking on the risk that each party poses to the other. Under Dodd-Frank, those clearinghouses are required to impose initial margin, variation margin, and capital requirements on swap dealers and major swap participants. In other words, through clearing requirements, those swap dealers and major participants of swaps would have to have capital/collateral to support their contractual commitments.

In the Proposed Determination, the Treasury never mentions the interconnectedness of the forex banks/swap dealers in considering systemic risk. According to the Proposed Determination, the forex market is primarily and almost exclusively used by large banks.[15] These

[15] "Roughly 95 percent of [forex] transactions occur between banks acting either on their own behalf or on behalf of their clients." *See* Proposed Determination at 25777, *supra* note 1.

limited numbers of large banks are counterparties to each other and 9000 third party users.[16] This interconnectedness increases systemic risk. If these transactions were cleared, the danger of default on these transactions would be removed. History shows, moreover, that the forex market is ripe for defaults, and with the proposed forex exemption, defaults unsupported by collateral provoking the kind of house of cards failures that presented themselves in the fall of 2008.

The financial industry's claim (and Treasury's summary agreement) that the forex market did not contribute to the financial crisis is belied by the facts.[17] For example, Better Markets has analyzed data released from the Fed that demonstrates that the forex market was rescued during the meltdown to the tune of $5.4 trillion.[18] Also, Michael Melvin and Mark Taylor issued a working paper concluding that there was a crisis in the forex market shortly after the 2007-2008 crisis.[19] Furthermore, a 2009 study by Naohiko Baba and Frank Packer of the Bank for International Settlements concluded that there were "major dislocations" in the forex market in the aftermath of the Lehman Brothers bankruptcy.[20] The study further states: "In FX and money markets, what had principally been a dollar liquidity problem for European financial institutions deepened into a phenomenon of global dollar shortage" and those problems were only resolved after the Fed injected cash into foreign central banks, in order to ensure that global banks had access to dollars.[21]

However, even if there were no evidence that the forex market contributed to the 2008 meltdown, Congress, in establishing mandatory clearing for swaps, did not specify that mandatory clearing was required only for those instruments directly responsible for the 2008

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[16] According to CLS International Bank, there are 60 settlement member banks and 9000 third party users. *See* Official Website of CLS Bank, Master List of Members of CLS Bank International (February 14, 2011), *available at* http://www.cls-group.com/SiteCollectionDocuments/CLS%20Bank%20Members%20Legal%20Names.pdf.

[17] *See* Comment Letter by Dan Shackelford, Vice President and Chair of Fixed Income Derivatives Committee, T. Rowe Price Associates, Inc. and Jonathan D. Siegel, Vice President & Senior Legal Counsel, T. Rowe Price Associates, Inc. to Mary Miller, Assistant Secretary for Financial Markets, Department of the Treasury (November 29, 2010); *see also* Comment Letter by Global FX Division of the Securities Industry and Financial Markets Association, Association for Financial Markets in Europe, and the Asia Securities Industry and Financial Markets Association, to Mary J. Miller, Assistant Secretary for Financial Markets, Office of Financial Institutions Policy, Department of the Treasury, Determination of Foreign Exchange Swaps and Forwards (November 29, 2010) [hereinafter "Swap Dealer Letter"].

[18] Letter by Dennis M. Kelleher, President & CEO, Better Markets, Inc., and David Frenk, Research Director, Better Markets, Inc., to Timothy Geithner, U.S. Secretary of the Treasury (February 25, 2011), *available at* http://www.bettermarkets.com/assets/pdf/FX-Ltr-Supp-2-25-11.pdf.

[19] Michael Melvin and Mark P. Taylor, *The Crisis in the Foreign Exchange Market*, CESifo Working Paper No. 2707, Category 7: Monetary Policy and International Finance, July 2009, *available at* http://www.cesifo-group.de/portal/pls/portal/docs/1/1186164.PDF.

[20] Naohiko Baba and Frank Packer, *From turmoil to crisis: dislocations in the FX swap market before and after the failure of Lehman Brothers*, BIS Working Paper, No. 285, July 2009, *available at* http://www.bis.org/publ/work285.pdf.

[21] *Id*.

financial crisis. Congress indicated that if *any* major area of the swaps market (except those for commercial end users) is not collateralized and made transparent, there is a risk of default, leading to cascading defaults which can bring down the world economy. The lack of the fullest transparency dictated by Dodd-Frank, i.e., exchange-like trading, means that regulators and market observers are blinded to the scope of potential defaults that threaten economic stability.

Also, the Treasury contends that because most forex derivatives mature in less than one week and the great majority mature in less than a year, they "carry significantly lower counterparty credit risk."[22] In this regard, the Treasury describes the similar characteristics between forex derivatives and repurchase agreements ("repos") and summarily concludes that because repos are safe short-term funding instruments, forex derivatives are safe as well.[23]

However, the 2008 meltdown clearly demonstrated that short term repos *did* pose substantial risk to financial stability. For example, the Financial Crisis Inquiry Commission ("FCIC") conducted extensive research into the repo market during the 2008 financial crisis. The FCIC concluded that the repo market was on the verge of freezing up, *i.e.*, it was highly illiquid, and that "to the surprise of both borrowers and regulators, high-quality collateral was not enough to ensure access to the repo market [during the crisis]."[24] After realizing that the Fed's new program, the Term Securities Lending Facility ("TSLF"), which came with a $200 billion price tag, was insufficient to revive the repo market, the Fed launched yet another expensive subsidy program, Primary Dealer Credit Facility, to provide "hundreds of billions dollars of credit" into the repo market.[25] Only after these costly interventions was the repo market saved. The Federal Reserve's Payment Risk Committee also studied the repo issue and stated that:

> The potential for the tri-party repo market to cease functioning, with impacts to securities firms, money market mutual funds, major banks involved in payment and settlements globally, and even to the liquidity of the U.S. Treasury and Agency securities, has been cited by policy makers as a key concern behind aggressive interventions to contain the financial crisis.[26]

Furthermore, the claim that forex maturities are short enough to prevent counterparty risk is not demonstrated through any actual analysis of observed currency volatilities and potential

[22] Proposed Determination at 25777, *supra* note 1.

[23] Proposed Determination at 25777, *supra* note 1.

[24] FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xxiv, 293 (Jan. 2011), *available at* http://www.fcic.gov/report [hereinafter "FCIC REPORT"].

[25] *Id*. at 294.

[26] Task Force On Tri-party Repo Infrastructure Payments Risk Committee Report, March 17, 2010, *available at* http://www.newyorkfed.org/prc/report_100517.pdf.

losses. Instead, it is simply made as an assertion. According to the most recent data provided by an industry organization, the Foreign Exchange Committee, over one-third of the monthly volume of new forex derivatives have maturities in excess of one month.[27] This represents $2.7 trillion in relatively long-duration transactions initiated each month, and notional amounts outstanding in such contracts would be even higher. Currency volatility over the course of a month or more can easily drive counterparty default. As the prominent financial economist Darrell Duffie stated in his comment on this proposed determination:

> The volatilities of currency prices are significant, and could increase dramatically in certain types of financial or currency crises, or dramatic currency realignments such as that following the "Plaza Accord" of September, 1985. The tail risks of counterparty exposure on FX contracts can be quite large….[28]

Given the evidence that forex derivatives can pose significant counterparty risk, and indeed the fact that such risk did materialize during the 2008 crisis, Treasury must present an actual independent analysis which clearly demonstrates that this risk is not significant. Certainly a casual analogy to the repo market – one of the major drivers of the 2008 crisis – will not sustain the claim that the forex market does not pose risk. If anything, a claim that the forex market is not risky would require a demonstration that the *forex derivatives are different from what were highly destabilizing repos*. Also, the simple reference to a large volume of short-maturity forex transactions does not support a belief that the market does not pose systemic risk, since there is also a very large volume of longer-maturity foreign exchange swaps and forwards which remain exposed to high volatilities in currency markets for a month or more.

b. <u>The forex market will significantly benefit from the additional transparency provided by the exchange-like trading template mandated by Dodd-Frank</u>.

As mentioned above, the recent report by the Committee on the Global Financial System/Markets Committee concludes: "Information about off-balance sheet foreign exchange activities is vital for forming a complete picture. These data are not available from the BIS banking statistics or other collections of international data."[29] With respect to the Treasury's Proposed Determination, Senator Maria Cantwell recently stated: "I can't believe the first decision the administration would make to carry out Dodd-Frank would be an *anti-transparency decision*. The idea that the foreign-exchange markets are not at risk is preposterous -- we now

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[27] *See* Foreign Exchange Committee, Semi-Annual Foreign Exchange Volume Survey, October 2010, *available at* http://www.newyorkfed.org/FXC/volumesurvey/.

[28] Comment Letter by Darrell Duffie, Professor, Graduate School of Business, Stanford University, to Inc to Mary Miller, Assistant Secretary for Financial Markets, Department of the Treasury, *On The Clearing of Foreign Exchange Derivatives* (May 12, 2011), *available at* http://www.darrellduffie.com/uploads/policy/DuffieClearingFXDerivatives2011.pdf.

[29] Guy Debelle, Chair, Joint Committee on the Global Financial System/Markets Committee Study Group, *The functioning and resilience of cross-border funding markets*, Bank for International Settlements, 11 (March 2010), *available at* http://www.bis.org/publ/cgfs37.pdf.

know that they required multitrillion-dollar bailouts. *Anytime you have a lack of transparency, there is potential for abuse*."[30]

Treasury contends that "mandatory exchange trading requirements under the CEA would be unlikely to improve price transparency significantly,"[31] citing the comment letter from the Securities Industry and Financial Markets Association, Association for Financial markets in Europe, and the Asia Securities Industry and Financial Markets Association (collectively "Swap Dealer Letter"). These organizations represent, *inter alia*, the interests of securities firms, banks, and asset managers including big bank swaps dealers. Treasury argues that "the use of electronic trading platforms [already] provides a high level of pre- and post- trade transparency." The Swap Dealer Letter and the Treasury, however, fail to state whether the price information is readily and promptly available to non-member third parties or to government regulators. In fact, not all market participants in the forex market have access to readily available pricing information.

Indeed, the recent controversy over whether banks are overcharging public pension funds for trading in the forex market demonstrates conclusively that the lack of transparency is, in fact, harmful to end-users. For example, the highly publicized recent complaint filed[32] against BNY Mellon reveals that "[b]anks don't charge [forex] clients commissions for currency trades, as they do for buying and selling stocks. Instead, banks make money by getting the client to buy at as high a price possible, or sell as low as possible."[33] This complaint demonstrates that there is a pre-trade price informational gap between banks and its customers. One of those customers includes a Los Angeles pension fund that manages pension assets for 156,000 current and retired county employees. The Wall Street Journal investigation into this matter shows that "the trades cost the pension fund $4.5 million more than if the average trade occurred at the middle of the trading range for each day."[34]

[30] Robert Kuttner, Prospect.com, Blowing a Hole in Dodd-Frank (March 18, 2011), *available at* http://prospect.org/cs/articles?article=blowing_a_hole_in_doddfrank (quoting Senator Maria Cantwell) (emphasis added).

[31] Proposed Determination at 25778, *supra* note 1 (citing Comment Letter by Global FX Division of the Securities Industry and Financial Markets Association, Association for Financial markets in Europe, and the Asia Securities Industry and Financial Markets Association, to Mary J. Miller, Assistant Secretary for Financial Markets, Office of Financial Institutions Policy, Department of the Treasury (November 29, 2010)).

[32] "A whistleblower group has sued BNY Mellon in Virginia and Florida, and rival State Street Corp. in California, accusing them of improperly pricing currency trades for state and local pension funds." See Carrick Mollenkamp and Tom McGinty, *Inside a Battle Over Forex --- Bank Gave Pension Fund Least-Favorable Rates, Analysis Shows*, WALL ST. J., A1 (May 23, 2011).

[33] *Id*.

[34] *Id*.

As a result, some of the nation's most sophisticated investors, including Black Rock and Fidelity Investments, have also complained that banks have taken advantage of their privileged position in currency trades to overcharge them. The Treasury makes no effort to even respond to these highly publicized events that are condemnatory of the existing uncleared forex derivatives market.

In fact, the Proposed Determination states that "banks are *uniquely qualified* to have access to CLS to settle transactions on a real-time basis[.]"[35] According to CLS, there are only 60 settlement member banks[36] with approximately 9,000 third party users.[37] This means that those third party users would need to rely on the settlement member banks for pricing of forex transactions. As was recently noted: "If the nation's most sophisticated private equity and mutual funds consider the [forex transaction] process so opaque that the banks are gaming even them, there is no company or investor that the banks can't take advantage of."[38]

Dodd-Frank requires that all forex swaps, including non-cleared swaps, be registered with certain swaps data depositories and that information about the swaps be reported as soon as technologically possible.[39] However, price reporting of these non-cleared swaps would occur *after* the transaction is completed. There would not be the necessary degree of price transparency for the pre-trade forex swaps. This method is highly inferior to exchange-like trading which provides prompt and regular pre-transactional pricing information to the markets, market observers, and to government regulators.

c. <u>The Treasury should not principally and unquestioningly rely on summary assertions by large financial institutions, which face inherit conflicts of interest and which strongly support pre Dodd-Frank era regulatory conditions.</u>

It has been widely publicized that forex trading revenue is one of the largest contributing factors to the bottom line of Wall Street firms. The Goldman Sachs' trading revenue from foreign exchange positions was $2.2 billion from the second quarter of 2010 alone.[39] Recent data shows that JPMorgan Chase generated $361 million dollars, Citibank $240 million dollars, and

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[35] Proposed Determination at 25780, *supra* note 1 (emphasis added).

[36] There are only seven U.S. settlement member banks: Bank of America, Bank of New York Mellon, Citibank, Goldman Sachs, JPMorgan Chase Bank, Northern Trust Company, State Street Bank and Trust Company. *See* Official Website of CLS Bank, Master List of Members of CLS Bank International (February 14, 2011), *available at* http://www.cls-group.com/SiteCollectionDocuments/CLS%20Bank%20Members%20Legal%20Names.pdf.

[37] *See* Proposed Determination at 25780, *supra* note 1.

[38] Robert Kuttner, *Blowing a Hole in Dodd-Frank*, PROSPECT.COM (March 18, 2011), *available at* http://prospect.org/cs/articles?article=blowing_a_hole_in_doddfrank.

[39] Comptroller of the Currency, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES SECOND QUARTER 2010, available at http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/ derivatives/dq210.pdf.

Goldman Sachs $460 million dollars from their foreign exchange positions during the fourth quarter of 2010.[40] Moreover, these large banks make 56 percent of their profits in derivatives in forex.[41]

The opaque nature of the forex market plays a key role in generating trading revenues for these banks. The lack of exchange-like trading means that there will be virtually no meaningful transparency in pre-trading. Furthermore, because there is no exchange-like trading, the pricing is entirely at the discretion of swaps dealers. The Treasury should not rely on these banks analysis without independently verifying the data and methodology; rather the Treasury should address these issues arising from the lack of transparency prior to making a final determination.

ii. *Consider whether forex derivatives are already subject to a regulatory scheme that is materially comparable to that established by CEA for other classes of swaps*.

The central tenet of Dodd-Frank is the mandatory clearing and exchange-like trading requirements. Without these regulatory controls, forex derivatives are not subject to materially comparable regulatory protections that are established by the statute for other classes of swaps.

One of the essential purposes of mandated clearing is to avoid situations where swap traders find themselves incapable of fulfilling their trade commitments (because of a lack of capital/collateral), thereby resulting in a situation such as that which occurred with American International Group, Inc. ("AIG") in 2008. It is well established that AIG did not have sufficient reserves either in capital or collateral to protect against an unanticipated turn in market conditions. As a result, the burden fell on the American taxpayer to rescue AIG at a cost of $185 billion.

If the 2008 Great Recession taught us anything, it is that market transactions must be properly capitalized and that there must be a market pricing mechanism, *i.e.*, clearing and exchange-like trading, that sets firm and readily accessible prices for what would otherwise be wholly opaque transactions priced by illusory mathematics, rather than the market itself.

iii. *Consider the extent of adequate payment and settlement systems*.

The Treasury mistakenly concludes that *any settlement risk* in forex derivatives is already addressed through the extensive use of payment-versus-payment ("PVP") settlement

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[40] Comptroller of the Currency, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES FOURTH QUARTER 2010, *available at* http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq410.pdf.

[41] *Id*.

arrangements offered by CLS Bank International ("CLS"). The Treasury reaches this conclusion based on the underlying assumption that the physical settlement of forex derivatives "contributes to a risk profile that is largely concentrated on *settlement risk*."[42]

However, the Treasury's assertion that the risk profile of forex centered on settlement risk, rather than counterparty credit risk, could not be more mistaken.[43] In fact, many experts conclude that there is "significantly" more counterparty risk associated with forex because notional amounts are exchanged.[44]

The CLS system completely disregards the counterparty credit risk. In other words, under the CLS PVP system, if one party does not satisfy its obligation, the other party is *relieved* from its obligation, as if the non-defaulting party had never entered into the transaction. The non-defaulting party is therefore left with un-hedged forex risk – an exposure that the forex derivative is intended to combat. Simply put, CLS merely settles transactions between two parties by collecting payments from each party and distributing payments once all parties meet their obligations. This CLS system does not protect the parties against a counterparty credit or default risk.

On the other hand, under the Dodd-Frank Act's clearing system, a clearinghouse, becoming the buyer to every seller and the seller to every buyer, stands between the buyer and seller of a contract to *guarantee* each against the failure of the other party. Therefore, in order to protect the parties in a forex transaction and to bring the confidence back to the financial system, there must be a clearing mechanism, not merely a settlement system that does not guarantee parties' obligations (and, in fact, allows the voiding of previously made commitments) to protect the public and the market participants.

Furthermore, the Treasury and the Swaps Dealer Letter state that "CLS estimates that it settles more than 50 percent of forex transactions that are subject to settlement risk."[45] What about the other 50 percent of $4 trillion-a-day forex transactions? They are completely vulnerable to the settlement risk in addition to the counterparty credit risk.

In May of 2008, BIS reported on efforts to address settlement risk, stating that "a notable share of FX transactions is settled in ways that *still generate significant potential risk across the*

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[42] Proposed Determination at 25776, *supra* note 1 (emphasis added).

[43] Proposed Determination at 25776, *supra* note 1.

[44] Naohiko Baba and Frank Packer, *From turmoil to crisis: dislocations in the FX swap market before and after the failure of Lehman Brothers*, BIS Working Paper, No. 285, July 2009, *available at* http://www.bis.org/publ/work285.pdf (citing Duffie and Huang, 1996 Swap Rates and Credit Quality, 51 J. OF FINANCE 2, 921-950).

[45] Proposed Determination at 25781, *supra* note 1.

global financial system and so *further action is needed*."[46] The report further states, "The fact that $1.2 trillion of FX obligations are still subject to settlement risk as a result of the use of traditional correspondent banking arrangements is partly due to the fact that some FX trades cannot be settled using existing PVP settlement services."[47] Therefore, the competent evidence of record completely belies the Treasury's conclusions regarding the counterparty credit risk.

iv. *Consider the use of a potential exemption of forex derivatives to evade otherwise applicable regulatory requirements*.

The Treasury finds that "[forex derivatives] are … not likely to be used to evade otherwise applicable regulatory requirements because of operational and transactions costs associated with potentially transforming these instruments into other derivatives that are subject to regulatory requirements under the Act."[48] The Treasury's "cost-benefit" justification is weak and premature at best because the Treasury neither provides what the costs would be nor the method that it would employ in order to calculate such costs. Rather, it simply assumes that the cost would be "significant."[49] The burden is on the Treasury to provide what these numbers would be, as directed by Congress. The fact is that with the mere tinkering of standardized clauses, the parties can mask non-forex transactions as forex. The cost of disguising other swaps as forex swaps is in fact the quite minimal price charged by a lawyer to tinker with boilerplate contractual language to create new standardized language masking the real nature of a swap.

In fact, there is no discernable difference, for example, between cross-currency swaps and forex swaps. A forex swap involves an exchange of one currency for another for a given time period (*e.g.*, forex forward), after which the currencies are re-exchanged. In other words, a forex swap can be defined as two forex forwards packaged together. In a currency swap, counterparties exchange equal principal amounts of two currencies and subsequently exchange a stream of interest rate payments. At the end of the pre-agreed time period, the principal amount is re-exchanged. These individual streams of payments act just like a forex forward. As such, *any* currency swap can be "constructed from a series of simple forex forward contracts."[50]

As MFX Solution has stated in its response to the Treasury's October 28, 2010 release, "it would therefore be impractical to try to draw a line between [forex derivatives] and other

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[46] *See* Bank for International Settlements, *Progress in reducing foreign exchange settlement risk* (May 2008), *available at* http://www.bis.org/publ/cpss83.pdf (emphasis added).

[47] *Id*.

[48] Proposed Determination at 25782, *supra* note 1.

[49] Proposed Determination at 25779, *supra* note 1.

[50] Comment Letter by Brian Cox, Executive Director, MFX Solutions, Inc., to Mary J. Miller, Assistant Secretary for Financial Markets, Office of Financial Institutions Policy, Department of the Treasury, Determination of Foreign Exchange Swaps and Forwards (November 29, 2010) [hereinafter "MFX Solutions"].

products like cross-currency swaps that are simply bundles of forex forward contracts[.]"[51] Indeed, for this very reason, MFX Solution advocates the exclusion of currency swaps as well as forex derivatives from the definition of "swap." In this regard, MFX argues that if forex swaps and cross-currency swaps were to be treated differently, "there would be an incentive for providers to unbundle such cross-currency swap contracts for regulatory purposes."[52] MFX Solution further argues that "unbundling" would "decrease the transparency of reporting such forex derivatives making these products more confusing for customers."[53] This line of argument is even recognized by the Treasury in the Proposed Determination.[54]

The CFTC shares the same concern. On August 17, 2009, in response to the then recent Treasury proposal that Dodd-Frank include an express statutory exemption for forex, CFTC Chairman Gary Gensler stated in a letter to Congress that "the concern is that these broad exclusions could enable swap dealers and participants to structure swap transactions to come within these foreign exchange exclusions *and thereby avoid regulation*…. In short, these exceptions could *swallow up the regulation* that the Proposed OTC Act otherwise provides for currency and interest rate swaps."[55] Again, he testified before the House Committee on Agriculture stating: "Our concern … is that we would not want … market participants [to] evade the oversight of these currency swaps and interest rate swaps and also that retail foreign exchange transactions are fully covered."[56]

Another way to use forex derivatives to mask other types of regulated transactions is best illustrated by the recent crisis in Greece. It is now known, for example, that Greece and Italy used, *inter alia*, fictional foreign currency swaps sold by U.S. swaps dealers as vehicles for masking short term sovereign debt in order to gain entrance to the European Union in exchange for paying swaps dealers hundreds of billions of dollars in Greek revenue streams extending to

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[51] *Id*.

[52] *Id*.

[53] *Id*.

[54] "While there is a possibility that foreign exchange swaps could be used by some market participants to speculate on the short the path of interest rates, Treasury believes that the operational challenges and transaction costs associated with transforming these instruments to replicate currency or interest rate swaps significantly reduce the likelihood that market participants would actually do so in order to evade regulatory requirements under the CEA." Proposed Determination at 25781, *supra* note 1.

[55] Analysis of Proposed Over-the-Counter Derivatives Markets Act of 2009, Commodity Futures Trading Commission, August 17, 2009 2, *available at* http://tradeobservatory.org/library.cfm?refid=106665.

[56] Transcript, *The Over-The-Counter Derivatives Market: Hearing Before the House Committee on Agriculture*, 111th Cong. (2009) (statement of Chairman Gensler, CFTC).

the year 2019.[57] As one leading derivatives expert has noted, in these kinds of transactions, "the participant receives a payment today that is repaid by the higher-than-market payments in the future. […] Such arrangements provide funding for the sovereign borrower at significantly higher cost than traditional debt. The true cost to the borrower and profit to the [swaps dealer] is also not known, because of the absence of any requirement for detailed disclosure."[58] Furthermore, in the case of Greece, the swaps dealers "devised a special kind of swap with fictional exchange rates [t]hat enabled Greece to receive a far higher sum than the actual euro market value of 10 billion dollars or yen."[59]

In the case of the Greek crisis, these forex swaps transactions were basically examples of unfair, unjustifiable, and predatory lending practices. As Senator Carl Levin states in his comment letter to Treasury on this issue: "Loans are particularly easy to re-engineer as [forex derivatives]. Indeed, some speculate that the use of [forex swaps] to conceal loans may already be commonplace."[60] He concludes, "[The Greek crisis] highlights the fact that foreign exchange derivatives can involve massive amounts of money, hidden sovereign debt, and issues involving foreign currencies and foreign central banks. It shows how a single foreign exchange transaction … can contribute to systemic risk, not only for a particular country, but forex regional and even global financial system."[61]

v. *Consider the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements.*

A final consideration requires the Treasury to examine whether there is adequate supervision for forex participants. In the Proposed Determination, the Treasury finds that "regulators are adequately supervising these participants, in part by requiring the implementation of risk-management and operational processes, including the use of payment-versus-payment settlement arrangements for settling transactions and the adoption of credit support annexes with

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[57] Charles Forelle, *Debt Deals Haunt Europe*, WALL ST. J., Feb. 22, 2010, at A1; Kate Kelly, et al., *The Woman Behind Greece's Debt Deal*, WALL ST. J., Feb. 22, 2010, at C1 (Goldman received $300 million in fees for Greek deal); Michael Hirsh, Wall Street's Euro Scams: Lobbyists are Quietly Working to Ensure Secret Derivatives Deals Behind Euros Stay Secret, NEWSWEEK, Feb. 16, 2010, *available at* http://www.newsweek.com/id/233645.

[58] Satyajit Das, *Stripping Away the Disguise of Derivatives*, FINANCIAL TIMES, Feb. 17, 2010, *available at* http://www.ft.com/cms/s/0/270fb2b6-1bcd-11df-b073-00144feab49a.html.

[59] Beat Balzli, *How Goldman Sachs Helped Greece to Mask its True Debt*, SPIEGEL ONLINE INTERNATIONAL, Feb. 8, 2010, *available at* http://www.spiegel.de/international/europe/0,1518,676634,00.html.

[60] Comment Letter by Carl Levin, U.S. Senator, to Mary J. Miller, Assistant Secretary for Financial Markets, Office of Financial Institutions Policy, Department of the Treasury, Determination of Foreign Exchange Swaps and Forwards (November 29, 2010).

[61] *Id*.

counterparties."[62] But, this argument proves too much. If the Treasury is right that bank regulation is sufficient, then Congress would have exempted all swaps by, for example, bank holding companies. Dodd-Frank rejected that route because banking regulators prior to the meltdown did not have enough data pertaining to this private bilateral market. Essentially, Treasury is throwing the $4 trillion-per-day forex market back to the wholly unregulated pre-meltdown era. Moreover, many of the substantial actors in the forex market, e.g., hedge funds and non-bank commercial end users, are not subject to bank regulation.

III. Conclusion

After wholeheartedly rejecting Treasury's insistence that forex derivatives be exempt from mandatory clearing by Dodd-Frank itself, Congress placed on the Treasury the highest burden to choose to disregard clearing, exchange trading and capital/collateral requirements for $4 trillion-per-day forex derivatives. Only after carefully considering all five factors, conducting an independent analysis, as provided in Dodd-Frank, and intelligently answering substantial arguments against an exemption can Treasury meet this burden.

Because the previously unregulated forex market is highly opaque, Congress considered it necessary for the Secretary first to collect data from market participants prior to making the final determination and provided the means to do so by imposing data reporting requirements and providing ample time for the Secretary to consider all data. There is no set deadline by which Treasury must reach its final determination. Congress expected that Treasury would consider the potential regulatory consequences of exempting forex. Exempting this $4 trillion-per-day market from the full range of the Dodd-Frank capital adequacy and transparency requirements, especially in light of unanswered and substantial analysis that this market was highly destabilized and needed rescuing during the meltdown is contrary to the clear Congressional intent and otherwise arbitrary and capricious.

Thank you for the opportunity to comment on this Proposed Determination. If you have any further questions, please contact Michael Greenberger, Professor at the University of Maryland School of Law, at mgreenberger@law.umaryland.edu or (410) 706-3846, or Marcus Stanley, Policy Director of Americans for Financial Reform, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

Americans for Financial Reform

[62] Proposed Determination at 25782, *supra* note 1.

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans United for Change
- Calvert Asset Management Company, Inc.
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos

- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women’s Policy Research
- Krull & Company
- Laborers’ International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People’s Action
- National Training and Information Center/National People’s Action
- National Council of Women’s Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer’s for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club

- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A

- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG

- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG