COMMITTEE LETTER

RESPONDING TO REGULATORY QUESTIONS RAISED BY THE SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY AND THE HOUSE AGRICULTURE COMMITTEE

The Honorable Richard O. Lugar
Chairman
Committee on Agriculture, Nutrition, and Forestry
Russell Senate Office Building
Washington, DC 20510

March 11, 1999

Dear Chairman Lugar:

The Foreign Exchange Committee (FX Committee) appreciates the opportunity to address in writing some of the questions jointly raised by the Senate Committee on Agriculture, Nutrition, and Forestry and the House Agriculture Committee. The FX Committee was formed in 1978 under the sponsorship of the Federal Reserve Bank of New York and includes representatives of major domestic and foreign commercial and investment banks and foreign exchange brokers. The FX Committee represents many of the most significant participants in foreign currency trading in the United States. The FX Committee's mission is to enhance knowledge and understanding of the foreign exchange and related international financial markets, foster improvements in the quality of risk management in these markets, and develop recommendations on specific market-related topics for circulation to market participants.

1. QUESTION 36:
What Public Policy Is Served by Excluding Certain Financial Products from the Commodity Exchange Act through the Provision Known as the Treasury Amendment? Are There Appropriate Reasons to Expand or Narrow the List of Products?

Before 1974, the Commodity Exchange Act (CEA) only regulated transactions in agricultural commodities. In that year, the CEA was amended to cover all commodities, including financial commodities. The so-called Treasury Amendment was added to the CEA at that time in order to unambiguously exclude certain financial products, such as foreign exchange transactions, from the scope of the CEA. This amendment was added for three reasons. First, these products had traditionally been traded in over-the-counter financial markets. Second, there was no perceived need to mandate that sales of these products for forward or future delivery be conducted on an exchange. Lastly, the participants in these markets were largely institutional and were not in need of the protections of a CEA, designed to ensure that market participants such as farmers (who were generally individuals) were not subject to market manipulation and fraud. As is expressly stated in the letter dated July 30, 1974, from the Treasury Department's Acting General Counsel to the Chairman of the Senate Agriculture Committee (Treasury Letter), the Treasury Department "[felt] strongly that foreign currency futures trading, other than on an organized exchange, should not be regulated by the new agency." In the Treasury Letter, the Treasury Department cites various policy reasons why off-exchange trading of foreign currency futures should be allowed to continue without regulatory oversight, including the following: (i) the market has proved to be highly efficient in serving the needs of international business, (ii) market participants in the foreign exchange markets are sophisticated and informed and do not need to be protected, and (iii) any future need for regulation could be adequately addressed by the Comptroller of the Currency and the Federal Reserve. It, therefore, urged the Senate to adopt language "to make it clear that [the CEA's] provisions would not be applicable to futures trading in foreign currencies or other financial transactions" of the nature described in the Treasury Letter.

The Treasury Letter's reasons for excluding these financial products from CEA coverage continue to be applicable today. The foreign exchange market is still largely an institutional over-the-counter market. According to the latest Bank for International Settlements (BIS) figures, each day, over $1.42 trillion dollars' worth of foreign currency transactions are conducted in the over-the-counter markets. The principal participants are highly sophisticated institutions such as banks (including the central banks of most countries in the world), investment banks, foreign exchange dealers and brokerage companies, corporations, money managers (including pension and mutual funds), and insurance companies.

Unfortunately, continuing uncertainty over the scope of the exclusion under the Treasury Amendment has perpetuated increased legal risk in the foreign exchange markets. These legal risks arise because if certain over-the-counter financial contracts are not covered by the Treasury Amendment, they could be deemed off-exchange futures contracts and, therefore, illegal under the CEA. This legal risk is unacceptable given the size of many participants' exposures and the importance of the foreign exchange market to the economy generally. If certain types of over-the-counter financial contracts were suddenly held not to be enforceable, it would have a seriously adverse effect on dealer capital and have an equally serious effect on the overall domestic banking system.

This legal uncertainty has undermined market participants' ability to respond to the mandate from U.S. banking regulators, along with the banking regulators of other countries who belong to the Basel Committee on Banking Supervision, that banks reduce the foreign exchange settlement risk in the banking system.[1] Although the private sector has responded swiftly to this mandate by attempting to develop and adopt a number of positive risk-reducing mechanisms, the Commodity Futures Trading Commission (CFTC) has taken the position that utilization of these new facilities may transform an otherwise lawful over-the-counter transaction into one that violates the CEA. The CFTC's position on this issue has seriously limited the ability of the foreign exchange markets to meaningfully reduce settlement risk.[2]

A Treasury Amendment that more clearly excludes transactions that are based on, involve, or are indexed to foreign currencies and that makes clear that those products are excluded from the CEA's regulatory scheme even if they are ultimately cleared and settled through a clearinghouse would greatly enhance the ability of foreign exchange market participants to reduce settlement risk and address the important public policy objectives raised by the BIS and federal bank supervisors.

---

[1]*Bank for International Settlements,* Reducing Foreign Exchange Settlement Risk: A Progress Report *(July 1998) and* Settlement Risk in Foreign Exchange Transactions *(March 1996).*

[2]*The CFTC's decision to narrowly interpret the Treasury Amendment in this circumstance is not unique. In the twenty-five years since the Treasury Amendment was enacted, there have been numerous innovations in the markets for financial products. In the case of many of these innovations, including foreign exchange options, the CFTC has repeatedly taken the position that they are not covered by the Treasury Amendment and, therefore, unenforceable. In the case of currency options, the issue was litigated all the way to the Supreme Court in* Dunn v. CFTC, *519 U.S. 465 (1997). The Supreme Court unanimously held that the Treasury Amendment broadly excludes foreign exchange options from the CEA.*

2. QUESTION 37:
Should Board of Trade Be Defined by Statute? How Would This Affect the Current Interpretation of the Treasury Amendment?

We believe that the better reading of the term “board of trade” in the Treasury Amendment is “organized futures exchange.” However, recent CFTC enforcement and investigative actions as well as the CFTC’s focus on clearing entities for over-the-counter contracts in its concept release indicate that the CFTC has a broader view of the term “board of trade” as used in the Treasury Amendment. These actions have included investigations of the Delta Clearing Corporation’s and the Government Securities Clearing Corporation’s offerings of clearing and settlement facilities for new products that involve transactions in government securities exempted from the CEA by the Treasury Amendment. These and other developments have resulted in renewed concern as to the legal enforceability of over-the-counter contracts in Treasury Amendment products. As a consequence, the development of a number of proposed mechanisms for the clearing of foreign exchange contracts entered into on a bilateral basis has been impeded by concerns over applicability of the CEA to products using those facilities.

We believe it is essential that the term “board of trade” not be extended to entities that facilitate the execution or clearing of bilateral over-the-counter transactions between parties acting for their own account. Technological developments have fostered new mediums for trading and settlement in the foreign exchange markets. These positive risk-reducing developments are beneficial to dealers and end users alike and reflect a natural evolution of this market. Banking regulators have, therefore, quite reasonably concluded that such innovations should not be stifled unnecessarily. The term “board of trade” should be defined to exclude entities or systems that are available only to sophisticated parties and that are designed to: (i) facilitate more efficient execution or settlement of foreign exchange transactions, (ii) provide greater liquidity to these markets, or (iii) reduce counterparty risk in these markets generally.

The existence of foreign exchange “bucket shops”—small, solely retail operators that prey on unsophisticated consumers—needs to be addressed. The FX Committee supports the objective of protecting retail investors. However, sophisticated counterparties do not need to be protected by government regulators from fraud. Moreover, if the retail investor’s agent or counterparty (or such agent or counterparty’s affiliate) is otherwise supervised or regulated by a federal banking or securities regulator, CFTC jurisdiction over a foreign exchange transaction is unnecessary because the retail investor is already protected by the supervisory regimes that apply to its counterparty. However, one of the more troubling aspects of the CFTC's actions in the area of retail fraud is that the CFTC—instead of proving fraud—argues that the structure, execution, or clearing of the fraudulent transactions make them illegal off-exchange futures that are void. That approach has troubling repercussions for legitimate over-the-counter transactions. Consequently, the CFTC should not have the authority to unilaterally challenge and invalidate transactions, including retail transactions, as illegal off-exchange futures as a means of pursuing fraud.

3. QUESTION 38:
Are Regulatory Inequities Inherent in the Amendment's Distinction between Instruments Traded on a "Board of Trade" and Those That Are Not? How Do Recent Court Decisions Affect the Amendment's Application?

Any current disparity in the regulatory and legal treatment of exchange-traded foreign currency futures, on the one hand, and options and over-the-counter transactions in financial products, on the other hand, is to a large extent a reflection of the vast differences between these two products and the parties they serve. The FX Committee continues to support the idea that organized futures exchanges deserve regulatory relief that takes into account these differences to the extent necessary.

Recent case law supports the view that the term "board of trade" is meant to encompass only formally organized futures exchanges and that the term does not refer to any execution or clearing function independent of a CFTC-designated contract market. In 1996, the Ninth Circuit held in *Commodity Futures Trading Commission v. Frankwell Bullion Ltd.* that the term "board of trade" in the Treasury Amendment meant "on-exchange" and "exempt[ed] from all off-exchange transactions."[3] Therefore, an entity that provides only execution, clearing, and/or settlement services for over-the-counter foreign exchange transactions and does not do so for a CFTC-designated contract market is not a board of trade.

---

[3]*See* Commodity Futures Trading Commission v. Frankwell Bullion Ltd., *99 F.3d 299, 303 (9th Cir. 1996).*

Unfortunately, as mentioned above, the CFTC's stated view on this issue has had a chilling effect on the development and availability of risk-reducing execution, clearing, and settlement systems in the United States. Private sector initatives that use technology to mitigate counterparty and systemic risk arising from over-the-counter trading are essential from both market and supervisory perspectives. These systems should be free to develop and flourish outside of the regulatory scope of the CEA and regulatory threats from the CFTC. Otherwise, financial institutions located in the United States will be at a competitive disadvantage relative to those located in jurisdictions where such initiatives are fostered and encouraged—an outcome that could encourage the movement of business not in the direction of futures exchanges, but rather away from the United States altogether.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee