AMERICANS
FOR FINANCIAL REFORM
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Americans for Financial Reform
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July 7, 2015

The Honorable Jacob J. Lew
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington DC 20220

Dear Secretary Lew:

On behalf of Americans for Financial Reform, we are writing to urge you to reconsider and reverse the Treasury Department's 2012 Determination that foreign exchange derivatives be excluded from Dodd-Frank regulations covering other forms of over-the-counter derivatives. Since that determination was made, numerous instances of large-scale corruption and price manipulation in foreign exchange markets by some of the world's largest banks have come to light. Market manipulation findings have led central banks around the world to reconsider the regulation and oversight of foreign exchange markets. But the U.S. Treasury has apparently not re-examined its justifications for granting sweeping regulatory exemptions to these markets. In light of recent events, we believe a reconsideration of regulatory exemptions for these markets is long overdue.

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[1] it created a presumption that foreign exchange swaps and forwards ("FX Derivatives") should be covered along with other derivatives under rules requiring clearing, transparent execution and other matters. But Congress went on to delegate authority to the Secretary of the Treasury (the "Secretary") to determine whether this presumption should be reversed, establishing detailed standards for this determination. In May 2011, the Secretary issued a Notice of Proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act[2] (the "Proposed Determination") and this was succeeded by a Final Determination in

[1] Dodd-Frank Act, Section 721(a)(21).
[2] Department of the Treasury, Notice of Proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, April 2011.

November 2012[3] that FX Derivatives should be excluded from such regulatory coverage (the "Determination"). The Secretary's Determination was accompanied by findings on each of the standards established in the Dodd-Frank Act.

While we believe that the Secretary's Determination was erroneous simply given the stresses on foreign exchange markets observed during the 2008 financial crisis, events since the end of 2012 have made it even clearer that the findings made by the Secretary were mistaken and the Determination was not in the best interest of the public. Before a year had passed after the Determination, multiple regulatory authorities around the world had launched investigations into manipulation of currency prices over many years by some of the largest international financial institutions. This led to billions of dollars of fines levied against seven banks. The fraud centered on collusion among various combinations of banks conducted in internet "chatrooms" that carried titles such as "The Cartel," "The Bandits' Club," "One Team, One Dream" and "The Mafia." Generally, the plan was to make certain that at and prior to the time of one of the two daily "fixings" (which are periods used commonly to establish reference prices for spot transactions to settle at the "fix price") the conspirators would be increasingly large net buyers or sellers to make certain that the price would be nudged up or down. This would generate profit for one or more of the chatroom colluders who had large spot contracts with customers that were to settle based on the fix price. If the beneficiaries of the plan had customers who wished to buy at the fixed price, they and their fellow colluders would nudge the price up so that it peaked at the fix. The colluders would also make sure sell positions were closed out pre-fix so that the fix price would be as high as possible because so little sell interest remained outstanding. Therefore, the beneficiaries would transfer currency at the fix price to customers that it acquired for (on average) less than the fix price of the intermediaries transaction (since the beneficiaries had been stockpiling currency as the price moved up to its peak at the fixing).

These findings illuminate many troubling aspects of the FX market, including the following:

- First, banks that are huge players in the foreign exchange markets are, through their traders, perfectly willing to manipulate prices at a significant cost to the public and their customers to make more profit.

- Second, they are so brazen that they are willing to collude with competitors, meaning that they were eager to set up oligopolistic market strategies, trusting that their competitors would behave just as venally as they did.

[3] Department of the Treasury, Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, November 2012.http://www.treasury.gov/press-center/press-releases/Documents/11-16-2012%20FX%20Swaps%20Determination%20pdf.pdf

- Third, the market is so concentrated that a few banks can change prices in a marketplace in which more than $5 trillion of transactions take place each day. This has major systemic risk implications.

- And fourth, the foreign exchange markets are so opaque that this manipulation occurred over and again for almost a decade and no one outside of the conspiracy knew about it, not even the regulators in the US, the EU, the UK, Japan or any other jurisdiction.

The manipulation of FX prices echoes other large scale manipulations by the largest international financial institutions. For example, a series of criminal settlements starting in 2012 for manipulation of the London Interbank Offered Rate was based on decades of price fixing in the interest rate market. This was similar to the FX scandal in many ways — many of the players were the same, it involved a huge and important worldwide market, and the audacity and venality of the behavior was the same, among other things. It is also related to the FX market because FX prices and interest rates are strongly related, each being a function of the other.[4] Manipulation of one market is a manipulation of the other. These may not be related schemes, but at least the relationship of the two markets is illustrative of the scope of the effect of price manipulation at this level.

The findings of widespread market manipulation in markets dependent on over-the-counter intermediation by large global banks, as well as benchmark indices set by these banks, have led to a major review of regulatory and conduct standards in these markets by central banks and financial regulators around the world.[5] Initial conclusions of this review include findings that regulatory gaps and lack of transparency contribute to market corruption, and that excessive reliance on over-the-counter intermediation can create unnecessary conflicts of interest.[6] All of these issues relate directly to reforms made in Title VII of the Dodd-Frank Act. Yet there has apparently been no reconsideration by the United States Treasury of its sweeping determination that FX Derivatives should be exempted from key Dodd-Frank Title VII regulations.

We believe that the action by the Secretary exempting these derivatives should be revisited and reversed. It is important to note that the Dodd-Frank Act was structured so that FX Derivatives would be fully regulated unless the Secretary determined that they should not be, so that the Secretary had to overcome this presumption in his Determination. In making

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[4] *See, for example,* Amin, K., and Jarrow, R. "Pricing Foreign Currency Options under Stochastic Interest Rates," *Journal of International Money and Finance* (1991).
[5] Bank for International Settlements (BIS), "Economic Consultative Committee statement on FX market best practices," May 11, 2015; Bank of England, "Fair and Effective Markets Review" overview.
[6] Bank of England, "Fair and Effective Markets Review," Final Report, June 2015.

such a Determination to reverse the basic structure of the Dodd-Frank Act, the statute required him to consider five factors:

1. whether the required trading and clearing of FX Derivatives would create systemic risk, lower transparency, or threaten the financial stability of the United States;

2. whether FX Derivatives are already subject to a regulatory scheme that is materially comparable to that established by this Act for other classes of swaps;

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

4. the extent of adequate payment and settlement systems; and

5. the use of a potential exemption of FX Derivatives to evade otherwise applicable regulatory requirements.

These five factors were dealt with in great detail in two comment letters in connection with the Determination, one from AFR and another from Better Markets, each of which is incorporated fully herein through citation.[7] Other experts, such as Professor Darrel Duffie of Stanford University, also pointed out that FX exposures pose systemic risk and that the risk management tools required in Dodd-Frank should therefore be applied to them.[8]

The findings with respect to market transparency, systemic risk, and financial stability must now be reconsidered in light of the FX price manipulation schemes. The blatant manipulation of prices is a compelling example of a market sadly lacking in transparency, and the ability to manipulate prices shows a market that is heavily concentrated among a small number of potentially 'too big to fail' banks.

The 2012 Determination appeared to reflect the belief that the FX Derivatives market is somehow protected from instability in the broader financial system. This belief is false. For example, the claim is made in the Determination that "the foreign exchange market was one of the few parts of the financial market that functioned effectively throughout the financial crisis."[9] This claim is simply a mischaracterization of the facts. In reality, the $4 trillion per day foreign exchange swaps market nearly ground to a halt in Autumn, 2008, threatening international money flows and the total collapse of world financial markets. International banks no longer trusted US banks, so that access to US dollars and US bank access to foreign currencies was failing rapidly. Immediately, the Federal Reserve Bank ("Fed") intervened by opening enormous and ultimately unlimited FX swap lines with foreign central banks. Banks could then transact through the central banks, calming the panic in

[7] See Americans for Financial Reform, "Comment On Proposed Treasury Determination of Foreign Exchange Swaps and Forwards", June 5, 2011; Better Markets, "Comment Letter on Forex Swaps and Forwards Under the Commodity Exchange Act", June 5, 2011.
[8] Darrell Duffie, "On the Clearing of Foreign Exchange Derivatives," Stanford University.
[9] Department of the Treasury, Notice of Proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, April 2011, page 22.

the FX market.[10] A complete meltdown was averted as the Fed pumped $5.4 trillion into the foreign exchange swap lines between September 15, 2008 and December 15, 2008.

In other contexts, regulators have freely admitted that foreign exchange markets, including FX Derivatives markets, experienced heavy pressure during the financial crisis and that this contributed to the global impact of the crisis. For example, after the crisis the Committee on the Global Financial System, made up of international regulators, formed a study group on the funding experiences of internationally active banks which concluded:[11]

> "As liquidity in major bank funding and FX swap markets evaporated, sizeable maturity mismatches across currencies added to balance sheet pressure on internationally active banks. Partly as a result, international banking activity declined sharply in late 2008." (p. 1)
>
> "The financial crisis put many international banks under severe funding stress. Banks were confronted with dislocations in numerous cross-border funding and FX swap markets, including those that are highly liquid under normal conditions." (p. 3)

Thus, in terms of systemic risk and financial stability, the crisis itself is ample evidence that these markets are vulnerable to systemic weaknesses similar to other derivatives markets, and should therefore be subject to the same regulatory requirements that Congress saw fit to impose on virtually every other type of derivative.

The Determination makes clear that the Secretary gave credence to industry assertions regarding existing market mechanisms that address certain risks that are peculiar to FX Derivatives. However, these assertions are not pertinent to the other market price risks embedded in FX Derivatives that are exactly the same as those embedded in other forms of derivatives transactions. It is these risks which the Dodd-Frank Title VII framework is designed to address.

Unlike other derivatives, FX Derivatives are structured as exchanges of two separate currencies. Therefore, there is a significant risk that one side will pay and the other side will fail. That is why the industry came up with a system in which there is one central stakeholder who must receive payments from both sides before any money is released. But, despite this structural difference, the size of the performance risk is measured by the reference price of the subject of the contract, just like an equity swap, an interest rate swap or a corn future. That risk is not mitigated by the central stakeholder who merely makes sure that one side does not lose because of its payment of the underlying currency. There could be a default before payments are due. And even if the payments become due and then

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[10] *See, e.g.*, 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 Papers, No. 285, July 2009; *see also* the list of independent authorities who arrived at the same conclusion in the March 23, 2011 letter to Assistant Secretary Mary Miller from Better Markets, footnote 1.

[11] "Funding patterns and liquidity management of internationally active banks," Committee on the Global Financial System, Bank for International Settlements (BIS), CGFS Papers No 39, May 2010.

default occurs, one party will lose the benefit of the bargain, just as any derivatives counterparty would.

It may be that any assertion of derivatives regulatory jurisdiction over the FX Derivatives market will cause banks in other jurisdictions to complain, especially if their home jurisdictions have chosen not to regulate these contracts as derivatives. However, the Dodd-Frank Act provisions make it clear that Congress wanted this marketplace to be regulated unless facts were elicited that showed regulation to be unwarranted. No such facts have come to light, and indeed events since the financial crisis should lower our confidence in the existing mechanisms of the FX swaps market.

We therefore urge the Treasury Department to reconsider its 2012 Determination exempting FX Derivatives from key Dodd-Frank regulations, and to reverse its decision.

Sincerely,

Americans for Financial Reform

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.

- AARP
- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- 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
- Center for Effective Government
- 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
- Green America
- Greenlining Institute
- Good Business International

- Government Accountability Project
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Home Defenders League
- Information Press
- Institute for Agriculture and Trade Policy
- 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
- Lawyers' Committee for Civil Rights Under Law
- Main Street Alliance
- Move On
- NAACP
- 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 Council of Women's Organizations
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Urban League
- Next Step
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- 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
- UNITE HERE
- 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

List of State and Local Partners

- 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
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- 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
- New Economy 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

- New Yorkers for Responsible Lending
- 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

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- UNET