June 6, 2011

The Honorable Timothy Geithner
Secretary of the Treasury
c/o Office of Financial Markets
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Notice of Proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act

Ladies and Gentlemen:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned notice of proposed determination, issued by the Department of the Treasury ("Treasury"), which would exempt foreign exchange swaps and foreign exchange forwards from the definition of the term "swap" under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

The determination by the Secretary of the Treasury ("Secretary") to exempt foreign exchange[2] swaps and foreign exchange forwards from regulation under the Dodd-Frank Act is unjustifiable on legal, policy, and pragmatic grounds. From a legal perspective, the decision does not come close to satisfying the statutory criteria that Congress established to control the Secretary's decision-making process. As a matter of policy, the exemption is a repudiation of the principles of risk mitigation, transparency, and accountability that are the very foundation of the Dodd-Frank Act. On a practical level, the decision entirely ignores a dramatic lesson from the past—the near collapse of the foreign exchange market during the financial crisis—thus perpetuating an opaque market that promises future systemic instability or even crisis.

Under the law, the determination must be reversed. Both foreign exchange swaps and forwards should be fully subject to regulation in accordance with the Dodd-Frank Act and the regulations promulgated thereunder.

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

[2] "Foreign exchange" is also referred to herein as "forex" and "FX."

SUMMARY

The Exemption Does Not Meet the Statutory Requirements.

The Secretary's determination to exempt foreign exchange swaps and forwards from regulation fails to meet any of the statutory tests that Congress established in the Dodd-Frank Act. None of the five factors that the Secretary is required to consider supports the exemption.

Moreover, an unbiased analysis of foreign exchange swaps and forwards that focuses on the relevant factors demonstrates that they are not qualitatively different from other classes of swaps in a way that would make them ill-suited for regulation as swaps. In addition, there are no objective differences between foreign exchange swaps and forwards and other categories of swaps that would warrant exempted status.

Foreign exchange swaps and forwards have all of the relevant characteristics of the other categories of derivatives that are subject to the clearing and exchange trading requirements of the Dodd-Frank Act. They are well-suited for such regulation.

Perhaps most importantly, the case for the exemption is especially weak since the Release concedes that **many** critical measures that might support such an exemption simply do not exist. And, the few that are currently in place ostensibly for ensuring transparency and mitigating risk in the foreign exchange markets are far from adequate under the five statutory tests. The Release expressly, but without basis, relies on the notion that over time, private market participants will voluntarily develop a sufficient market infrastructure for foreign exchange swaps and forwards.

Just one of many examples from the Release (detailed further below) is the statement that the **creation** of global foreign exchange trade repositories will dramatically expand reporting to regulators.[3] The Release goes on to claim that these repositories are the tools that will enable regulators to detect the inevitable attempts to use foreign exchange swaps and forwards to evade regulatory requirements.[4]

Yet, the Release expressly admits that no such repositories exist and, therefore, no such mechanism to detect such evasion exists either. The Release merely states that private sector "plans for [such repositories] are already underway."[5]

Regarding this example and many other instances in the Release, mere hope or faith that something may (1) come into existence in the future and (2) be adequate and effective simply does not provide valid legal support for the Treasury's decision.

Moreover, the Release fails to provide any justification for this faith that the private sector will put aside its self-interest and its profits and subject itself to robust regulation.

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[3] Release at 25781.
[4] *Id.*
[5] *Id.*

On the contrary, history makes clear that industry's attempts at self-regulation will be far too long in coming and ultimately far too weak.

Faith in an industry that has time and again failed to police itself is unjustified and, in the context of the recent financial crisis, an abdication of regulatory responsibility. What is required instead is the immediate imposition of the comprehensive regulatory regime that has already been designed by Congress to protect the public and the public treasury and which is ready for implementation now. There is both no need and no justification for outsourcing such a critical task on the hope that in future years the industry will do the right thing.

The Exemption Will Undermine the Policy Goals of Transparency and Risk Mitigation at the Heart of the Dodd-Frank Act.

Exempting foreign exchange swaps and forwards will undermine two of the most fundamental aims of the Dodd-Frank Act: achieving a transparent and systemically sound marketplace. The clearing requirement is essential to properly manage counterparty risk in the derivatives markets. Trading via exchanges and swap execution facilities ("SEFs"), together with the dissemination of market data, is essential to move derivatives trading out of the shadows and into venues that mitigate systemic risk.

Most foreign exchange transactions are matched over-the-counter. Although electronic systems are widely used in this marketplace,[6] many of these matching systems are single-dealer based. There is no doubt that moving the trading activities in these products to SEFs and exchanges, which match multiple buyers with multiple sellers, will increase transparency and competitiveness in the marketplace.

The over-the-counter-market is the perfect environment for asymmetrical information and market power. This asymmetry encourages risk taking by those who maintain trading and informational advantages. Trading and clearing facilities, provided they offer fair and free access, equalize information flow, control abusive behavior, and manage risk so that price distortions, anti-competitive conduct, and high risk behavior are all less likely. These structures offer the only feasible way to create a marketplace that is relatively free from the asymmetry that can convert inevitable market disturbances into catastrophes. An exemption for the large and diverse foreign exchange market undercuts that essential goal.

The Exemption Is Indefensible in Light of the Near Collapse of the Foreign Exchange Market in 2008.

Many commentators have asserted that the foreign exchange market did not play a role in the financial crisis of 2008. Even the Release reflects this point of view, declaring that according to many observers, "the foreign exchange market was one of the few parts of

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[6] Comment Letter from the self-described Global FX Division to the United States Department of the Treasury, dated November 15, 2010 (herein referred to as "Global Industry Letter").

the financial market that functioned effectively throughout the financial crisis."[7] But that is factually inaccurate.

In September of 2008, the foreign exchange swaps market virtually shut down. The Federal Reserve Bank ("Fed") intervened by opening enormous and ultimately unlimited transatlantic swap lines with foreign central banks, thus reinforcing the foreign exchange swap markets and defusing the crisis.[8] Although a complete meltdown was averted when the Fed pumped $5.4 trillion into the foreign exchange swap lines between September 15, 2008 and December 15, 2008, this experience is yet another reason why these markets must be subject to the same regulatory requirements that Congress saw fit to impose on virtually every other type of swap.

Such a crisis is not, of course, a prerequisite to comprehensive reform in this or any other market. The Dodd-Frank Act seeks to address regulatory gaps regardless of their contribution to the financial crisis. This is an appropriate effort to address identifiable flaws in our regulatory system before they ripen into crises of immense proportions. Quite apart from the turmoil that afflicted the foreign exchange swaps and forwards market in 2008, the regulation of these products under the Dodd-Frank Act is, on its face, necessary.

Foreign exchange derivatives constitute a highly leveraged funding market that is a major factor in the interconnectedness of financial institutions, and a major source of systemic risk.[9] Therefore, this type of derivative, at least as much as any other, should be subject to the requirements of the Dodd-Frank Act. The crisis in these markets in September of 2008 powerfully confirms the point.

Industry Resistance to Comprehensive Regulation Is Based on Self-Interest.

The industry arguments being made in support of the exemption echo remarkably similar anti-transparency and anti-regulatory claims that were made in the decade leading up to the crisis of 2008. As was the case then, those arguments spring from a desire to preserve a profitable status quo, not from the merits of whether the exemption can be justified on legal or policy grounds.

It has been reported that the foreign exchange market was the single largest source of revenue for bank derivatives and cash trading businesses in the second quarter of 2010.[10] According to the Comptroller of the Currency, U.S. commercial banks recorded $4.3

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7 Release at 25780.

8 *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, *available at* http://www.bis.org/publ/work285.pdf?frames=0; *see also* list of independent authorities arriving at the same conclusion, in March 23, 2011 letter to Assistant Secretary Mary Miller from Better Markets, *available at* www.bettermarkets.com.

9 Even the Global Industry Letter confirms this: "In addition to being the world's largest financial market, the foreign exchange market underpins other financial markets and the global economy generally." At 7. And, the Foreign Exchange and Currency Derivatives Dealers are a who's who of the very large, complex and interconnected banks. *See id.* at 14, n. 27.

10 Robert Schmidt and Silla Brush, *Banks Push U.S. Treasury to Exempt Foreign Exchange Swaps from Dodd-Frank*, Bloomberg, Nov. 24, 2010.

billion in revenue from foreign exchange derivatives during this period.[11] These facts suggest a motive for industry participants who oppose transparent trade-matching and clearing, since profitability always suffers from greater transparency.

Moreover, the industry does not address the merits of the issue. For example, the leading industry groups advocating for the exemption in the Global Industry Letter make sweeping assertions about the foreign exchange market, but then cite as "authority" studies from 1988, 1990, 1993, 1996, etc. It is beyond dispute that the foreign exchange markets of 2011 bear little if any resemblance to the markets of the late 1980s and early 1990s. To the extent the Global Industry Letter cites a current study, it is one that was purchased by the authors of the letter, and it naturally supports the industry's business and economic interests. Moreover, other than citing the study in conclusory fashion, the Global Industry Letter does not disclose any of the methodology or data underlying the "study."

In contrast, all of the independent studies confirm that the FX market was on the verge of collapse in the Fall of 2008 and that regulation is warranted.[12] Neither the Treasury, in announcing its proposed decision, nor the industry, has rebutted these independent studies.

In short, there is no basis for the exemption in law, policy, or experience. The statutory test has not been met; regulation is necessary to ensure transparency and risk mitigation; and the near collapse of the foreign exchange market in 2008, which required a massive multi-trillion dollar intervention by the Fed, removes any doubt that these markets must be fully regulated. All independent, credible studies support these conclusions. The exemption should not be granted.

THE STATUTORY STANDARD

The Dodd-Frank Act creates a presumption in favor of regulating foreign exchange swaps and forwards under the same regime that applies to all swaps, and it sets a high standard that the Secretary must meet to justify an exemption. The governing statutory provision, in Section 721(a), opens with the declaration that "Foreign exchange swaps and foreign exchange forwards **shall** be considered swaps," unless the Secretary determines otherwise in accordance with specified criteria.

Congress plainly favored the full regulation of these instruments, and it therefore established strict substantive tests and procedural requirements that the Secretary would have to satisfy before determining that an exemption was warranted.

First, as a prerequisite to the exemption, Section 721(a) of the Dodd-Frank Act requires the Secretary to determine that foreign exchange swaps and forwards—

(I) should be not be regulated as swaps under the Dodd-Frank Act; **and**

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[11] Report available at www.occ..treas.gov/topics/capital-markets/financial-markets/trading/derivatives/derivatives-quarterly-report.html.

[12] *See* authorities cited in note 7, *supra*. *See also* Darrell Duffie, *On the Clearing of Foreign Exchange Derivatives*, Graduate School of Business, Stanford University (May 12, 2011).

(II) are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the CFTC related to the scope of the term "swap" and other matters.

Section 721(a) also specifies five factors that the Secretary must consider in determining whether to exempt foreign exchange swaps and forwards from the definition of "swap:"

(1) whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States;

(2) whether foreign exchange swaps and foreign exchange forwards 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 foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.

In the event that the Secretary makes a determination to exempt foreign exchange swaps and forwards from regulation as swaps, the Section 721(a) further requires the Secretary to submit to the appropriate committees of Congress the following information:

(1) an explanation regarding why foreign exchange swaps and foreign exchange forwards are qualitatively different from other classes of swaps in a way that would make the foreign exchange swaps and foreign exchange forwards ill-suited for regulation as swaps; and

(2) an identification of the objective differences of foreign exchange swaps and foreign exchange forwards with respect to standard swaps that warrant an exempted status.

Moreover, Section 721(a) provides that any determination by the Secretary will not become effective unless and until it is submitted to the appropriate committees of Congress. As yet further evidence of Congress's reluctance to exempt foreign exchange swaps and forwards from regulation as swaps, the Dodd-Frank Act makes explicitly clear that, notwithstanding any exemption—

(1) all foreign exchange swap or forward transactions will still be subject to reporting requirements;

(2) any swap dealer or major swap participant that is a party to a foreign exchange swap or forward will still be subject to business conduct standards; and

(3) any foreign exchange swap or forward that is in fact listed and traded on or subject to the rules of a designated contract market or swap execution facility will not enjoy any exemption from any provision in the Dodd-Frank Act prohibiting fraud or manipulation.

These provisions reveal an unusual depth of Congressional concern over the possibility that foreign exchange swaps and forwards might be afforded an exemption from full-scale regulation as swaps. To justify the exemption, the Secretary must make a compelling case that these financial instruments deserve special treatment under the law. The Secretary has failed to carry this burden.

COMMENTS

I. The Secretary's Determination to Exempt Foreign exchange Swaps and Forwards from Regulation Is Not Supported by Any of the Five Statutory Factors that the Secretary Must Consider.

The validity of the exemption hinges on five core factors that the Secretary must evaluate under the Dodd-Frank Act. None of those factors supports the exemption. The arguments advanced in the Release are unpersuasive. In some instances, they are irrelevant and in others they actually undercut the Secretary's determination, as they confirm significant weaknesses in the current regulatory framework applicable to these instruments.

The Release also contains repeated references to future initiatives that will supposedly address the loopholes that currently exist in the foreign exchange marketplace. These vague assurances only highlight the need for comprehensive, mandatory, and expeditious application of the regulatory regime prescribed in the Dodd-Frank Act. We consider each of the five statutory factors in turn.

"Whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the U.S.?"

Under this test, the exemption is clearly unwarranted. Far from aggravating systemic risk or undermining transparency and stability, mandatory trading and clearing of foreign exchange swaps and forwards will have significant positive effects. Mandatory clearing will help mitigate systemic risk, exchange trading will increase transparency and competition, and together these by-products of regulation will promote financial stability.

The Release offers no arguments or data to support the notion that the regulation of these products would actually lead to any of the three enumerated harms. In fact, the

Release concedes that mandatory clearing of these instruments would "further protect participants against the economic loss of profit,"[13] which in turn would help protect banks against insolvency and systemic risk. However, the Release simply contends that imposing a trading and clearing requirement would "introduce significant operational challenges and potentially disruptive effects in this market which would outweigh any marginal benefits for transparent trading or reducing risks in these instruments."[14]

This argument carries no weight under the statutory test. The relevant inquiry under the first factor is whether the regulation of foreign exchange swaps and forwards would have any of the three deleterious effects identified in the statute. Nowhere does Section 721 of the Dodd-Frank Act entitle the Secretary to instead base his determination on the balance struck between the benefits of regulation and the practical challenges and costs that inevitably arise from the imposition of a new regulatory regime.

Indeed, implementation of the Dodd-Frank Act in general and specifically with respect to swaps regulation will undoubtedly entail significant "operational challenges" and "disruptive effects," yet these are precisely the costs that Congress was prepared to accept to establish a more stable, transparent, and fair financial marketplace. The first factor provides no support whatsoever for the exemption.

<u>"Whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory regime that is materially comparable to that established by the Act for other classes of swaps."</u>

There is no regulatory regime currently applicable to foreign exchange swaps and forwards that is comparable to the framework mandated under the Dodd-Frank Act. These products are not subject to mandatory clearing or trading, and none of the mechanisms cited in the Release serve as comparable or adequate substitutes.

The Release highlights the beneficial role of the CLS Bank International settlement system known as PVP ("CLS"). Akin to a "paypal" or escrow service, the CLS system helps mitigate settlement risk by ensuring that each party fulfills its payment obligations under the applicable swap or forward contract. Although of undoubted value, this aspect of the current marketplace is no substitute for a regulated trading and clearing environment: it is not a mandatory system, it is not applicable to all trading, it is subject to change, and it is monopolistic.

Most importantly, the CLS obviously offers no central counterparty services, which are essential to mitigate counterparty credit risks. The CLS system holds funds paid in performance of one side of a forex swap until the other side has performed by transferring funds to CLS as well. It only protects against the risk of performance by one party without reciprocal performance by the other. It in no way addresses the economic consequences of any other type of default, and it cannot be considered adequate as a substitute for mandatory clearing.

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[13] Release at 25779.
[14] *Id.*

On this point, the Release asserts that "the established regulatory regime also actively encourages the use of Credit Support Annexes ("CSAs") and master netting agreements to reduce counterparty credit risk exposures."[15] However, the "encouraged" use of private contractual provisions is not a credible substitute for mandatory clearing mechanisms operated by entities that are registered and subject to a host of core principles covering virtually every aspect of a clearing operation. In fact, years of heavy reliance on such private agreements in the swaps markets proved to be a poor alternative to meaningful regulation, which of course led to the new and much stronger regime for swaps under the Dodd-Frank Act.

The use of CSAs in documenting bi-lateral foreign exchange trading arrangements is widespread, as it is in all OTC derivatives markets, but it is also insufficient for a host of reasons. Posting of collateral under a CSA does not equate with clearing. The existence of a CSA does not mean that collateral to cover counterparty risk is actually posted. It merely provides a mechanism for posting if and only if conditions warrant it (*e.g.* a ratings downgrade occurs or credit limits are exceeded).

Moreover, bilateral arrangements using CSAs involve additional risk factors that are absent under a clearing regime, such as re-hypothecation of posted collateral and the potential inadequacy of management systems in place at particular financial institutions. One need only recall the experience of the Lehman Brothers bankruptcy for an example of the issues posed by re-hypothecation. While collateral had been posted under bilateral derivatives and prime brokerage agreements, that collateral only covered the most recent mark-to-market liability. And re-hypothecation of collateral posted to and by Lehman Brothers necessitated a complex and time consuming process of tracing transfers through multiple layers and market participants, creating a state of uncertainty that in itself posed systemic risk.[16]

In addition, CSAs are vulnerable to market contagion. Market participants know that a default or simply a credit concern in one area of a financial institution's business (*i.e.* foreign exchange) can lead to forced liquidation of other positions. In many cases this results in a spiraling down of the perceived creditworthiness of that institution, leading to a self-fulfilling failure.

This was graphically illustrated in 2008 as weakness in mortgage credit businesses led to the downfall of some institutions. This effect does not necessarily stop at the directly affected institution. As in 2008, when institutions were linked by derivatives, a domino effect is likely, if not certain.

Neither the CLS system nor the use of CSAs are "materially comparable" to a comprehensive regulatory framework that includes mandatory trading and clearing. Under the second statutory test, the exemption cannot be justified.

[15] Release at 25780.

[16] Sean Farrell, *Hedge Funds with Billions Tied up at Lehman Face Months of Uncertainty*, The Independent, Oct. 6, 2008.

<u>"The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements."</u>

This factor also weighs heavily against exempting foreign exchange swaps and forwards from regulation. As a threshold matter, bank regulator supervision is per se inadequate to the extent market participants are not banks. While the vast majority of trading in foreign exchange swaps and forwards may involve banks, not all transaction do, and the exemption will therefore perpetuate an unnecessary gap in regulatory coverage.

More importantly, however, bank regulator oversight of these markets is bound to be inadequate, since even among bank participants, there are no mandatory, uniform, and transparent margin requirements in place. Instead, as reflected in the Release, what dominates this marketplace is an ad hoc assortment of voluntary "banking" practices aimed at "risk management."

Even these practices, according to the Release, leave significant room for improvement. The Release cites two initiatives aimed at assessing and improving risk management in the foreign exchange markets. According the Release, the Fed will be conducting an assessment of current risk management practices, in conjunction with other jurisdictions, to better inform the development of supervisory guidance regarding risk controls such as CSAs. The Release concedes that this assessment may ultimately "highlight the need for any additional supervisory or regulatory action."[17]

In addition, the Release explains that an international coalition of banking regulators has been "securing commitments from market participants since 2005 to strengthen market infrastructure, risk management practices, and transparency in the OTC derivatives market." This group is apparently still seeking new commitments from market participants to advance risk management in the foreign exchange market.[18]

As laudable as these initiatives may be, they nevertheless confirm that such regulation does not now exist and may never exist. Moreover, even if such incremental and essentially voluntary measures come into being, they cannot possibly substitute for the mandatory, comprehensive, and strong system of regulation that Congress deemed appropriate under the Dodd-Frank Act.

<u>"The extent of adequate payment and settlement systems."</u>

The current payment and settlement systems available in the foreign exchange swaps and forwards market are inadequate, and the Release actually highlights this fact. It states that according to CLS estimates, CLS "settles more than 50% of foreign exchange swaps and forward transactions that are subject to settlement risk."[19] The Release further observes that CLS has announced a "multi-year strategic objective to expand settlement services to include additional currencies, increase volume capacity, and add additional

[17] Release at 25780.
[18] *Id.*
[19] Release at 25781.

settlement times," and that the Fed is reviewing these plans and encouraging the expansion of other PVP settlement services.[20]

The Release thus confirms that a significant volume of foreign exchange swap and forward transactions—nearly half—are not settled through CLS and that a "multi-year" effort is actually necessary to develop a satisfactory payment and settlement system. This state of affairs is not "adequate" under any reasonable interpretation and it makes a compelling case for the immediate application of the comprehensive and mandatory regulatory regime for swaps provided for in the Dodd-Frank Act.

"The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements."

If foreign exchange swaps and forwards remain exempt from regulation as swaps, and are thereby exempt from mandatory clearing and margin requirements, it is in fact highly likely that these instruments will be used to circumvent the regulations governing non-exempt swaps under the Dodd-Frank Act.

The reality is that forex swaps are based on interest rates for the two constituent currencies. The principal drivers of the conventional valuation model for a forex swap are the interest rates in the two currencies.[21] It does not require advanced financial engineering to re-characterize a desired interest rate transaction as a forex swap.

The Release offers little comfort on the point. It acknowledges the "possibility that foreign exchange swaps could be used by some market participants to speculate on the short term path of interest rates."[22] It attempts to assuage these concerns by suggesting that the "operational challenges and transaction costs" associated with using these instruments to replicate currency or interest rate swaps "significantly reduce the likelihood that market participants would actually do so in order to evade the regulatory requirements under the CEA."[23]

But if we have learned any lessons from the history of our financial markets—including the recent financial crisis in particular—it is that market participants have a boundless ingenuity for developing new products and strategies that fall within the interstices of any regulatory framework. It falls to regulators to eliminate those opportunities, not facilitate them with exemptions.

The Release also emphasizes that the creation of global foreign exchange trade repositories—"plans for one of which already are underway"—will dramatically expand reporting to regulators, enabling regulators to detect attempts to use foreign exchange swaps and forwards to evade regulatory requirements.[24] This observation, of course,

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[20] *Id.*
[21] Baba and Packer, *From Turmoil to Crisis Dislocations in the FX Swap Market before and after the Failure of Lehman Brothers*, Bank for International Settlements,Working Paper No. 285, July 2009, at 3.
[22] Release at 25781.
[23] *Id.*
[24] *Id.*

implicitly acknowledges that attempts at evasion are virtually inevitable. It also confirms that adequate voluntary reporting and detection systems are merely in the "planning stages" and are presumably years away from implementation.

The Release thus reveals basic flaws in the application of this statutory factor regarding the use of foreign exchange swaps and forwards to evade the law. The Release acknowledges the threat of such evasion, but is content to address the problem by relying on after-the-fact detection systems that may some day be in place. It would be far better to prevent abuses in the first instance by immediately subjecting these instruments to regulation, rather than rely on detection and remediation of possible violations once they have already occurred. Moreover, such an approach cannot possibly be justified if the reporting platforms upon which it relies are nowhere near implementation.

The inescapable fact is that foreign exchange transactions are based on currency, not physical products or securities. This makes them particularly susceptible to manipulation for purposes of regulatory avoidance. This was graphically demonstrated by the reported currency trades entered into by the Greek government and U.S. banks which were in reality an extension of debt.[25] The lesson from this widely reported story was the ease with which foreign currency structures can be converted to other purposes.

The potential for abuse also arises from the complexity of these products. While proponents of exemption have argued that foreign exchange swaps and forwards are largely simple and straightforward, the fact is that a great many of them are also complex and bespoke. Sometimes these arguments are made in the same document.[26]

Foreign exchange transactions are often excessively complex because they are transacted in the over-the-counter market. A simple swap or forward has a relatively low profit margin, which can be, and often is, multiplied many times over through the use of embellishments that are pitched during the negotiation of a transaction. Like an automobile salesman, a trader makes much more from the add-ons than from the underlying vehicle—although the additional profit in this case is in the millions of dollars, not hundreds.[27]

This complexity facilitates regulatory avoidance, but it is quite unnecessary. Virtually all legitimate transactions can be accomplished in transparent markets and can be cleared. The imposition of trading and clearing requirements does not inhibit the ability to hedge real risks; it simply compels market participants to use reliable and understandable methods, visible to all and transacted in a way that would eliminate needless risk.

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[25] Louise Story, Landon Thomas, and Nelson Schwartz, *Wall Street Helped to Mask Debt Fueling European Crisis*, The New York Times, Feb. 13, 2010.

[26] *See, e.g.,* Global Industry Letter.

[27] With a lack of imagination that the financial industry rarely displays, the Global Industry Letter claims "[i]t is difficult to foresee . . . how other swaps could be financially reengineered to become FX forwards and FX swaps." Page 6. Of course, history demonstrates repeatedly how market participants quickly move into any unregulated crevice in the regulatory structure with "innovative" products. *See, e.g.,* Gillian Tett, Fool's Gold.

In reality, Treasury must examine two very different marketplaces when considering the exemption. Most of the discussion has centered on the high-volume, straightforward foreign exchange markets. The other one consists of highly structured transactions. On a transaction-by-transaction basis, structured transactions create even greater market opacity and risk.

The Dodd-Frank Act must be applied to both the complex and simple segments of the markets. Any consideration of an exemption must address both the heightened risks arising from the complicated transactions, as well as the sheer magnitude of the risk arising from the simple transactions. **Neither segment of the market should be exempted.**

II. Foreign Exchange Swaps and Forwards Are Not Qualitatively Different from Other Classes of Swaps in Any Ways that Would Make them "Ill-Suited" for Regulation as Swaps.

The Dodd-Frank Act includes a number of requirements intended to ensure that any exemption from regulation for foreign exchange swaps and forwards would only be granted if carefully considered and thoroughly explained. One of those requirements is that the Secretary must explain the qualitative differences that would make these instruments ill-suited for regulation as swaps. A considerable portion of the Release is devoted to this effort, but the arguments are not persuasive.

Some points simply do not address the issue of whether foreign exchange swaps and forwards are "ill-suited" for regulation. Rather, they attempt to show that such regulation is unnecessary. For example, the Release contends that settlement risk associated with these instruments has been addressed through the development of the PVP system by CLS.[28] This point does nothing to suggest that foreign exchange swaps and forwards would be "ill-suited" for settlement via the mechanisms prescribed under the Dodd-Frank Act. Moreover, as discussed above, the claim is inaccurate, since the Release concedes that the current settlement infrastructure does not capture a large amount of the trading in foreign exchange swaps and forwards and that CLS settles only half of the total volume.

Similarly, the Release strives to establish that the existing market in foreign exchange swaps and forwards is already "highly transparent."[29] Here again, however, the claim is both irrelevant and unfounded. It is irrelevant since the current levels of transparency in the market have no bearing whatsoever on whether foreign exchange swaps and forwards are "ill-suited" to an exchange-trading environment and the reporting transparency that comes with it. The fact that there may be some transparency in a marketplace is no justification for resisting comprehensive regulation of that marketplace. Indeed, there is no question that application of the exchange trading and reporting requirements under the Dodd-Frank Act to foreign exchange swaps and forwards would be highly feasible and appropriate.

The notion that these markets are "highly transparent" is also unfounded. The Release concedes that only "41 percent and 72 percent of foreign exchange swaps and

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[28] Release at 25778.
[29] *Id.*

forwards respectively, already trade across a range of electronic platforms," with the attendant pre- and post-trade transparency.[30] This data hardly describes a transparent market.[31]

The core argument advanced in the Release is that **mandatory clearing** of foreign exchange swaps and forwards is (a) not necessary, and (b) not feasible. Neither of these contentions withstands scrutiny.

Foreign Exchange Swaps and Forwards Pose Significant Counterparty Credit Risk.

The Release argues that foreign exchange swaps and forwards create very low counterparty credit risk because they entail fixed payment obligations, they are settled through the transfer of physical currency, and they are predominantly short term.[32] In fact, none of these features eliminates counterparty risk.

Counterparty credit risk remains a significant concern in the foreign exchange markets. There is simply no distinction between the risk of a counterparty default in these markets, measured by the market value of a replacement position, as compared with other derivatives markets which are the subject of the Dodd-Frank Act. This is a large market, representing $817 billion of turnover per day in the U.S., according to the Federal Reserve Bank of New York.[33] Worldwide turnover is estimated at $4 trillion per day.[34] Counterparty default risk among financial institutions is a significant systemic threat. Further, the exchange of currencies at the conclusion of the transaction has no relevance to the counterparty credit risk that exists from the inception of the transaction to its conclusion.

Moreover, the fact that they entail fixed payment obligations is precisely what causes the counterparty risk of non-performance: changes in relative values of currencies between the time the fixed payments are set and the date of performance defines the loss from a counterparty default.

The duration of the instrument is also not determinative of risk. There is no doubt that a large percentage of foreign exchange market transactions have short durations when compared with other classes of derivatives. However, credit risk in these markets is only indirectly related to duration. If a default occurs, counterparty losses will be a function of the loss experienced in replacing the contracts measured by price changes. The loss will be

30 *Id.*

31 Of course, all of the recently reported allegations of misconduct regarding FX trading can only happen because there is such poor transparency in the market, which provides yet another and independent reason to deny the exemption. *See* Mollenkamp, Wei, and Zuckerman, *States Widen Currency-Trade Probes*, Wall Street Journal, Feb. 3, 2011; Mollenkamp, Wei, and Zuckerman, *Suit Alleges Mellon Created Fake Trades, Overcharged*, Wall Street Journal, Feb. 4, 2011; and Zuckerman, Mollenkamp, and Wei, *Suspicion of Foreign Exchange Gouging Spreads*, Wall Street Journal, Feb. 10, 2011.

32 Release at 25776.

33 Federal Reserve Bank of New York, *The Foreign Exchange and Interest Rate Derivatives Markets: Turnover in the United States*, Apr. 2010.

34 Bank for International Settlements, *Triennial Central Bank Survey – Foreign Exchange and Derivatives Market Activity – Preliminary Results*, Sept. 2010.

a function of price volatility and notional quantity. Volatility varies across different durations, but it is by no means certain that longer durations will have greater volatility.

In fact, in highly stressed conditions, the opposite is likely to be true. Factors that influence volatility in currency values and in relationships between currency prices can have far more extreme effects on short duration prices as the dates for physical settlement approach. This phenomenon is completely logical, since the impact of an isolated and rare but extreme event on price necessarily wanes over time. Therefore, short duration does not necessarily imply a lower risk to the system; it might actually mean that the risk is greater, if the market is under extreme short-term stress and dysfunction such as during a crisis.[35]

Furthermore, even if non-crisis risk is more concentrated in longer-duration contracts, the fact remains that longer duration contracts are currently increasing in prevalence. The percentage of over-the-counter foreign exchange transactions with durations exceeding 1 year increased consistently between 2000 and 2009. In 2009, 20% of foreign exchange transactions were of durations between one and five years and 18% were of durations greater than 5 years.[36]

Even though a larger percentage of the market is of short duration, the longer-duration market is nevertheless important in terms of systemic risk. It is a large portion of the derivatives market taken as a whole. The Federal Reserve Bank of New York estimates that 62% of forwards and 28% of swaps have durations in excess of seven days.[37] This is in the context of a market with *$817 billion of daily turnover in the U.S*. alone.[38]

It is true that the management mechanisms used by clearinghouses, focused on future price moves, are unusable for extremely short forward periods. But the limitation is at the next day duration level. Any duration beyond this can easily be accommodated. The success of platforms like LHS.Clearnet in clearing short-tenor contracts, even overnight repos, is a testament to this fact.[39] It has proven that the movement of large quantities of data and the measurement of risk associated with the positions represented by that data do not pose a significant challenge. The task is to create systems which are reliable and highly automated, and this has been accomplished.

There is also no doubt that broader clearing of foreign exchange derivatives will reduce credit exposures by increasing funded margin to offset risk. This is often characterized as an unnecessary burden.[40] However, ignoring risk is a dangerous path,

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35 A case in point is the Fed's intervention to preserve the foreign exchange market in 2008, described in detail below.

36 Bank for International Settlements, *Triennial Central Bank Survey – Foreign Exchange and Derivatives Market Activity – Preliminary Results*, Sept. 2010.

37 Federal Reserve Bank of New York, *The Foreign Exchange and Interest Rate Derivatives Markets: Turnover in the United States*, Apr. 2010.

38 *Id.*

39 http://www.lchclearnet.com/member_notices/flash_infos/bonds_and_repos/overnight_repos_italian_debt/2009-10-26.asp.

40 As to claims that the imposition of margin is an unnecessary "burden," analysis suggests that margin is de facto included within the cost structure of swaps. Expressly requiring margin only makes it

even if it seems more convenient. Shortcuts in risk management created, in part, the disaster that still plagues the American and world economies. If the Dodd-Frank Act means anything, it compels the regulators and the financial services industry to use the capabilities that are available to restore order to the derivatives markets by recognizing and prudently managing risks.

Imposing a Clearing Requirement Is Feasible.

The second argument advanced in the Release is that establishing a clearing requirement with respect to foreign exchange swaps and forwards presents difficult operational challenges that are not worth the additional protection against counterparty credit risk that mandatory clearing would provide. The Release explains that given the sheer size and volume of the foreign exchange swaps and forwards market, it is unlikely that a central counterparty would undertake the risks associated with guaranteeing both settlement and market exposure to replacement cost in the event of default.[41]

Although establishing a clearing regime for these instruments presents some challenges, those challenges are manageable, and they are small relative to the benefits that will accrue.

Fundamentally, foreign exchange transactions involve counterparty risk measured by market price moves, as with all swaps that are covered by the Dodd-Frank Act. Foreign exchange forwards are distinctive because they involve an exchange of quantities of currencies. However, this difference is not material. Clearing will involve periodic marks-to-market and the resulting payment of maintenance margin. Therefore, when the contract matures, the value of market movements will have passed from one of the counterparties to another. From a funding perspective, the result is the same as if the parties had posted collateral to secure counterparty risk based on marks to market. The simple adjustment of the final settlement to account for the prior transfer of value would leave the parties in the same economic position, without having experienced counterparty default risk prior to maturity.

There are a number of techniques that could be used by the clearinghouses to address the passing of value to secure counterparty default risk. One approach, together with two variations, is described below.

Clearing the price risk in a foreign exchange swap requires the separation of the settlement risk from the price-linked credit risk. The following structure accomplishes this.

At the time the foreign exchange swap is entered into, the parties also enter into a fixed to floating currency swap denominated in U.S. dollars. The fixed payment is the dollar side of the foreign exchange swap. The floating side is the value in U.S. dollars of the foreign exchange swap, marked daily. This swap will be cleared through a derivatives

transparent; it does not necessarily increase it and there are good arguments that the transparency will actually reduce it.

[41] Release at 25777.

clearing organization ("DCO"). There are two variations in structure that could be used to clear the foreign exchange swap credit risk.

Variation A

The DCO (which now stands between the two counterparties vis-à-vis the currency swap) records the original price of the currency swap. This amount is for use in the final settlement described below. The initial margin is imposed on the currency swaps. The **currency swaps** are structured to **settle** daily (rather than to be margined daily to provide collateral) at the mark-to-market price. On the day that **the foreign exchange swap** settles and confirmation of settlement is received, there is a corresponding final settlement on the currency swaps that reverses all prior settlements and zeros out all of the economics of the currency swap. In the event of a default by one counterparty to the foreign exchange swap, the stream of payments from the currency swap will have offset the replacement cost faced by the opposite counterparty. In other words, counterparty credit risk will have been mitigated in a way entirely analogous to traditional central counterparty clearing.

Note that, unlike other swaps and futures, the final settlement through the DCO is different for each of these currency swaps since it depends on the original price. While DCOs have never done this, the system requirements are straightforward.

Variation B

For foreign exchange swaps settled through CLS or a similar institution, the PVP provider will calculate the original price and date of the imputed currency swaps from the foreign exchange swap data it receives. At the settlement date for the foreign exchange swap, it will calculate the net variation margin which has been paid and received by the two counterparties under the cleared currency swap. It will then adjust the settlement of the foreign exchange swap to reconcile the financial results of the transaction by accounting for variation margin paid or received on the currency swap.

For those not settled through CLS, the counterparties will make the calculation of the reconciliation. The data on settlement prices at the DCO are readily available.

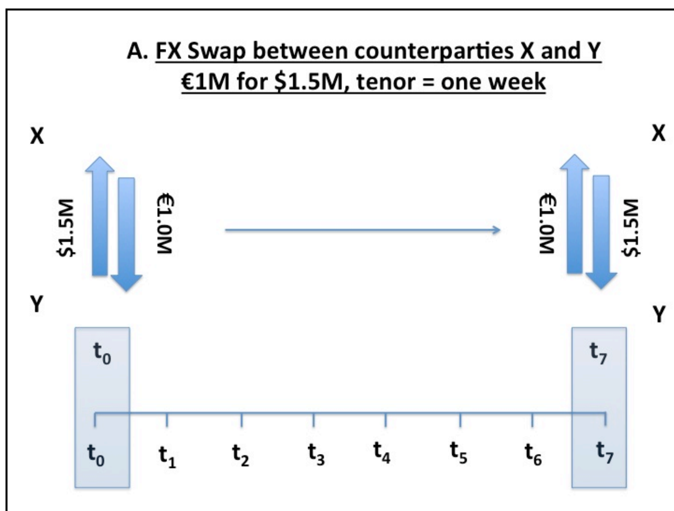
The following illustrative example represents a FX swap between two counterparties, X and Y. They agree to exchange 1 million Euros for 1.5 million Dollars today, and to re-exchange the same amounts one week later.

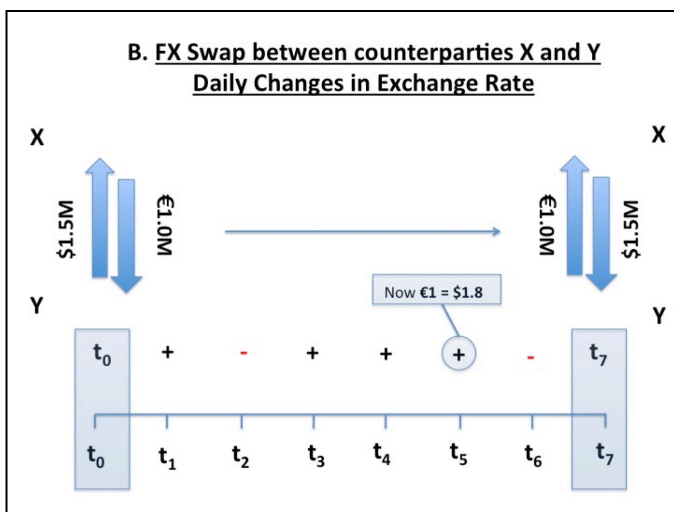
Panel A diagrams the structure of the swap.

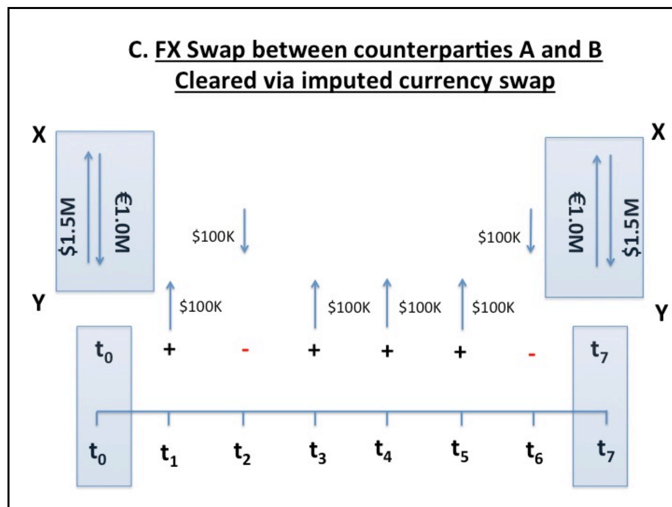
Panel B assumes daily price moves of 0.1 $/€ with "+" representing an increase and "-" representing a decline. By t_5, €1 = $1.8. Therefore, in the event of a default by counterparty Y, counterparty X faces a replacement cost of $300,000. In the uncleared case, this represents an uncollateralized counterparty credit risk.

Panel C shows how the case differs when the contract is cleared via the mechanism described above, using an imputed fixed-for-floating currency swap. The flow of payments

from the daily settlement of the currency swap offsets the previously uncollateralized credit risk. This risk of default, which exists until the successful settlement of the forex swap, has now been eliminated by clearing the currency swap using margining, which is well-understood in the market. At t_7, the flow of payments on the currency swap can either be unwound or netted with the payments due on the FX swap.







In short, foreign exchange swaps and forwards share all of the fundamental characteristics that make all swaps appropriate subjects for regulation under the Dodd-Frank Act. With respect to clearing in particular, regulation is vitally important and, as demonstrated above, eminently feasible. On all of these grounds, as well as the five-factor test, the Secretary's determination fails to satisfy the statutory prerequisites for the exemption.

III. The Near Collapse of the Foreign Exchange Markets in 2008 Dramatically Underscores the Need to Regulate Foreign exchange Swaps.

Data released by the Fed in December of 2010 proves that the foreign exchange markets were on the verge of collapse days after the financial crisis began in September of 2008. This new data also proves that only a massive emergency intervention in the foreign exchange markets by the Fed prevented a collapse. This episode of profound instability refutes the claim that the foreign exchange markets performed well during the financial crisis and do not need to be fully regulated.

There is a substantial body of independent research and analysis by experts at internationally recognized institutions that supports these conclusions. These authorities agree that after the Lehman bankruptcy, the FX markets froze, were on the verge of collapse, and would have collapsed but for the Fed intervention: "Global funding market pressures were evident in the virtual shut-down of the FX swap market."[42] This is amply supported in the independent, professional literature.[43]

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[42] N. Baba and F. Packer, *From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers*, Bank for International Settlement (BIS) Working Paper No. 285, (July 2009) at 6.

[43] *See, e.g.,* P. McGuire and G. Peter, *The US Dollar Shortage in Global Banking and the International Response*, BIS Working Paper 291 (October 2009); L. Goldberg, C. Kennedy, J. Miu, *Central Bank Dollar Swap Lines and Overseas Dollar Funding Costs*, Federal Reserve Board of New York (Staff Report) (Jan. 2010); T. Griffoli and A. Ranaldo, *Limits to Arbitrage During the Crisis: Funding Liquidity Constraints and Covered Interest Parity*, Swiss National Bank (Feb. 2011); M. Yiu, J. Fung, L. Jin, and W.Ho, *Liquidity Crunch in Late 2008*, Hong Kong Institute for Monetary Research (Oct. 2010);, C. Hui, H. Genberg and T.

While these studies were brought to the attention of the Treasury Department during the comment period both in writing and in a meeting, to our knowledge they have never been considered and certainly never been addressed. For example, there is no mention of this substantial body of authority in the Release.

It is also apparent that the underlying loss of liquidity in the foreign exchange markets that crippled them was attributable to fears about counterparty creditworthiness and the inability of bank participants to enter additional foreign exchange transactions given the state of their balance sheets. These are precisely the hazards that a comprehensive regulatory regime, including mandatory trading and clearing requirements, are designed to address.

The near collapse of the foreign exchange market in the fall of 2008 was similar to the upheaval seen in other markets, including repurchase ("repo"), money markets, commercial paper, and other parts of the shadow banking system. The same counterparty distrust that threatened those other markets also froze the foreign exchange markets and liquidity quickly evaporated. As in those markets, the Fed had to bail out the foreign exchange markets with more than $2.9 trillion in October 2008 alone and with more than $5.4 trillion of foreign exchange swaps in the three months following the Lehman Brothers bankruptcy.

While these multi-trillion dollar amounts were massive, they actually dramatically understate the role of the Fed, which guaranteed the entire market when it removed all limits on the ability of foreign central banks to access the Fed for foreign exchange transactions in October 2008. Between the collapse of Lehman and mid-October, the Fed increased its intervention in the foreign exchange markets by more than 700 percent. Even that action was insufficient to stop the crisis as spreads continued to widen and liquidity continued to evaporate. The foreign exchange markets were rapidly spiraling toward collapse, forcing the Fed to take even greater emergency action: in early October 2008, the Fed announced that it had removed all limits on its intervention, informing the markets that it would effectively guarantee the entire market.

Only after this wholesale Fed backstop for the entire foreign exchange market did the crisis begin to ebb and did the market begin to stabilize. As in the repo, commercial paper, and other markets, the Fed's emergency intervention stopped the market's death spiral.

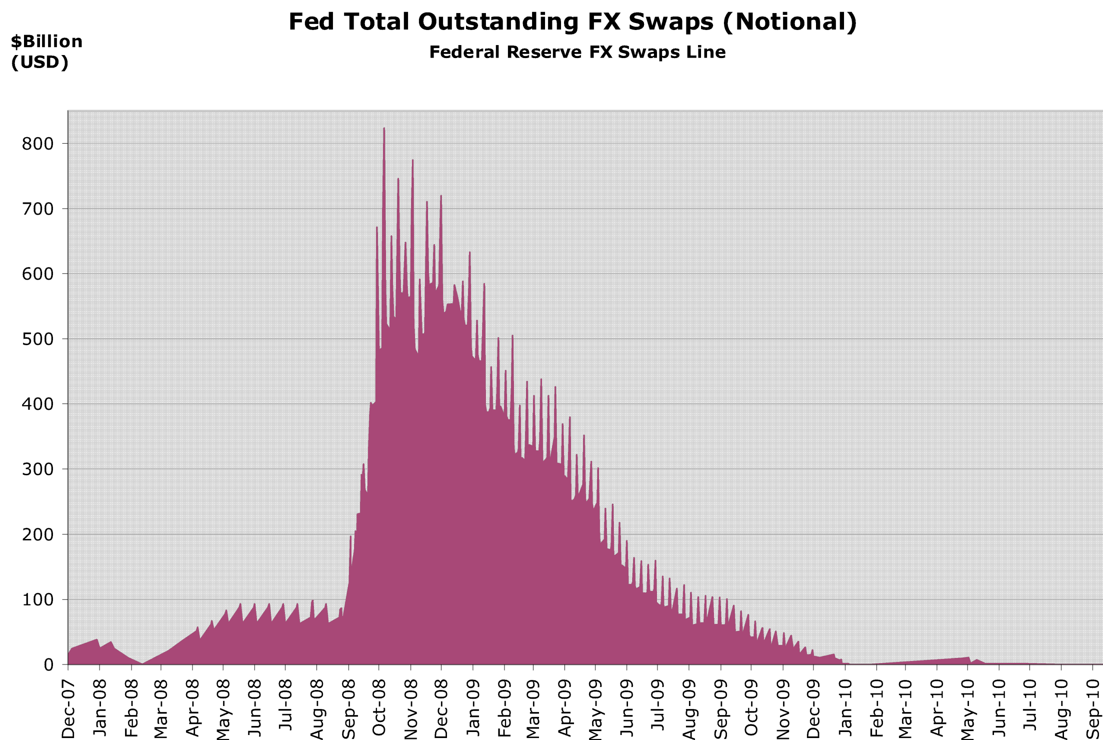
The new data also reveals for the first time that the Fed's intervention was not primarily restricted to the spot cash market, but reached time periods ranging from overnight to more than 90 days. The Fed believed that it was necessary to backstop the entire market, both short- and long-dated. The intervention was not merely, as some have claimed, an accommodation of the spot foreign exchange transfers, but comprehensive support for the market.

Chung, *Funding Liquidity Risk and Deviations From Interest Rate Parity During the Financial Crisis of 2007*-2009, International Journal of Finance and Economics (July 2010); I. Fender and J. Gyntelberg, *Overview: Global Financial Crisis Spurs Unprecedented Policy Actions*, BIS Quarterly Review (Dec. 2008).

This near collapse in the foreign exchange swap market, averted only through the Fed's extraordinary and costly intervention, should remove any doubt that the exemption is a mistake. It would be irresponsible to permit such markets to continue operating in the shadows without transparency or regulation. This part of the shadow banking system must also be brought into the light.

The December Data Shows that the Fed Flooded Foreign Markets with Dollars to Prevent Collapse in the Fall of 2008.

The recently released Fed data[44] reveals for the first time the scale of the Fed's intervention in foreign dollar markets in response to the imminent collapse of the FX market. The charts below, based on that data, show that the Fed pumped massive amounts of dollars overseas, creating a **parallel system** for overseas dollar funding to support the ailing foreign exchange markets, which were on the verge of seizing up completely.

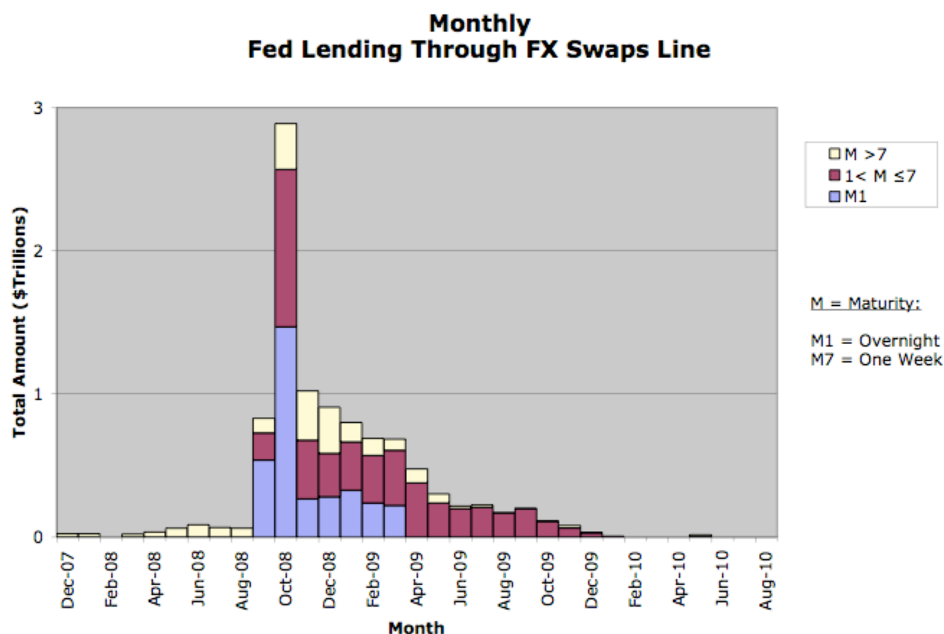


Graph 1. [Source: Federal Reserve Bank]

As Graph 1 above shows, after Lehman Brothers' collapse, the Fed was forced to inject huge quantities of liquidity into the FX market, with net exposure ranging from $500 billion to more than $800 billion at its highest point. This contrasts with the pre-Lehman environment, in which the stress created by the March 2008 Bear Stearns' collapse

[44] http://www.federalreserve.gov/newsevents/reform_swaplines.htm. The new Fed data was only made public on December 1, 2010. Unfortunately, that was two days after the November 29 deadline for submissions to the Treasury regarding the possible exemption of foreign exchange swaps and futures from certain provisions of the Dodd-Frank Act.

required around $100 billion in Fed net exposure from March through August 2008. During the crisis period, therefore, the Fed was forced to expand its FX **exposure** by almost 700 percent, a clear indication that the FX markets were in dire distress.[45]



Graph 2. [Source: Federal Reserve Bank]

The data on Graph 2 above shows that, just days after the extraordinary events that culminated with the Lehman bankruptcy filing on September 15, 2008, the Fed dramatically increased its swap lines.[46]

We now know that this announcement triggered a series of very substantial interventions by the Fed in the foreign exchange swap markets on the scale of hundreds of billions of dollars. As described above, between the collapse of Lehman and mid-October, the Fed increased its intervention in the foreign exchange markets several times over. While total lending through the swaps line in August 2008 before the crisis began was just $62 billion, total new lending in October 2008 was $2.9 trillion. Therefore, while the Fed's maximum **exposure** increased by 700 percent, their actual lending activities through the FX swap lines increased by more than 4000 percent on the pre-crisis figure. Thus, when

45 The new Fed data allows for the calculation of two measures of the extent of its intervention in the FX markets via the FX liquidity swap line. The first is notional net exposure, a measure of the total notional value of the swaps outstanding on any given day. As the Fed opened more swaps during the FX liquidity crisis, its total net notional exposure increased by the notional value of the new swaps; when existing swaps expired, the Fed's net notional exposure decreased by the notional value of the expiring swaps. The second measure is total Fed lending. This captures total new Fed lending via the FX swaps line on a month-by-month basis, broken down by maturities. The net notional exposure measurement is useful because it takes into account both the trading of new swaps and the expiration of old swaps on a rolling basis, providing a daily snapshot of the Fed's notional exposure. The total lending measure is useful because it places an accurate number on the level of new funds made available through the swaps line during each separate month of the crisis.

46 http://www.federalreserve.gov/newsevents/press/monetary/20080918a.htm.

we look at total lending rather than net notional exposure, we see an even clearer signal that the foreign exchange market was on the verge of collapse following Lehman's bankruptcy.

But even that massive intervention quickly proved inadequate to halt the crisis in the foreign exchange markets. The prospect of a wholesale collapse of these markets necessitated another dramatic move by the Fed in October 2008: it removed all existing limits on the amount of its swaps lines, thereby offering unlimited dollar funding at a wide range of maturities.[47] Thus, the Fed, acting on its belief that the foreign exchange markets were in crisis, concluded that only unlimited, wholesale backstopping might avert a collapse in the markets.

This action was understandable and even necessary—for in the uncleared FX markets, counterparty credit risk concerns meant that no U.S. financial institutions could lend dollars to foreign financial institutions, ordinarily the most common way for overseas institutions to gain access to dollar funding. Because those foreign institutions had dollar obligations they had to meet, the failure of the FX markets, notably FX swaps and forwards, left them in danger of imminent default, necessitating a wholesale intervention by the Fed.

In light of this, the Fed announced that counterparties in these FX operations would be able to borrow any amount they wished against the appropriate collateral in each jurisdiction. Accordingly, sizes of the reciprocal currency arrangements (swap lines) between the Federal Reserve and the BoE, the ECB, and the SNB were "increased to accommodate whatever quantity of U.S. dollar funding is demanded." [48] The Bank of Japan was considering the introduction of similar measures.

As a result, for a period of several months following Lehman's collapse, the Fed provided a rolling facility of unlimited foreign exchange swaps to backstop the markets. These swaps totaled $2.9 trillion in October 2008 alone and more than $5.4 trillion in the three months following the Lehman bankruptcy.[49] On several days, the total notional value of outstanding foreign exchange swaps provided by the Fed to bolster the market exceeded $700 billion.[50] The Fed's maximum net notional daily exposure in the foreign exchange markets was greatest on October 22, 2008, when it reached $823.1 billion. [51]

The new swap-writing activity remained high until the spring of 2009, at which point it began to taper off. However, even after this initial "crisis period" ended, the Fed's

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[47] http://www.federalreserve.gov/newsevents/press/monetary/20081013a.htm.

[48] *Id.* (emphasis added).

[49] This was the total notional value of new swaps opened through the Fed's central bank liquidity swaps line between the Fed's first use of the line after the Lehman Bankruptcy (Sept. 18, 2008) and 3 months later (Dec. 18, 2008).

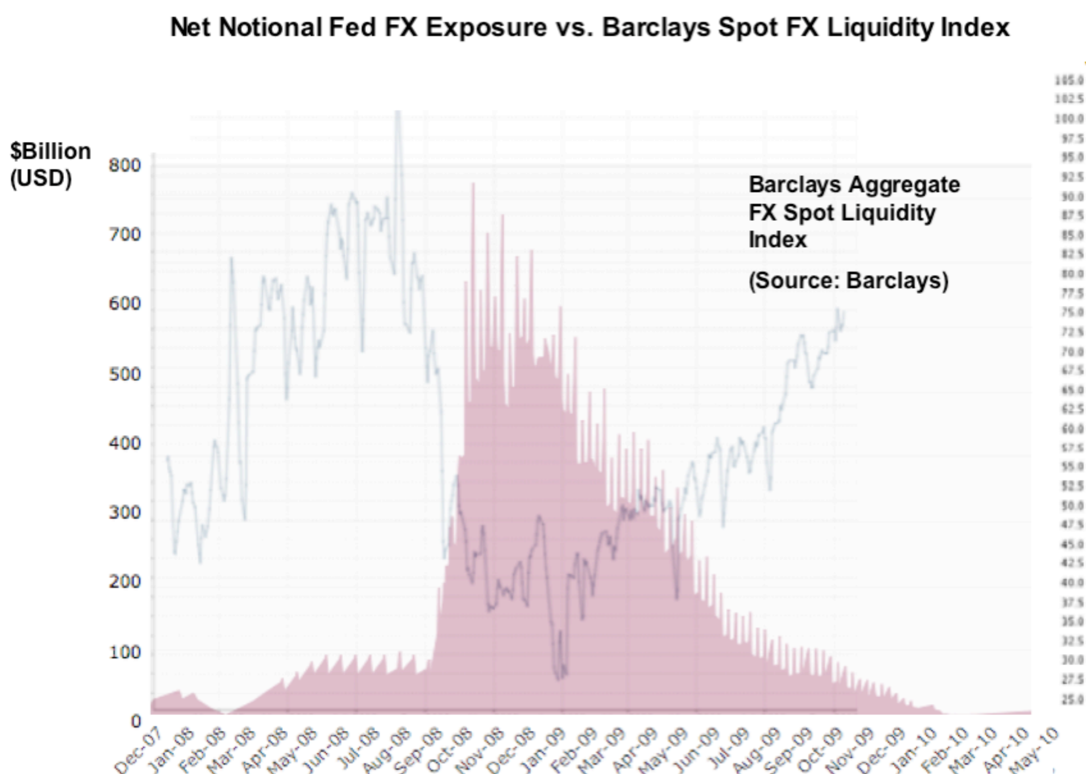
[50] This was calculated from newly released Fed data as the total notional value of swaps opened (traded) by COB on a given date, minus the number matured by COB on that date.

[51] Using the newly released data from the Fed, the maximum net exposure was calculated as the sum of all opened trades minus all closed trades as of the close of business. The Fed calculates its net exposure in the foreign exchange markets slightly differently. It uses the settlement date of the first leg of new trades rather than the date the trade was made, thereby lowering the number by netting. Thus, some data indicates that the high water mark was $586.1 billion. However, both figures are accurate.

rescue efforts in the foreign exchange markets continued well into late 2009 and early 2010, albeit at a reduced level.

The Fed Intervention into the Foreign Exchange Markets Was Necessitated by the Precipitous Drop in Liquidity in the Foreign Exchange Markets.

The December data shows that the Fed's massive intervention coincided with a precipitous drop in FX liquidity, and was evidently triggered by it. The Fed's action provided essentially all the liquidity in the foreign exchange market and prevented its collapse. The next chart, Graph 3 below, overlays the net exposure of the Fed's foreign exchange swap lines, as shown in Graph 1 above, with Barclays Aggregate FX Spot Liquidity Index. This clearly indicates that the Fed's intervention was precipitated by a massive drop in FX liquidity.



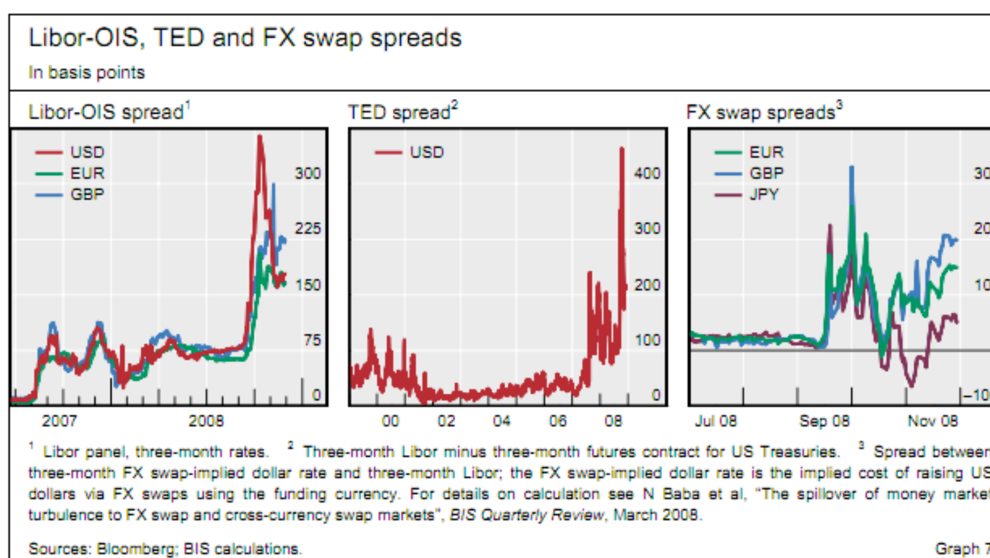
Graph 3.

Earlier in 2008, FX liquidity had struggled, to a degree, with the collapse of Bear Stearns, prompting a drop in counterparty confidence. The Barclays FX Spot Liquidity Index had already hit a low of 42.5 in March 2008 after the fire sale of Bear Stearns to JP Morgan Chase. However, by the time of the Lehman collapse it had recovered to a healthy level of 102.5. The Lehman collapse then triggered an unprecedented drop as the index tested new lows within days and did not bottom out at 27.5 until January 2009.[52]

[52] As is explained in I. Fender and J. Gyntelberg's, *Overview: global financial crisis spurs unprecedented policy actions,* Bank for International Settlements (Dec. 2008), "A higher index reflects better liquidity conditions. The FX Liquidity Index is constructed using the notional amounts traded for a fixed set of

As is clear, the Fed's unprecedented action in the FX markets beginning in mid-September 2008 halted the steep decline in FX liquidity, with the central bank amassing more than $800 billion in notional exposure in its efforts to stabilize the market. In October 2008, when the Fed announced it was lifting all limits on the FX swaps line, the rate of decline in FX spot liquidity slowed substantially and, with some setbacks and additional massive interventions, FX liquidity finally began to increase in January 2009.[53]

Nor was the disruption in FX markets limited to the spot market. FX swap spreads widened to 300 basis points ("bps"), an extraordinarily high level, indicating a market on the verge of collapse. The tremendous stress in the FX markets was also revealed in the widening interest-rate spreads, which had to be another very troubling indicator to the Fed. As Graph 4 below shows, spreads widened sharply immediately following Lehman's bankruptcy filing:



Graph 4. [Source: I. Fender and J. Gyntelberg, *Overview: global financial crisis spurs unprecedented policy actions,* Bank for International Settlements (Dec. 2008)]

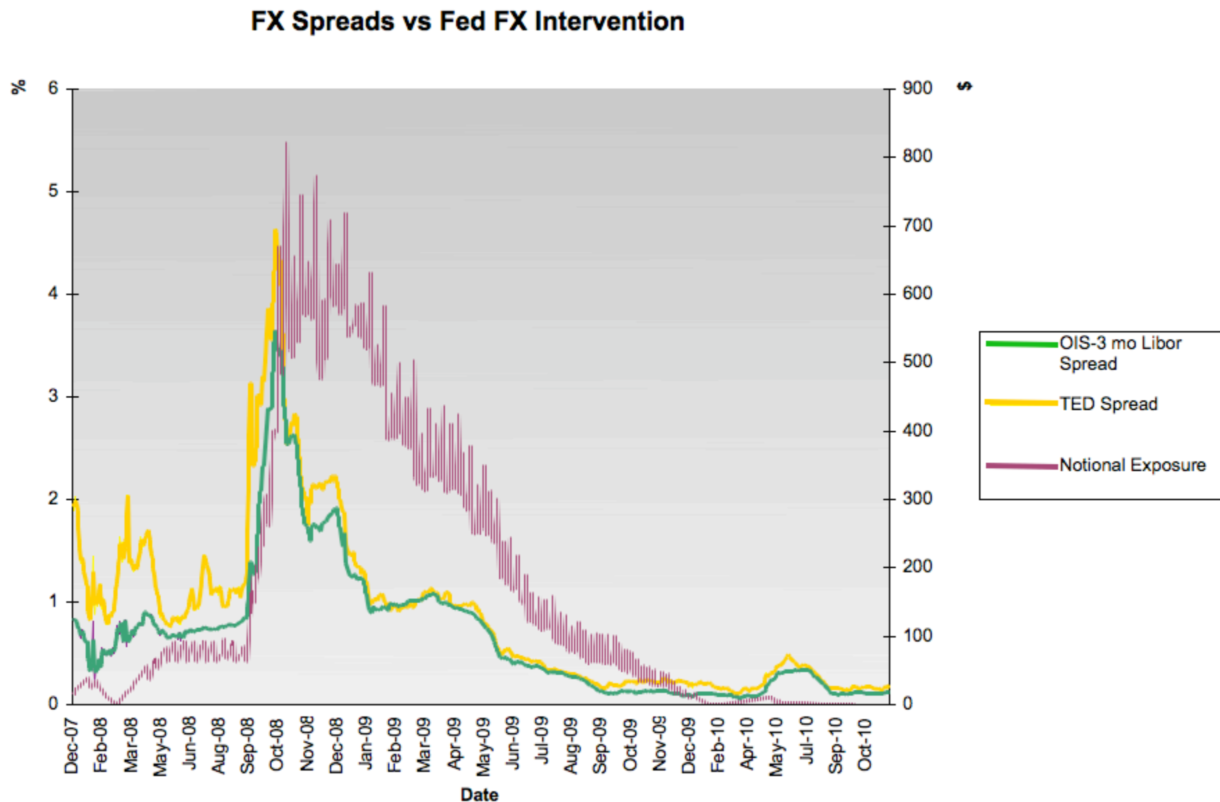
The Libor-OIS spread jumped to a high of 364bps on October 10, 2008. Its average over the previous year (even including the turmoil caused by the Bear Stearns collapse) had been only 69bps. The TED Spread, another important indicator of the health of the FX market, rocketed to a high of 464bps, also on October 10th. This represented a

FX spreads, aggregated using a weighting by currency pair." In other words, Barclays looks at the notional values of FX activity in various currency pairs, and compares them to a benchmark of "normal conditions" (=100).

53 Total new Fed lending through the FX swaps lines in January 2009 was $801billion. The peak net notional exposure during that month was $633.1billion on January 14, 2009, which was the high water mark for notional Fed exposure since October 2008 and coincided with a global low for spot FX of around 27.5. This implies that when the FX spot liquidity hit rock bottom the Fed was prompted to make one final massive intervention to reassure the markets once and for all. This intervention appears to have successfully triggered an upturn in FX spot liquidity, allowing the Fed to gradually roll off its net notional exposure from that point forward.

quadrupling from its average over the previous year of 114bps. FX Swap spreads, as reported by BIS, peaked slightly earlier, exceeding 300bps on October 1st. Before Lehman's failure, they had averaged around 20bps.

When these spreads are overlaid on the new Fed data in Graph 5 below, it is apparent why the Fed deemed such massive, emergency, and wholesale intervention necessary. The foreign exchange markets were effectively frozen. It was only once the Fed provided unlimited liquidity that spreads narrowed and the market began to recover:



Graph 5.

In October 2008, FX spreads all hit their peaks (Libor-OIS 364bps on October 10th 2008; TED Spread 464bps, also on October 10th; FX Swap spreads, reported by BIS, >300bps on October 1st).

In response, the Fed lifted the cap on their swaps line on October 13. The spreads started narrowing. The Fed quickly ramped up its net notional exposure, which reached its peak on October 22 at $823.1 billion. By the end of October, TED was back down to 260bps and Libor-OIS to 240. By the end of November, they were down to 220bps and 180bps respectively.

The Fact that the Fed Provided Support Indirectly Via Swap Lines to Foreign Central Banks Does Not Change the Underlying Reality.

Some have suggested that the foregoing conclusions are incorrect because the Fed did not intervene directly in the FX swaps markets, that there was merely a "shortage of dollars," and that the Fed swaps with foreign central banks assisted the ABS, CP, and other commercial markets, but not the FX market. As set forth below, none of these arguments change the fact that the Fed's actions were necessitated by a failure of the FX market, among others.

While it is true that the Fed only lent via swap lines to foreign central banks and did not lend directly into the FX market, it nonetheless did so because the FX market was not providing sufficient dollars to foreign financial institutions. The purpose of the Fed's action was to inject dollars into foreign financial institutions via foreign central banks. Those central banks in turn immediately conducted auctions with their dealer banks, which then used them directly or lent them to private financial or commercial market participants (directly or via swap lines). The Fed's October 13, 2008 press release makes this expressly clear: "In order to provide broad access to liquidity and funding to financial institutions," the central banks were announcing unlimited swap lines.[54]

Those foreign financial institutions would ordinarily get those U.S. dollars primarily via the FX markets, which is what they did before the Lehman bankruptcy.[55] After all, those markets, including the FX markets, are merely mechanisms for transmitting currencies around the world. In the ordinary course, U.S. dollars go from the U.S. via U.S. financial market participants **to** other countries via foreign financial institutions to satisfy U.S. dollar denominated obligations. The currency market mechanisms, including the FX market, broke down immediately following Lehman's bankruptcy and the Fed swap lines were put in place and funded to satisfy the foreign dollar demands that could not be satisfied in the frozen FX and other money markets.

Because the Fed did this outside of but parallel to the FX market (and, in part, in substitution for the broken FX market mechanism), the claim that the Fed's actions did not support the FX market is a sematic distinction without a difference: the Fed-lent dollars went immediately to satisfy foreign need for U.S. dollars that would have been—but could not be—satisfied in large part by the FX market. And, the very reason those dollars were provided by the Fed was that the FX market was failing to do so.

The Fed Evidence Proves that the FX Market Did Not Perform Well During the Crisis, Undercutting One of the Principal Arguments in Support of the Exemption.

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[54] The Fed's purpose and the mechanics of this are covered in a number of the studies cited in footnote 7 above.

[55] Other sources of dollar funding include upstream channeling for institutions with U.S. subsidiaries as well as straightforward collateralized dollar loans. However, the FX markets are the single largest source of foreign dollar funding, with FX swaps and forwards accounting for around half the total trading volume according to BIS.

But for the Fed intervention, the foreign exchange markets would have stopped functioning. Thus, setting aside assertions by the industry and its allies (including paid-for studies), there simply is no support for the claim that the FX market performed well during the crisis. Indeed, the data and the research lead to the opposite conclusion.

Claims that the foreign exchange markets worked well during the crisis have persisted notwithstanding the overwhelming evidence to the contrary. One example of such a claim is the National Association of Manufacturers' comment letter, which quoted Treasury Department "talking points": "FX swap and FX forward markets performed well during the crisis."[56] The Release itself reflects the same point.[57]

If the enormous intervention by the Fed to prevent the collapse of the foreign exchange markets is considered as representing a well-functioning market, then, and only then, can anyone claim that those markets performed at all. Without such intervention, the foreign exchange markets would have collapsed, which would have brought down every major non-U.S. bank, which would have then brought down every major U.S. bank. If the foreign exchange market performed well, then so did the repo, money market, and commercial paper markets. The conditions were parallel: in each case, the market would have failed completely were it not for massive Fed intervention.

At a minimum, the prior arguments in support of the exemption require a fresh and independent review.[58] They were largely based on the premise that the markets functioned well throughout the crisis. Since that premise is demonstrably false, those arguments are without support as well.

The Fed's emergency actions in preventing the collapse of the foreign exchange markets were the same ones that were necessary to save the other parts of the shadow banking system. And, the same reasons that require regulation of other swaps and the other parts of the shadow banking system (which also pose an unreasonable risk to the entire financial system and economy) apply equally to the foreign exchange markets.

Collapse of the foreign exchange markets would almost certainly have led to a global depression, which is why the Fed intervened without limits and made it clear that they would do whatever was necessary to ensure that they continued to function. Private bank transactions during this period were only possible because the participants knew that they could be rolled over into the Fed facility if necessary (which also resulted in an enormous riskless windfall for the few U.S. banks with balance sheets healthy enough to transact foreign exchange business).

That unlimited guarantee by the Fed and the trillions of dollars it injected are what gave the appearance of the markets performing well during the crisis. Without those

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[56] Letter from National Association of Manufacturers to Secretary of Treasury Department dated November 29, 2010.

[57] Release at 25780.

[58] Better Markets proposed such an independent verification process in its prior letter. *See* Letter from Better Markets, Inc. to U.S. Department of the Treasury, Re: Notice of Request for Comments - Determination of Exemption for Foreign Exchange Swaps and Futures, dated November 29, 2010, at 11-12.

actions, the market would have collapsed, and that is one of the many reasons why no exemption should be granted.

CONCLUSION

As set forth above, the determination to exempt foreign exchange swaps and forwards from regulation is unsupported by the five factors that the Secretary must consider. Further, foreign exchange swaps and forwards are not qualitatively different from other classes of swaps in a way that would make them ill-suited for regulation as swaps. There are no objective differences between foreign exchange swaps and forwards and standard swaps that would warrant exempted status.

The exemption will undermine the goals of the Dodd-Frank Act, by preventing much-needed transparency and risk controls from being applied to foreign exchange swaps and forwards. The real-world dangers that make regulation of these markets so necessary were illustrated in dramatic fashion during the financial crisis.

The intensity of those who favor exemption, fueled by a desire to preserve this profitable marketplace in its current form, regardless of the risk, must not be allowed to frustrate the goals of the Dodd-Frank Act. The exemption of foreign exchange swaps and forwards should not be granted.

We hope these comments are helpful.

Sincerely,

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