MICROFINANCE CURRENCY RISK SOLUTIONS

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COMMENT

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David A. Stawick
Secretary, Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW.
Washington, DC 20581

Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"; Proposed Rule (File Number S7-39-10)

Dear Secretary Stawick:

MFX Solutions, Inc. (**MFX**) is writing to provide comments to the Commodity Futures Trading Commission (the **CFTC**) in response to the proposed rules and request for comment published in the Federal Register on December 21, 2010 in connection with Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **Dodd-Frank Act**).[1]

MFX is a non-profit microfinance industry cooperative dedicated to providing microfinance lenders with affordable and accessible hedging instruments designed to mitigate currency risk. The microfinance industry provides very small loans to underserved entrepreneurs in the developing world. MFX offers certain over-the-counter derivatives in foreign exchange, including foreign exchange swaps, foreign exchange forwards and foreign exchange options (all such over-the-counter derivatives, **OTC FX Derivatives**), exclusively to microfinance lenders in the United States and Europe, allowing these lenders to provide loans in thinly traded currencies at a reduced cost to microfinance institutions around the world.

Section 721 of the Dodd-Frank Act permits the Secretary of the Treasury to make a written determination that "foreign exchange swaps" or "foreign exchange forwards," or both, should be exempted from the definition of "swap" under the U.S. Commodity Exchange Act, as amended by the Dodd-Frank Act (the **CEA**), provided that such transactions are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the CFTC. MFX provided comments with respect to, and is following developments regarding, the Secretary of the Treasury's determination.[2] However, MFX appreciates that whether the Secretary of the Treasury will make such a determination is uncertain, and even if such determination is made, the exemption may not extend to all of the OTC FX Derivatives that MFX carries out for its clients. MFX is therefore concerned that it may inadvertently fall within the definition of "swap dealer" and is providing the CFTC with its comments on that definition as proposed by the CFTC in the Additional Definitions Release.

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1 Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 75 Fed. Reg. 80,174 (Dec. 21, 2010) (to be codified at 17 C.F.R. Part 1 and 17 C.F.R. Part 240) (hereinafter, the **Additional Definitions Release**).

2 The comment letter provided by MFX to the US Department of Treasury can be found at: http://www.regulations.gov/#!documentDetail;D=TREAS-DO-2010-0006-0014.

1. BACKGROUND

The Dodd-Frank Act sets out a new regime of regulation for the over-the-counter derivatives markets. In particular, the Dodd-Frank Act will require entities known as "swap dealers" to register as such with the CFTC and comply with capital, margin and business conduct rules applicable to those entities.

Section 721 of the Dodd-Frank Act defines "swap dealer" as any person that "(i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps". In addition, Section 721(c) of the act requires the CFTC to adopt additional rules to further define "swap", "swap dealer", "major swap participant" and "eligible contract participant". The CFTC published these proposed rules in the Additional Definitions Release and requested public comment on its proposal.

2. MFX'S BUSINESS AND MODEL

MFX was formed in 2008 by a group of microfinance organizations, including lenders, investors, raters, networks, and foundations, seeking to minimize currency risk in the microfinance industry. MFX operates as a non-profit microfinance industry cooperative dedicated to providing microfinance lenders with: (i) tools and knowledge to quantify currency risk; and (ii) affordable and accessible hedging instruments designed to mitigate currency risk. MFX has partnered with Overseas Private Investment Corporation (**OPIC**), an independent agency of the U.S. government, and the Currency Exchange Fund (**TCX**), an initiative of the Dutch Development Bank FMO and the Dutch government, to serve microfinance investment funds and institutions that provide microfinance loans to microbusinesses in developing and newly industrialized countries.

MFX has the unique mission of reducing currency risk for small microfinance lenders. These microfinance lenders are typically funds or other financial institutions located in the United States or Europe that provide financing to microfinance institutions, which in turn provide underserved entrepreneurs with very small loans to support microbusinesses. MFX gives microfinance lenders the ability to make loans to microfinance institutions in local currency by entering into OTC FX Derivatives with such lenders (**Client Transactions**). Although the ultimate beneficiaries of the Client Transactions are the microbusinesses, the microfinance lender that is party to the Client Transaction would be considered a "financial entity" for purposes of the Dodd-Frank Act. The currencies for which MFX provides hedging facilities are typically thinly traded (for example sub-Saharan Africa, Central America and Central Asia) and consequently hedging instruments are not generally available from commercial financial institutions. A typical Client Transaction entered into by MFX has a notional value of U.S.$500,000-2,000,000. MFX expects its notional hedging portfolio to reach a value of U.S.$400 million after two to three more years of operation.

To manage its market risk, MFX fully offsets Client Transactions via a matching hedge, generally a matching OTC FX Derivative, with a counterparty, which can be either TCX or a commercial bank (the **Offsetting Transaction**, and together with the corresponding Client Transaction, the **Transaction**). As an intermediary, MFX retains a small margin, covering costs and business viability, on the two transactions that, in all other respects, mirror one another. MFX therefore carries no foreign exchange market risk or any other form of market risk.

A key aspect of MFX's model is its collateral arrangement which is designed to reduce the burden of collateral on microfinance lenders while ensuring that all Transactions are appropriately collateralized. MFX's collateral arrangement is made of two complementary elements: (i) a pre-existing agreement with TCX or other commercial banks, which agree to enter into the Offsetting Transactions; and (ii) a guarantee from OPIC, which guarantees the default of the microfinance lenders.[3] MFX assigns the OPIC guarantee as collateral in the Offsetting Transactions which MFX uses to match its foreign exchange market risk.

3. MFX'S STATUS UNDER THE DODD-FRANK ACT IS UNCLEAR

MFX understands the need for reforms in the financial industry and is supportive of the CFTC's efforts in promulgating new rules and regulations to give effect to the requirements of the Dodd-Frank Act. MFX believes that it is important to keep the Dodd-Frank Act's stated purpose in mind when promulgating new rules:

> *To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.*

MFX does not believe that, given the size and stated purpose of its activities, its business model can reasonably be seen to implicate the core concerns set out in the stated purpose of the Dodd-Frank Act. Nonetheless, because it engages in certain types of financial transactions covered by the Dodd-Frank Act, MFX could be significantly impacted by the proposed financial reforms.

As mentioned above, Section 721 of the Dodd-Frank Act permits the Secretary of the Treasury to exempt "foreign exchange forwards", "foreign exchange swaps", or both, from the definition of "swap" in the CEA. If "foreign exchange swaps" and "foreign exchange forwards" are so exempted, the vast majority of MFX's Transactions would remain subject to the swap data reporting requirements set out in Section 727 of the Dodd-Frank Act and MFX is preparing to comply with these reporting requirements. MFX fully supports the CFTC's work in setting out the proposed framework for swap data reporting as a means of bringing transparency to the market.

Despite being a very small, low risk intermediated activity, MFX's business has several unique aspects that would make it difficult for MFX to operate if "foreign exchange swaps" and "foreign exchange forwards" are not excluded from the definition of "swap". As mentioned above, if the Secretary of the Treasury does not exempt "foreign exchange swaps" and "foreign exchange forwards" from the definition of swap, MFX believes that it could be considered a "swap dealer" under the CEA. Compliance with the margin and capital requirements for swap dealers mandated by the Dodd-Frank Act will likely impose significant additional costs on MFX. As with the requirements imposed by clearing and other exchange trading requirements, the increased costs of compliance could make the cost of MFX's services too expensive for the microfinance lenders which rely on MFX's services and could ultimately result in those microfinance lenders providing fewer loans to underserved entrepreneurs and microbusinesses in the developing world.

In addition, MFX serves a specialized market niche with microfinance lender clients who require foreign exchange products tailored to hedge their specific loan exposures. In particular, the Transactions are not of the type for which a liquid market already exists and such contracts would be difficult if not impossible to clear or to bring within applicable exchange trading requirements. MFX's business also utilizes a specialized collateral regime based on its OPIC guarantee rather than cash or securities. MFX does not believe that its Transactions would be eligible for the end user exemption from clearing given that all of the parties to these Transactions would be considered "financial entities". Therefore, if MFX's Transactions are considered "standardized" and thus required to be

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[3] More details regarding OPIC's involvement with MFX and the guarantee it provides can be found at: http://www.opic.gov/sites/default/files/docs/microfinancing_06_2010.pdf.

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cleared, it is unlikely that any central clearing house would accept MFX's OPIC guarantee as collateral. MFX would therefore probably be required to post cash or securities as collateral, increasing its costs and the costs for its clients, which many ultimately render MFX's services too expensive for its microfinance lender clients.

4. FINANCIAL INTERMEDIARIES SUCH AS MFX SHOULD NOT BE CONSIDERED "SWAP DEALERS" UNDER THE DODD-FRANK ACT

In the Additional Definitions Release, as well as in many of its other proposed rules and releases, the CFTC expressed the view that it is seeking to avoid duplicative regulation when implementing the provisions of the Dodd-Frank Act. MFX agrees with the CFTC's position on this point and believes that when promulgating new rules, the CFTC should be mindful of the extent to which market participants' activities will be adjusted by the need to comply with new rules and regulations. Accordingly, the CFTC should ensure that any new rules do not regulate any particular activity more than once. In particular, MFX believes that there is a chance for duplicative regulation if parties that act as intermediaries, such as MFX, are also regulated as "swap dealers".

MFX does not believe that it would be considered a "swap dealer" under the first, second or fourth prong of the definition of "swap dealer" set out above. MFX should not be a "swap dealer" under the first or fourth prong of the definition because it does not act as, or hold itself out as, a "dealer" in the ordinary sense of the word. MFX only enters into Transactions as an intermediary between the microfinance funds on the one side and TCX or a commercial bank on the other. Similarly, MFX should not be considered a "swap dealer" under the second prong of the definition as it does not make a market in any swap as it neither holds itself out nor acts as a source of liquidity in the foreign exchange markets, nor does it price swaps on anything other than a cost plus basis.

However, MFX believes that it could be considered a "swap dealer" under the third prong of the definition. Technically, MFX regularly enters into foreign exchange swaps with counterparties in the ordinary course of business for its "own account". However, it believes that the function it serves more closely resembles that of a customer intermediary such as a futures commission merchant (**FCM**) or introducing broker (**IB**) rather than a dealer.

The Additional Definitions Release provides that the CFTC would not consider an FCM or IB that enters into swaps as agent for customers to be trading for its "own account" for purposes of the definition of "swap dealer".[4] However, MFX believes that "own account" should be clarified such that "own account" does not simply mean "as principal", but instead refers to swaps that are entered into by a entity on its own initiative rather than to intermediate a transaction between a customer and another party. This clarification is warranted given the fact that, due to various changes required by Dodd-Frank Act, an FCM, IB or other intermediary may be required to enter into swaps as principal with its customers in order to allow its customers to access certain types of products or counterparties, or to permit such swaps to be cleared by a central clearing party (**CCP**).

For example, one model that has been suggested for clearing of customer swaps is for an FCM to enter into a swap with a customer as principal and then enter into a corresponding back-to-back swap with the CCP. Under this model for customer clearing, although the FCM enters into the customer swap and the back-to-back swap as "principal", this should not mean that the FCM is acting for its "own account", but rather that the FCM is acting for its underlying customer. If "own account" is simply read to mean "as principal" in all instances, then any such FCM could be considered a "swap dealer", despite the fact that the economics of the FCM's role in the customer swap have not actually changed from the model in which the FCM entered into a swap as agent for its customer. Requiring such FCMs to register as "swap dealers" would result in duplicative regulation in that the FCM's

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4 See Additional Definitions Release, 75 Fed. Reg. at 80,177 (fn 19).

activity could be regulated twice – first as swap intermediation activity and second as swap dealing activity.

Similar to the FCM in the above example, MFX enters into OTC FX Derivatives as an intermediary or agent rather than acting for its "own account", connecting microfinance lenders with TCX or the commercial bank counterparty at a lower cost due to the availability of MFX's OPIC guarantee. MFX only enters into a Client Transaction on the condition that either TCX or a commercial bank with which it has a pre-existing agreement will enter into the corresponding Offsetting Transaction and accept as collateral the OPIC guarantee. Any spread MFX charges on a Transaction is solely to cover the costs of its operations; furthermore, MFX does not hold the foreign exchange or market risk on its Transactions. On this basis, MFX does not believe that its activities should be considered entering into swaps for its "own account" and should therefore not fall within the third prong of the definition of "swap dealer" in the Dodd-Frank Act. Instead, if MFX is properly subject to regulation under the CEA, it would be more appropriately regulated as either an FCM or an IB on the basis that MFX acts solely to intermediate the Transaction between its microfinance lender clients and TCX or the commercial bank counterparty. In particular, because it does not collect margin or any other property of its customers in respect of its Transactions, to the extent that it should be regulated under the CEA, MFX believes it is most appropriately regulated as an IB.

For the reasons set out above, MFX respectfully requests that the CFTC consider amending the proposed definition of "swap dealer" to clarify that financial intermediaries that enter into swaps either as agent for a customer or as principal are not considered "swap dealers" when such swaps are entered into solely for the purpose of intermediating a transaction between a customer and another financial counterparty. Such a distinction would ensure that an FCM, IB or other regulated intermediary is not subject to duplicative regulation in respect of its swap activity that is undertaken on behalf of its customers. MFX does not believe that exempting from the definition of "swap dealer" those FCMs, IBs and other intermediaries that enter into swaps and other commodity interests as principal on behalf of customers would pose a risk to the U.S. financial system.[5] Because of swap data reporting requirements, the CFTC would have real-time access to all relevant information in respect of such swaps. In addition, FCMs and IBs are already appropriately regulated under the Dodd-Frank Act to minimize the possibility that such intermediaries could lead to increased systemic risk in the U.S. financial system. Accordingly, the CFTC would have the tools to monitor such intermediaries' transactions and thereby confirm that these entities were actually entering into matched trades for the benefit of customers rather than engaging in traditional "swap dealer" activity.

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MFX appreciates the ability to provide its comments on the proposed definition of "swap dealer" set out in the Dodd-Frank Act and as further defined in the CFTC's proposed rules. Please feel free to contact me or others at MFX at your convenience with any questions.

Sincerely,

Brian Cox
President

[5] Such an approach would accord with the comments received by the CFTC in respect of the definition of "major swap participant" in which commenters suggested, in our view rightly, that certain types of entities should be conditionally or unconditionally excluded from the definition of "major swap participant" on the basis that such entities do not present the risks that underpin the regulatory rationale for the definition. See Additional Definitions Release, 75 Fed. Reg. at 80,202-80,203.