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

Re: Exemption of Foreign Exchange Swaps and Forwards from Dodd-Frank Regulation

Dear Secretary Geithner:

We welcome the opportunity to comment on the Treasury Department's proposed issuance of a determination to exempt foreign exchange swaps and forwards from the exchange trading and clearing requirements of the Dodd-Frank Act. Public Citizen is a national, nonprofit public interest organization with 150,000 members and supporters that champions citizen interests before Congress, the executive branch agencies and the courts.

Public Citizen strongly urges the Treasury Department not to exempt foreign exchange ("FX") swaps and forwards from the definition of "swap" under the Commodity Exchange Act ("CEA") and thus from exchange trading and clearing requirements.

Moreover, we are concerned that the proposed exemption opens the United States up to a potential challenge of the non-FX-related exchange trading and clearing requirements under international services trade agreements. This possibility has been widely noted, as these so-called "trade" rules were written well before the lessons learned from the financial crisis. For instance, the Commission of Experts on Reforms of the International Monetary and Financial System (chaired by Nobel Prize winner Joseph Stiglitz, with the participation of a host of distinguished academics from around the world) wrote: "The framework for financial market liberalization under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors."¹ For this

reason, we urge the Treasury Department to seek amendments to the GATS and other trade agreements to allow the United States more room to re-regulate the financial sector without risking trade pact attack.

Exemption of Foreign Exchange Swaps and Forwards is Not Justified

Public Citizen is a member of the Americans for Financial Reform group, and we support and incorporate herein their letter, also submitted today opposing the proposed exemption.

Other countries' experience with FX swaps and forwards market shows need for regulation

In the run-up and wind-down to the economic crisis, the International Monetary Fund (IMF) has documented how Brazil and South Korea experienced bouts of capital floods and flights that led to extreme fragility in their markets. In some cases, these tendencies were exacerbated through FX swap and forward channels. Brazil, faced with the prospect of excessive capital inflows, imposed a tax on margin payments on derivatives transactions. The IMF found that investors circumvented this policy by restructuring their speculation through the FX forward carry trade, resulting in balance of payments pressures.² Korea imposed a ratio of FX forward contracts to underlying export revenues of 100 percent in June 2010. The IMF has deemed this policy a success, and said it appears “to have contributed to a sizable reduction in outstanding external short-term debt of banks.”³

Exemption of FX Swaps and Forwards Could Open Other Dodd-Frank Regulations Up to Attack

For two decades, the Department has been a leading advocate for deepening the financial services obligations of the U.S. and other countries under international trade agreements.⁴ But U.S. commitments under the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS) may complicate efforts to selectively implement the Dodd-Frank central clearing mandates.

Background on WTO's promotion of deregulation

The U.S. scheduled its GATS financial services commitments in accordance with the Understanding on Commitments in Financial Services (“Understanding”). The Understanding commits its adopters to partial Mode 1 (cross-border supply), full Mode 2 (consumption abroad) and Mode 3 (commercial presence) market access commitments for banking and securities related financial services as defined in the GATS Annex on Financial Services Articles 5(a)(v-xvi), unless a non-conforming measure was scheduled as a limitation in the market access column of an adopter's schedule. Moreover, unless otherwise noted in its schedule, the U.S. financial services sector is bound to the full GATS Article XVI market access and Article VI domestic regulation rules.

The GATS Article XVI market access rules require the elimination of specifically indicated maximum quantitative restrictions (including bans), and freedom of transfers in and out of a country, in committed sectors and modes of supply.

The Understanding's market access rules are construed more broadly. For Mode 1, Understanding Paragraph B(3) requires adopters to "permit non-resident suppliers of financial services to supply, as a principal, through an intermediary or as an intermediary, and under terms and conditions that accord national treatment" a subset of financial services (not including trading activities). For Mode 2, Understanding Paragraph B(4) requires adopters to "permit [their] residents to purchase in the territory of any other Member" all banking and securities related services, plus certain insurance services. For Mode 3, Understanding Paragraph B(5) requires adopters commit to "grant financial service suppliers of any other Member the right to establish or expand within [their] territory, including through the acquisition of existing enterprises, a commercial presence." Understanding Paragraph B(6) states that "A Member may impose terms, conditions and procedures for authorization of the establishment and expansion of a commercial presence in so far as they do not circumvent the Member's obligation under paragraph 5 and they are consistent with the other obligations of the Agreement."

The disciplines for GATS Article VI are still being hammered out in negotiations in the WTO's Working Party on Domestic Regulation. The initial negotiating mandate in Article VI requires that *all* domestic regulations (including those that do not specifically violate the market access commitments outlined above) be "(a) based on objective and transparent criteria, such as competence and the ability to supply the service; (b) not more burdensome than necessary to ensure the quality of the service; (c) in the case of licensing procedures, not in themselves a restriction on the supply of the service." It is expected (although not certain) that these rules will only apply to sectors in which a country took specific commitments.⁵ A prudential measures defense provision in GATS Annex 2(a), for its part, specifies that even prudential measures may not "be used as a means of avoiding the Member's commitments or obligations under the Agreement." This provision is vague and worrisome, as a country would only need to invoke the prudential measures defense if were challenged for having avoided its commitments or obligations under the GATS.

One subsector has particular relevance for the Dodd-Frank Act's derivatives rules. Annex Article 5(a)(x) reads:

"Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:

- (A) money market instruments (including cheques, bills, certificates of deposits);
- (B) foreign exchange;
- (C) derivative products including, but not limited to, futures and options;
- (D) exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;
- (E) transferable securities;
- (F) other negotiable instruments and financial assets, including bullion."

The U.S. utilized the Understanding, and is accordingly committed to offer at least full Mode 2 and 3 market access to the sector described in Annex Article 5(a)(x). (Arguably, a quirk in the U.S. Schedule suggests that the United States committed to full Mode 1 market access for this sector as well.⁶)

For analysis of the GATS compatibility of the Dodd-Frank clearing and exchange requirements, the U.S. schedule does not list any relevant limitations on the commitment in the securities and FX trading subsector. (There is only one loosely related non-conforming measure, for “Trading of Securities and Derivative Products and Services Related Thereto; Participation in Securities Issues”: “Federal law prohibits the offer or sale of futures contracts on onions, options contracts on onions, and options on futures contracts on onions in the United States, and services related thereto.”⁷) In other words, trading of FX, FX swaps, and other swaps are included in the U.S. GATS commitments. Accordingly, the U.S. has committed itself to ensure that its regulations in this sector are consistent with all U.S. commitments – including GATS Articles XVI and VI.

Potential Conflict with Dodd-Frank

The Department contends that foreign exchange swaps and forwards are fundamentally different from other “swaps” such as “interest rate swaps,” and therefore should be exempted from the clearing and exchange trading requirements that will otherwise apply to swaps under Dodd-Frank Act’s amendments to the CEA.

As the Americans for Financial Reform letter states, the Department does not adequately explain the basis for this distinction. But even assuming such a distinction could be justified at the conceptual level, the GATS typology makes no such distinction, and groups interest rate and FX swaps together. This suggests that GATS negotiators viewed FX swaps and non-FX derivatives as being closely related activities whose trade should be governed by similar GATS rules.

WTO members have already raised questions about the GATS compatibility of the Dodd-Frank Act.⁸ If mandatory clearing of non-FX derivatives, say, were to be attacked as a violation of U.S. GATS commitments under Article VI, the U.S. would have a hard time defending the measure. One of the factors that WTO panels have used in contemplating whether a challenged regulatory measure meets the so-called “necessity test” is the availability of alternative measures that the government has used or could use that are deemed to have a less trade-restrictive impact.⁹ If mandatory non-FX derivatives exchange trading and clearing under Dodd-Frank were challenged as a violation of U.S. GATS commitments, a complainant country could point to the lack of mandatory exchange trading and clearing for FX swaps and forwards as part of an argument against the “necessity” of such requirements for other financial instruments such as interest rate swaps. Given the uncertainty surrounding the GATS rules (in particular the uncertain and untested scope of a prudential defense measure contained therein),¹⁰ the Department should not make any exemptions that could complicate a U.S. defense in the event of a WTO challenge of Dodd-Frank.

For this reason, in addition to other reasons cited by Americans for Financial Reform, we urge the Treasury Department to not exempt foreign exchange swaps from the comprehensive reregulation of swaps under Dodd-Frank. We also believe that the Department should look to amend GATS Articles XVI and VI, and the Understanding, so that international trade rules do not get in the way of financial reregulation at home or abroad. Alternatively, the U.S. should withdraw the securities and FX trading sector (Annex Article 5(a)(x)) from its GATS commitments, and work with the other WTO members to allow for a period where similar

commitments can be withdrawn without triggering the compensation negotiations described in GATS Article XXI.

Sincerely,



Todd Tucker
Public Citizen's Global Trade Watch

ENDNOTES

¹ Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, September 2009 Report, at 82. Available at: http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf.

² IMF, "Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework," February 14, 2011, at 63-64. Available at: <http://www.imf.org/external/np/pp/eng/2011/021411a.pdf>.

³ IMF, "Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework," February 14, 2011, at 73. Available at: <http://www.imf.org/external/np/pp/eng/2011/021411a.pdf>.

⁴ Harry Freeman, "The Role of Constituents in U.S. Policy Development Towards Trade in Financial Services," in Alan Deardoff and Robert Stern, *Constituent Interests and U.S. Trade Policy*, (Ann Arbor: University of Michigan, 1999).

⁵ Panagiotis Delimatsis, "Due Process and 'Good' Regulation Embedded in the GATS - Disciplining Regulatory Behaviour in Services Through Article VI of the GATS,"

Journal of International Economic Law, 10:1, 2006, at 39.

⁶ The U.S. schedule contains the following market access limitation for all banking and securities related services sectors:

"Unbound with respect to paragraph 2(e) of Article XVI of the Agreement, and paragraphs A, B.5 and B.6 of the Understanding in relation to the expansion, via the establishment of a branch or the acquisition of one or more branches of a bank without acquisition of the entire bank, by a foreign bank into another state from its "home state," as that term is defined under applicable law. Except as specifically set forth elsewhere in this schedule, such expansion shall be provided on a national treatment basis in accordance with headnote 3." This limitation is a negative pregnant that indicates that the United States is otherwise bound by both the Understanding and GATS Article XVI market access rules.

Moreover, in its recent paper, the WTO Secretariat raises the issue of "whether a cross-border financial transaction should be classified as a mode 1 or a mode 2 transaction" and notes that – in an era of e-commerce – there is no straightforward definition of in what territory a financial service transaction is delivered, consumed or otherwise consummated. The Secretariat goes on to say, "It is clear that this question becomes particularly relevant when different levels of commitment have been undertaken for each of the two modes of supply, which is often the case, with more liberal commitments undertaken in general for mode 2." (See WTO, Financial Services," Background Note by the Secretariat, S/C/W/312 and S/FIN/W/73, Feb 3, 2010, at 14.)

A recent paper by Federal Reserve economists is even more pointed, calling the classification system "particularly useless when addressing prudential concerns, fears of contagion and capital flows," and that the Mode 1/2 distinction is especially "blurry, because it is not clear whether the consumer or the service crosses the border." See: Francisco Parodi and Alejandra Pereira, "Financial Services Trade Liberalization in the Doha Round: Implications for Latin America," *Integration and Trade*, January-June 2005, 9: 22. First part of quote from the draft version.

⁷ The schedule also contains the following market access limitations for this subsector: "Unbound for the authority to act as a sole trustee of an indenture for a bond offering in the United States. Unbound with respect to the use of simplified registration and periodic reporting forms for securities issued by small business corporations."

⁸ Communication from Barbados, "Unintended Consequences of Remedial Measures taken to correct the Global Financial Crisis: Possible Implications for WTO Compliance," Committee on Trade in Financial Services Document, JOB/SERV/38, Feb. 18, 2011. Available at: <http://www.coc.org/system/files/BarbadosSubmission.pdf>

⁹ "United States - Measures Affecting the Cross-Border Supply of Gambling and Betting Services - AB-2005-1 - Report of the Appellate Body," WTO Document WT/DS285/AB/R, July 4, 2005, at paras 306-308.

¹⁰ See Todd Tucker, "How to Reform WTO and FTA Rules to Confront Too-Big-To-Fail Banks," Public Citizen Memorandum, May 10, 2011, at 18-22. Available at: <http://www.citizen.org/documents/memo-gats-conflict-with-bank-size-limits-may-10-2011.pdf>