The Derivative Project

February 17, 2011

Joint CFTC-SEC Advisory Committee
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File No. 265– 26

Dear Joint CFTC-SEC Advisory Committee Members:

In accordance with Federal Register announcement dated February 3, 2011, we appreciate the opportunity to submit written comment for your joint meeting to be held February 18, 2011.

The Derivative Project is a U.S. taxpayer advocacy and individual investor organization, trained in end-user over-the-counter derivative risk management and counter party credit risk management at a major U.S. Bank.

We respectfully request that your joint committee address the following questions and provide thorough answers, so U.S. taxpayers may provide well-informed comments to their Congressional representatives for input to the House Financial Services Committee and Senate Banking Committee on implementation of Dodd-Frank regulations.

It has been brought to our attention that false information on the economics of Dodd-Frank regulation was submitted in written testimony by a "consulting firm Keybridge."[1]

We respectfully request that the committee not only determine, obtain and present to the U.S. taxpayer the underlying correct facts presented in the Keybridge Research Report but simultaneously provide answers to the following questions, that is critical information for every U.S. taxpayer, in the short and long term future of our economy.

Summary

It is our understanding that there are only an approximate 10% of over-the-counter derivative contracts traded by the top five major derivative banks, as defined by the Office of the Comptroller of the Currency (OCC) that are executed on behalf of end users. Further, it has come to our attention that numerous lawsuits have been brought against "custody banks" for "price gouging" in the over-the-counter foreign exchange

[1] *The New York Times*, **Deceptive Lobbying on Derivatives**, February 16, 2011

markets.[2]

There are major systemic risk concerns with implementation of clearinghouses for over-the-counter derivatives.[3]

Given these four critical factors:

- Temptation for "price gouging" the end user, when there is not a regulated futures exchange that permits ongoing price discovery and unnecessary costs to a judicial system in hearing these claims against derivative dealers
- Close to 80% of all over-the-counter derivative contracts are used for speculation and not to meet end user needs
- Significantly greater regulatory costs to the U.S. taxpayer for the monitoring of systemic risk that over-the-counter derivative contracts present
- Increased systemic risk for the U.S. taxpayer, moral hazard and probable repeat use of U.S. taxpayer dollars to bail out the large over-the-counter derivative dealer, as was the case with AIG when the U.S. government insisted the U.S. taxpayer pay AIG and its counterparties over $182 billion for failed speculative over-the-counter derivative trades in credit default swaps.

Therefore, it is imperative the Committee provide detailed rationale and facts to the following questions that directly impact U.S. taxpayer revenue allocations:

What are the regulatory costs[4] to monitor the systemic risk for all over-the-counter derivative contracts that are not used by end users, by contract type?

- Credit Default Swaps
- Interest Rate Swaps
- Foreign exchange Spot, Forward and Swap Contracts

How would the regulatory costs decrease for the U.S. taxpayer if credit default swaps and interest rate swaps were moved to a regulated futures exchange and eliminated in the form of an over-the-counter derivative contract? We propose the consideration that futures contracts be created, in lieu of OTC derivative contracts, whenever feasible for the end user or derivative dealer, as examined and determined by parties outside the derivative dealer community. We respectfully request this study be done on behalf of all

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[2] *Wall Street Journal*, **Suspicion of Price Gouging**, February 10, 2011

[3] *Wall Street Journal,* **Another Dodd- Frank Triumph, Did We Mention Its New Source of Systemic Risk,** February 16, 2011

[4] Regulatory costs must be defined by the Joint Committee and are to include costs to regulate and monitor proposed OTC derivative clearinghouses, OCC costs to monitor and track OTC derivative contracts, technological systems to monitor and control "systemic risk", SEC and CFTC staff to monitor over-the-counter contracts and other factors not known to the U.S. taxpayer

U.S. taxpayers, by an independent source, as defined and agreed to by a U.S. taxpayer advocate, such as The Derivative Project.

Define for the U.S. taxpayer when "custom" over-the-counter contracts are "really" needed due to the additional regulatory burden placed on the U.S. taxpayer of OTC contracts in lieu of contracts that trade on a regulated exchange. .

End users, such as importers and exporters, need to hedge payables and receivables for a specific amount and a specific date, thus making it difficult to have a "perfect hedge" through a standardized FX futures contract that trades on a regulated exchange. However, in general, interest rate and credit default swaps can very easily utilize standardized contracts, because by definition, they do not require specific contract amounts and dates.

We respectfully request that the Joint Committee delineate by type of over-the-counter derivative contract for the U.S. taxpayer what circumstances necessitate "custom OTC contracts." For example, credit default swaps, used to hedge a 'credit event" do not require a fixed date, nor a specific dollar amount. Why does the U.S. taxpayer have to bear the systemic risk for clearing houses and increased regulatory costs for credit default swaps, when they do not require "custom" terms and could easily be moved to a regulated futures exchange?

Bloomberg[5] reported on Monday that Dodd Frank regulatory costs might approximate $6.5 billion.

- What percent of that amount is for monitoring OTC derivative contracts?
- What amount can be saved for U.S. taxpayers, by moving OTC contracts to regulated exchanges, that do not require custom contract specifications, such as those required by end users in foreign exchange hedges?
- Why should the U.S. taxpayer be responsible for these regulatory costs when over 80% of the regulatory costs go to monitor speculative trades by the five major derivative banks?
- Should the major derivative dealers pay a "speculation tax" if Congress continues to allow speculative over-the-counter derivatives trades that have nothing to do with end user hedging needs?
- What other industry does Congress allow, that presents systemic risk to the U.S. taxpayer, to exist, without recouping costs for monitoring potentially harmful activity to the U.S. taxpayer?

Conclusion

The over-the-counter derivative markets originally developed as an inter-bank market between major global commercial banks to hedge end users foreign exchange exposures

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[5] *Bloomberg,* **Dodd-Frank May Cost $6.5 Billion and 5000 Workers**, February 14, 2001

with the advent of the Bretton Woods treaty. These markets were efficient, based on self-regulation between the commercial banks. It is apparent there is no longer self-regulation. Why should the U.S. taxpayer be burdened with these regulatory costs, when they derive no income from the trades?

With the calamitous events of the 2007-2008 financial crisis, it is now incumbent on this Joint Committee to examine the role of over-the-counter derivatives in our capital markets, including a detailed analysis of the pros and cons of the use of these OTC contracts, by type, for the U.S. taxpayer and our economy overall.

Please delineate for the U.S. taxpayer, in an environment of large deficits, the cost/benefit of the allocation of $6.5 billion in regulatory costs. What is the IRR of this $6 billion investment in government staff, technology and procedures in lieu of investment in infrastructure and jobs outside the government sector?

What are the costs to our judicial system for lawsuits deriving from price gouging in the over-the-counter markets, where there is no price transparency? Why is it not more cost effective for the U.S. taxpayer to move these contracts to regulated exchanges, to ensure price transparency and minimize future judicial costs?

In sum, is the U.S. taxpayer better off in the long haul, will our GDP grow at a faster, more sustainable rate, if Congress makes the call that we as a society will move away from government spending to monitor an industry based on $600 trillion in speculation?

The answer to the increased regulatory costs is to eliminate the issue that requires the increase in costs, which in this instance is quite simple and feasible. In the preponderance of the cases, futures contracts can easily replace over-the-counter derivatives, saving the U.S. taxpayer close to $6 billion dollars in regulatory costs and future judicial costs resulting from lack of price transparency. It is just not what the large derivative banks want. These lost revenues will serve to shrink their bonus pool. It is incumbent on the Joint Committee to detail the facts for Congress and the U.S. taxpayer on why these contracts cannot be moved to regulated futures exchanges and why the U.S. taxpayer must allocate scarce resources to monitor speculative trades for five large derivative dealer banks.

The U.S. taxpayer does not want any more misleading reports, such as the Keybridge Research report. Congress and this Joint Committee have the duty to ensure the facts are true and correct if they are going to rule on U.S. taxpayer costs of this magnitude.

The past two decades have seen our GDP grow from 15% revenues from financial services to close to 30% financial services revenue in fiscal year 2010. In the short run, loses in GDP income are difficult for all sectors, but at some point this unhealthy dependency on a GDP that is based on financial services speculation income, in lieu of sustainable growth industries, such as technology, must be reckoned with.

Ineffective allocations of billions of dollars in unnecessary regulatory dollars are no longer affordable with close to 10% unemployment. There is a feasible alternative, replace over-the-counter derivative contracts with regulated futures exchange contracts.

Thank you for the opportunity to submit these comments.

Sincerely,

Susan O. Seltzer
President
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