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November 29, 2010

Mary J. Miller  
Assistant Secretary for Financial Markets  
Office of Financial Institutions Policy  
1500 Pennsylvania Avenue, NW.  
Washington, DC 20220

**Re: Determination of Foreign Exchange Swaps and Forwards – Request for Comment**

Dear Assistant Secretary Miller:

MFX Solutions, Inc. (**MFX**) is writing to provide comments in response to the Department of the Treasury's notice and request for comments dated October 28, 2010 in connection with Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **Dodd-Frank Act**). Section 721 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 US Commodity Exchange Act, as amended by the Dodd-Frank Act (the **CEA**), and are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the Commodity Futures Trading Commission (**CFTC**).

As discussed in greater detail below, MFX believes that exempting "foreign exchange swaps" and "foreign exchange forwards" from the definition of "swap" in the CEA, as amended by the Dodd-Frank Act, is warranted. Granting such an exemption is important not only to MFX's business and its microfinance clients, but also to the functioning of the broader currency exchange market, both globally and in the United States. Subjecting MFX's currency hedging transactions to the clearing and collateral requirements of the Dodd-Frank Act would make it more difficult for MFX to carry out its development mission and would ultimately impact the micro-entrepreneurs that benefit from the loans MFX's clients provide.

Please find below MFX's preliminary comments regarding the factors and determinations relevant to the exemption of "foreign exchange swaps" and "foreign exchange forwards" from the definition of "swap" under the CEA.

## 1. BACKGROUND

Section 721 of the Dodd-Frank Act authorizes the Secretary of the Treasury to make a written determination that "foreign exchange swaps" or "foreign exchange forwards", or both, should not be regulated as "swaps" under the CEA and are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the CFTC.<sup>1</sup> Should the Secretary of the Treasury determine to use its exemptive authority, foreign exchange swaps and foreign exchange forwards would be exempted from many of the substantive provisions of the Dodd-Frank Act, including the clearing and designated contract market or swap execution facility transacting requirements (any such requirement, a **Trading Facility Requirement**) for standardized swaps. All foreign exchange swaps and foreign exchange forwards exempted by the Secretary of the Treasury, however, would under the Dodd-Frank Act be required to be reported to a "swap data repository", or to the CFTC if no such swap data repository exists. In addition, any party to a foreign exchange swap or foreign exchange forward that is a "swap dealer" or "major swap participant" will remain subject to the business conduct standards set out in the CEA as introduced by the Dodd-Frank Act.

## 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: (1) the knowledge to quantify currency risk; and (2) affordable and accessible hedging instruments designed to mitigate currency risk. MFX has partnered with the U.S. government's Overseas Private Investment Corporation (**OPIC**) 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 to reduce currency risk for small microfinance lenders so that they can continue to serve poor entrepreneurs with very small loans to support microbusinesses. MFX gives lenders in the United States and Europe with the ability to make loans to microfinance institutions in local currency by providing foreign exchange swaps and foreign exchange forwards and options to such lenders. The currencies in which MFX provides hedging facilities are typically exotic (for example sub-Saharan Africa, Central America and Central Asia), where hedging instruments are not available from commercial financial institutions. A typical foreign exchange swap or foreign exchange forward entered into by MFX has a notional value of U.S.\$1-2 million. 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 the foreign exchange risk from its clients via a matching hedge, generally a foreign exchange swap or a foreign exchange forward, with a counterparty, which can be either TCX or a commercial bank. 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.

A key aspect of MFX's model is its collateral arrangement which is designed to reduce the burden of collateral on smaller development lenders while ensuring that all transactions are appropriately collateralized. MFX does so pursuant to a guarantee from OPIC, which guarantees the default of MFX's

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<sup>1</sup> As used in this letter, "foreign exchange forward" and "foreign exchange swap" refer to the transactions defined in Sections 1a(24) and 1a(25), respectively, of the CEA.

microfinance industry clients. MFX then assigns this guarantee as collateral on hedges with its offsetting counterparty (TCX or a commercial bank) to whom MFX offloads its foreign exchange market risk.

Despite being a very small, low risk enterprise, MFX has several peculiarities that would make it difficult for MFX to operate if foreign exchange swaps and foreign exchange forwards are not exempt from the Dodd-Frank Act's clearing requirements and Trading Facility Requirements. MFX serves a specialized market niche with clients who need foreign exchange products tailored to hedge their specific loan products. In particular, the foreign exchange swaps and forward exchange forwards MFX enters into with its clients are not of the type for which a liquid market already exists and such contracts would be difficult if not impossible to clear and comply with applicable Trading Facility Requirements. MFX's business also utilizes a specialized collateral regime based on its OPIC guarantee rather than cash or securities. If MFX's foreign exchange swaps and foreign exchange forwards are required to be 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 and ultimately possibly rendering MFX's services too expensive for its microfinance institution clients.

In addition, if foreign exchange swaps and foreign exchange forwards are not exempted from the definition of "swap" by the Secretary, MFX believes that it could be considered a "swap dealer". Compliance with the registration, reporting, and margin and capital requirements implemented pursuant to the Dodd-Frank Act will likely impose significant additional costs on MFX. As with the requirements imposed by clearing and other Trading Facility Requirements, the increased costs of compliance could render MFX's services too expensive for the microfinance institutions which rely on MFX's services.

### **3. ANALYSIS**

MFX believes the Secretary of the Treasury should consider the following factors when determining whether to exempt foreign exchange swaps and foreign exchange forwards from the definition of "swap" in the CEA.

#### **3.1 Driving foreign exchange swaps and forwards business offshore**

MFX concurs with the letter of SIFMA, AFME and ASIFMA dated November 15, 2010 (the **SIFMA Letter**) and in particular with the concern expressed in the SIFMA Letter that applying the Dodd-Frank Act to US-sourced foreign exchange swaps and foreign exchange forwards will drive the foreign exchange business offshore. As a US-based provider to clients in Europe and an exporter of financial services, MFX is keenly aware of how its business could be disrupted if clearing is applied to illiquid, customized products or if certain legitimate collateral arrangements are disallowed in the United States. The foreign exchange swap and foreign exchange forward markets for major currencies are historically the most robust swaps markets. These markets neither contributed to nor were substantially disrupted by the global financial crisis. Eliminating US-based suppliers of these products and, in MFX's case, eliminating the only specialized supplier of hedging to the microfinance industry, would be a steep price to pay, particularly because doing so would fail to address the main sources of systemic risk caused by other types of derivative transactions.

#### **3.2 The need for swaps that match the hedging needs of MFX's clients**

Foreign exchange swaps and foreign exchange forwards are, when used for hedging purposes, fundamentally designed to help a business plan future cash flows. Organizations must be able to structure their hedging specifically to match cash flows. MFX deals with lenders who provide loans to small institutions that serve the global poor. Most of these microfinance lenders do not price currency risk into

the microfinance loans they provide and therefore need hedging products that fully match their foreign currency cash flows. The loans provided by microfinance lenders can be either fixed or floating rate loans and have varying repayment and amortization schedules. They also are in a wide variety of currencies, few of which have liquid prices available for foreign exchange swaps or foreign exchange forwards. A clearing requirement that requires standardized products for ease of trading and clearing rather than customized products that meet the needs of clients would result in the inability of microfinance lenders to effectively manage their risk.

### **3.3 The need to exempt all currency swaps that are economically equivalent to foreign exchange forwards**

The need for businesses to be able to access currency swaps and other currency transactions that match their business risk means that it is important that an exemption for foreign exchange swaps and foreign exchange forwards clearly includes related and economically equivalent products that are commonly used in the foreign exchange market, notably cross-currency swaps. Section 1a(24) of the CEA defines a foreign exchange forward as "a transaction that solely involves the exchange of [two] different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange". Section 1a(25) of the CEA defines a foreign exchange swap as "a transaction that solely involves (A) an exchange of [two] different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and (B) a reverse exchange of the two currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange".

What is notable about these definitions is that a foreign exchange swap can also be defined as two foreign exchange forwards packaged together. A cross-currency swap, by contrast, exchanges a cash flow in one currency for a cash flow in another, which makes cross-currency swaps ideal for hedging the series of interest and principal payments in typical standard loan products. Like a foreign exchange swap, any cross-currency swap, whether it involves exchanging fixed or floating implied interest rates, can be constructed from a series of simple foreign exchange forward contracts.

It would therefore be impractical to try to draw a line between foreign exchange swaps and foreign exchange forwards and other products like cross-currency swaps that are simply bundles of foreign exchange forward contracts for purposes of any exemption the Secretary of the Treasury provides for such transactions. If cross-currency swaps were to be treated differently, there would be an incentive for providers to unbundle such cross-currency swap contracts for regulatory purposes. "Unbundling" would decrease the transparency of reporting such foreign exchange swaps and foreign exchange forwards making these products more confusing for customers, including MFX's clients. In addition, treating cross-currency swaps differently from its component foreign exchange forwards could also promote arbitrage between markets where foreign exchange swap products are unbundled and those where they are bundled. In addition, by adding complexity and uncertainty to the market, such a distinction between cross-currency swaps and foreign exchange swaps and foreign exchange forwards could drive business offshore without actually achieving the goal of regulation and risk reduction. As such, MFX urges the Secretary of the Treasury to ensure that products such as cross currency swaps and other similar currency transactions are treated the same for purposes of any exemption for foreign exchange transactions from the CEA.

### **3.4 The difficulty of standardizing collateral in a clearing house**

Centralized clearing would establish industry-wide benchmarks for collateral requirements but with significant constraints on the flexibility of organizations to price and structure deals to suit individual requirements. MFX trades in highly illiquid currencies which would be difficult to standardize for

collateral purposes. Also, as part of its public policy mission, MFX uses an open guarantee from OPIC in lieu of collateral. The availability of this OPIC guarantee as collateral is the key to making the foreign exchange swaps and foreign exchange forwards affordable for microfinance lenders while insuring the same risk reduction as standard cash collateralization. However, in a standardized clearing house environment this innovation would likely not be tolerated. Looking beyond the lack of flexibility, centralized clearing would add a further significant cost to many of MFX's transactions and could undermine MFX's mission to help development lenders adopt better risk management practices using hedging. This is because highly illiquid markets with few participants willing to carry market risk could have very volatile valuations and require very high levels of collateral that are not commensurate with the actual risk in a diversified, netted portfolio of positions.

It should be noted that MFX does not oppose basic standards for collateral levels as long as such standards take into account the effect of netting and currency diversification on reducing potential counterparty exposure. However, given the difficulty of implementing a one-size-fits-all collateral regime via a clearing system and the strong record of collateralization in these markets to date, MFX believes that it is not necessary to include foreign exchange swaps and foreign exchange forwards in the sections of the CEA which apply to collateral.

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MFX appreciates the ability to provide its comments on "foreign exchange swaps" and "foreign exchange forwards" in respect of the Secretary of the Treasury's authority to exempt such transactions from the definition of "swap" in the CEA. Please feel free to contact me or others at MFX at your convenience with any questions.

Sincerely,



Brian Cox  
Executive Director