The World Bank
Washington, D.C. 20433
U.S.A.

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Commissioner Jill Sommers
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Dear Commissioner Sommers:

International Bank for Reconstruction and Development,
International Finance Corporation, and Other Multilateral
Development Institutions in which the United States is a Member –
Use of Derivatives and Basis for Exclusion from the Dodd-Frank Act

Thank you for meeting with a delegation from the International Bank for Reconstruction and Development ("IBRD" or "Bank") and the International Finance Corporation ("IFC") on March 22, 2011 to discuss implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). IBRD and IFC are international, intergovernmental organizations formed, owned, and controlled by 187 and 182 sovereign members, respectively. The United States is the largest shareholder of each institution. IBRD and IFC use derivatives to manage risk and extract the maximum value from the capital entrusted to them by their members. For the reasons described below, the use of derivatives by IBRD and IFC should continue to be authorized, monitored, and controlled by their sovereign members on a collective basis, rather than through national legislation and regulation.

While this letter focuses on IBRD and IFC, it is being submitted on behalf of all multilateral development institutions in which the United States is a member (collectively, the "MDBs").[1] While some of the specific examples provided below relate to IBRD and IFC

[1] As set forth in 22 U.S.C. §262r(c)(2), (3), and (4), the term "multilateral development institutions" includes IBRD, European Bank for Reconstruction and Development, International Development Association, IFC, Multilateral Investment Guarantee Agency, African Development Bank, African Development Fund, Asian Development Bank, Inter-American Development Bank, Bank for Economic Cooperation and Development in the Middle East and North Africa, and Inter-American Investment Corporation. Not all of these institutions currently use derivatives in their development operations, or do so only on a limited basis. For example, International Development Association, the concessional lending arm of the World Bank Group, engages in limited transactions with IBRD (as its sole current counterparty) to ensure that sovereign donor contributions in multiple currencies are not eroded by foreign exchange movements. Nevertheless, the principles set forth in this letter should apply to all multilateral development institutions. (One caveat: our understanding is that the Bank for Economic Cooperation and Development in the Middle East and North Africa has never become effective, notwithstanding the authorization for United States membership reflected in the above statutory citations.) While the term MDB is used herein as an abbreviation due to its familiarity, the requested relief encompasses all multilateral development institutions as set

operations and activities, the overall analysis applies to all MDBs. All of the MDBs share the same fundamental mission: to promote economic development and reduce poverty in developing countries. Within the World Bank Group, IBRD provides loans to middle income countries, IFC provides loans to and makes equity investments in private sector entities across the developing world, and International Development Association provides concessional lending in the form of credits and grants to the poorest countries. Some of the other MDBs have a regional focus. However, all of the MDBs are focused on promoting better economic prospects for the billions of people who still live in poverty in the developing world. The MDBs are a critical part of the post-World War II financial system created by the United States and other sovereigns.

As described in more detail below, we request that the CFTC and the SEC use their definitional authority under the Dodd-Frank Act to clarify the definitions of "swap" and "security-based swap" as used in the Commodity Exchange Act and Securities Exchange Act of 1934, respectively, to exclude any agreement, contract, or transaction a counterparty of which is a multilateral development institution as defined in 22 U.S.C.§262r(c)(3).

1. IBRD, IFC, and Other MDBs Use OTC Derivatives for Risk Management Purposes: IBRD, IFC, and other MDBs use over-the-counter ("OTC") derivatives to hedge currency, interest rate, and other market risks in lending, borrowing, equity management, and investment operations, and to provide equivalent risk management tools to clients in developing countries and other official sector institutions. For example, IBRD, IFC, and other MDBs are able to borrow in currencies and interest bases that offer the lowest possible cost, and then on-lend to countries and other clients in the currencies and interest bases that match these countries' and clients' needs through the use of derivatives that hedge interest rate and currency risk. These risk management transactions are integral to the development operations of IBRD, IFC, and other MDBs – indeed, it is difficult to imagine how any of these institutions could operate effectively in a multi-currency, floating rate environment *without* the use of OTC derivatives.[2] *IBRD, IFC, and the other MDBs use derivatives for such hedging purposes and do not engage in speculative transactions.*

Furthermore, IBRD, IFC, and the other MDBs have the capacity to effectively manage OTC derivatives operations. IBRD executed one of the first international cross-currency swaps in 1981 and has been active in the derivatives market for three decades. Over the years, IBRD has supported market initiatives to manage risk, including its own role in requiring even highly-rated major market counterparties to collateralize trades undertaken with itself and other MDBs. IBRD, IFC, and the other MDBs have developed the necessary capabilities for managing the risks associated with OTC derivatives, including transaction valuation tools and collateral management operations. As further examples, IBRD and IFC have independent legal units that ensure that appropriate legal agreements are in place prior to trading, and both institutions have

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forth in 22 U.S.C. §262r(c)(3), so as to cover the Multilateral Investment Guarantee Agency, a member of the World Bank Group.

[2]Beyond lowering borrowing costs and providing risk management solutions to clients, the use of derivatives by MDBs also allows them to further local bond market development, another objective of the G20.

independent risk management units that set and monitor commercial counterparty credit exposure.

Finally, IBRD, IFC, and the other MDBs are wholly owned by their sovereign shareholders; there are no equity shares held by individuals or financial institutions. Furthermore, there are no substantial bonuses or differential compensation arrangements that depend on financial performance. Thus, neither management nor staff of these institutions has any individual financial incentive to undertake undue risk.

2. *IBRD, IFC, and Other MDBs Operate Under an Effective Collective Governance System:* IBRD was established in 1945 and set the model for international development organizations. IBRD and IFC have resident Boards, with all members appointed or elected by their sovereign shareholders, including the United States. The resident Boards (and the Audit Committee thereof) have in-depth familiarity with, and oversight authority over, IBRD's and IFC's financial operations. Among other responsibilities, the Boards authorize all categories of derivatives use by IBRD and IFC, and receive regular reports on treasury and risk management operations.

From the 1944 Bretton Woods Conference on, IBRD and subsequent MDBs have been operated on a collective governance model, as the most appropriate framework for international, intergovernmental organizations. In particular, the founding members recognized that being subject to regulation under a variety of potentially conflicting national laws and regulations would be inefficient at best, and crippling at worst. From the outset, sovereign members codified these principles by granting certain privileges and immunities to IBRD and IFC in their respective Articles of Agreement (and to other MDBs in their equivalent organizational agreements). All member governments have agreed to accept and implement the privileges and immunities of IBRD and IFC in domestic law, as the United States has done in the Bretton Woods Agreements Act (22 U.S.C. §286) and the International Finance Corporation Act (22 U.S.C. §282), as further supplemented by the International Organizations and Immunities Act (22 U.S.C. §288) and the Foreign Sovereign Immunities Act (28 U.S.C. §1602). Equivalent arrangements are in place for the other MDBs.[3]

The collective governance arrangement has stood the test of time. IBRD, IFC, and the other MDBs have been able to operate effectively and efficiently on a global basis with the benefit of both the privileges and immunities described above and with the understanding of the United States and other governments that national regulatory regimes were not intended to apply to the activities of international organizations. In the United States, the securities of IBRD and IFC are "exempted securities" under the Securities Act of 1933 and the Securities Act of 1934,[4] as are the securities of other MDB issuers. In 1955, the SEC confirmed in writing (immediately

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[3] See, e.g., 22 U.S.C. §283 (Inter-American Development Bank Act), 22 U.S.C. §283aa (Inter-American Investment Corporation Act), 22 U.S.C. §284 (International Development Association Act), 22 U.S.C. §285 (Asian Development Bank Act), 22 U.S.C. §290g (African Development Fund), 22 U.S.C. §290*i* (African Development Bank Act), 22 U.S.C. §290*k* (Multilateral Investment Guarantee Agency Act), 22 U.S.C. §290*l* (European Bank for Reconstruction and Development Act), and 22 U.S.C. §290*o* (Bank for Economic Cooperation and Development in the Middle East and North Africa Act).

[4] See 22 U.S.C. §282k and 22 U.S.C. §286k-1.

prior to the passage of the International Finance Corporation Act) that IFC (like IBRD before it) was not the type of organization that Congress intended to subject to regulation under the Investment Company Act of 1940. In 2001, the SEC exempted the IBRD and International Development Association from regulation under the Investment Advisers Act of 1940, for similar reasons.

The EU has a similar, consistent record of regulatory forbearance, expressly exempting MDBs from the recent Prospectus Directive and Transparency Directive. Perhaps more salient for the current discussion, the proposed European Market Infrastructure Regulation – which is intended to serve as the European counterpart to Title VII of the Dodd-Frank Act – expressly excludes "multilateral development banks" such as IBRD and IFC from its coverage.

3. The CFTC and the SEC Should Exclude IBRD, IFC, and the other MDBs from Regulation under Title VII of the Dodd-Frank Act: If the Dodd-Frank Act were interpreted to impose national regulation on the activities of IBRD, IFC, and other MDBs, this would represent an unprecedented intrusion on the internal operations of these international, intergovernmental organizations, and a clear deviation from the pattern of the last 65 years. Moreover, it is not apparent how such an interpretation could be reconciled with the international obligations of the United States under the Articles of Agreement of IBRD and IFC and the constitutional documents of other MDBs, as well as the United States statutory implementations thereof. Our view is that the most efficient and effective mechanism for dealing with this issue is for the CFTC and the SEC to define the terms "swap" and "security-based swap" to exclude transactions with MDBs of which the United States is a member.

The CFTC and the SEC Have a Mandate and the Authority Under the Dodd-Frank Act to Further Define Terms Such as "Swap" and "Security-Based Swap": Section 712(d)(1) of the Dodd-Frank Act expressly directs the CFTC and other relevant agencies to further define the terms "swap" and "security-based swap", implicitly recognizing that the current definitions are not complete and comprehensive:

> Notwithstanding any other provision of this title and subsections (b) and (c), the Commodity Futures Trading Commission and the Securities and Exchange Commission, in consultation with the Board of Governors, shall further define the terms "swap" [and] "security-based swap" . . . .

Section 712(d)(2)(A) of the Dodd-Frank Act provides further authorization regarding definitions to the CFTC and the other relevant agencies:

> Notwithstanding any other provision of this title, the Commodity Futures Trading Commission and the Securities and Exchange Commission, in consultation with the Board of Governors, shall jointly adopt such other rules regarding such definitions as the Commodity Futures Trading Commission and the Securities and Exchange Commission determine are necessary and appropriate, in the public interest, and for the protection of investors.

As the introductory language to each of the provisions quoted above makes clear, the authority of the CFTC and the SEC to define such terms is not subject to any other provisions or limitations in Title VII. Moreover, the definitions of "swap" and "security-based swap" – which Congress expressly directed the SEC and the CFTC to further define – already include exclusions for transactions by certain official sector entities. To the extent that the CFTC and the SEC determine that additional official sector entities were not intended to be covered by Title VII, the definitions of "swap" and "security-related swap" provide the most appropriate vehicle for codifying this conclusion. To the extent that Section 712(d)(2)(A) is relevant, we believe that the facts set forth elsewhere in this letter make the case that the public interest would best be served by facilitating the developmental and poverty reduction missions of the MDBs under the current collective governance model.

Finally, as evidenced by the SEC interpretations of the Investment Company Act of 1940 and the Investment Advisers Act of 1940 referenced above, there is no need for a statute to include an explicit exemption for MDBs for the relevant regulator to reach a conclusion that the statute was not intended to reach the activities of such international, intergovernmental organizations.

The CFTC and the SEC Should Exercise Their Discretion in a Manner That is Consistent With Existing Law and United States Obligations: As noted above, the United States is a signatory to the Articles of Agreement of IBRD and IFC, and the equivalent organizational documents of the other MDBs. To take IBRD as an example, Article VII of IBRD's Articles of Agreement establishes the "Status, Immunities, and Privileges" of IBRD (referred to as "the Bank" in its Articles). Article VII, Section 4 ("Immunity of Assets from Seizure") provides that "Property and assets of the Bank, wherever located and by whomsoever held, shall be immune from search, requisition, confiscation, expropriation or any other form of seizure by executive or legislative action." Article VII, Section 5 ("Immunity of Archives") provides that "The archives of the Bank shall be inviolable." Article VII, Section 6 ("Freedom of Assets from Restriction") provides that "To the extent necessary to carry out the operations provided for in this Agreement and subject to the provisions of this Agreement, all property and assets of the Bank shall be free from restrictions, regulations, controls and moratoria of any nature." Article VII, Section 3 ("Position of the Bank with Regard to Judicial Process") provides that "No actions shall . . . be brought by members or persons acting for or deriving claims from members." Article VII also sets forth a number of other privileges and immunities of IBRD, and concludes with Section 10 ("Application of Article"), which provides that "Each member shall take such action as is necessary in its own territories for the purpose of making effective in terms of its own law the principles set forth in this Article and shall inform the Bank of the detailed action which is has taken." IFC's Articles of Agreement include substantively identical provisions,[5] as do the organizational documents of the other MDBs.

The United States fulfilled its obligations under Article VII, Section 10 by passing into law the Bretton Woods Agreements Act in 1945. The Bretton Woods Agreements Act expressly provides as follows:

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[5] See Article VI, Sections 4, 5, 6, and 10, as well as the other privileges and immunities provided therein.

> The provisions of . . . article VII, sections 2-9, both inclusive, of the Articles of Agreement of the Bank, shall have full force and effect in the United States and its Territories and possessions upon acceptance of membership by the United States in, and the establishment of . . . the Bank. (22 U.S.C. §286h)

The International Finance Corporation Act provides the same codification for IFC.[6] As noted above, the implementation of these privileges and immunities is further supplemented by the International Organizations and Immunities Act and the Foreign Sovereign Immunities Act. Furthermore, the constitutional documents of the other MDBs include equivalent privileges and immunities, to which the United States has agreed and implemented under its laws.[7]

In our view, application of Title VII of the Dodd-Frank Act to IBRD, IFC, and the other MDBs would be inconsistent with existing US law and international obligations, as detailed above. To take the most obvious example, regulatory inspection powers seem flatly inconsistent with Article VII, Sections 4 and 5 of IBRD's Articles of Agreement and equivalent provisions in the constitutional documents of other MDBs. To take another obvious example, IBRD, IFC, and the other MDBs are facing increased global demand for financing in the wake of the financial crisis, and their core development functions could be impaired by the imposition of national regulatory capital requirements. Potential national regulation of capital usability strikes at the heart of the governance issue raised above: in effect, a regulator in one country could override the judgment of as many as 186 other sovereigns regarding the appropriate use of the taxpayer-funded capital that such sovereigns have contributed to the MDBs over the years, or that they may contribute in the future in connection with pending selective or general capital increases at several MDBs. These are by no means the only examples of potential conflicts, but we believe that they make our concerns clear.

There is no evidence that Congress intended such a result. In the absence of explicit Congressional instructions to the contrary, we believe that the CFTC and the SEC should use their definitional authority to interpret the Dodd-Frank Act in a manner that is consistent with decades of United States legislation and the international agreements of the United States in respect of IBRD, IFC, and the other MDBs. As noted above, there are regulatory precedents for concluding that financial regulatory statutes were not intended to apply to international organizations, even in the absence of explicit statutory exemptions.

The CFTC and the SEC Should Exercise Their Implementation Authority in a Manner That is Consistent with International Regulatory Standards: Section 752(a) of the Dodd-Frank Act provides that CFTC and the SEC shall "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation . . . of swaps [and] security based swaps . . ." As noted above, the EU's draft

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[6] See 22 U.S.C. §282g

[7] See, e.g., 22 U.S.C. §283g (Inter-American Development Bank Act), 22 U.S.C. §283hh (Inter-American Investment Corporation Act), 22 U.S.C. §284g (International Development Association Act), 22 U.S.C. §285g (Asian Development Bank Act), 22 U.S.C. §290g-7 (African Development Fund), 22 U.S.C. §290*i*-8 (African Development Bank Act), 22 U.S.C. §290*k*-10 (Multilateral Investment Guarantee Agency Act), and 22 U.S.C. §290*l*-6 (European Bank for Reconstruction and Development Act).

European Market Infrastructure Regulation (the "Regulation") has already considered the status of MDBs. Article 1(4) of the Regulation states that "This Regulation shall not apply to . . . multilateral development banks. . ." This exclusion – which covers other official sector institutions as well – is explained in an introductory clause as being justified "in order to avoid limiting their power to perform their tasks of common interest," consistent with the analysis set forth above. This follows well-settled precedents in previous EU rules that excluded MDBs, including the recent Prospectus Directive and Transparency Directive. In accordance with Section 752(a) of the Dodd-Frank Act, the CFTC and the SEC should use their implementing authority to exclude MDBs from regulation, in order to ensure consistent international standards in respect of the regulation of swaps.

4. Excluding IBRD, IFC, and other MDBs from Regulation Under Title VII Would Not Create Systemic Risk or Impair the CFTC's Ability to Regulate the Derivatives Market: Excluding transactions entered into by IBRD, IFC, and other MDBs from the definition of "swap" and "security-based swap" would have both direct and indirect effects. IBRD, IFC, other MDBs, and their transactions would not be subject to mandatory clearing, collateralization, and capital requirements. For all of the reasons set forth above, we believe that MDBs have the capacity to effectively manage OTC derivatives transactions on a prudent basis, subject to continuing collective oversight by sovereign shareholders.

We acknowledge that the exclusion of transactions entered into by IBRD, IFC, and other MDBs from the definition of "swap" and "security-based swap" would also have indirect effects on our counterparties – e.g., counterparties would not be required to centrally clear transactions with MDBs. For a variety of reasons, we do not believe that these indirect effects should present any material regulatory concerns. All MDBs have robust capital structures and backing from sovereign shareholders. MDBs are among the safest counterparties in the markets, as recognized by the low risk weightings assigned to transactions with MDBs by banking regulators under the Basel II framework and the high ratings assigned by credit rating agencies. While MDBs are an important part of the international financial system, the aggregate volume of derivatives transactions involving MDBs are not so large as to create systemic risk in the market (and are far smaller than the volume of transactions already exempted from the Dodd-Frank Act).

Furthermore, the level of indirect counterparty effects is likely to be relatively limited. MDBs are not opposed to central clearing *per se*, and may end up voluntarily clearing many transactions (as may exempt end users). There is no reason to believe that exchanges will set up separate systems for such transactions, so voluntarily cleared transactions should be subject to the same rules as mandatorily cleared transactions. Moreover, it is not likely that counterparties of MDBs will set up separate reporting systems for MDB transactions, so the reporting to the commissions is likely to be unaffected. Overall, we do not believe that excluding a relatively limited slice of carefully managed transactions by official sector entities from the definitions of "swap" and "security-based swap" would present any material risks to the MDBs, the commercial counterparties of the MDBs, or the financial system as a whole.

5. Summary: IBRD, IFC, and other MDBs use OTC derivatives in a responsible manner, subject to appropriate risk management measures and under the oversight of sovereign shareholders. The collective governance mechanism for international organizations has worked well for over 65 years, and there is no evidence that the Dodd-Frank Act was intended to alter this arrangement in any way. The derivatives activities of the MDBs account for a fraction of a multi-trillion dollar market, and do not represent any real risk to the international financial system. Accordingly, the Dodd-Frank Act should be implemented in a manner that excludes IBRD, IFC, and other MDBs. We have attached for your consideration the proposed text of a definition of the term "swap" under section 1a(47) of the Commodity Exchange Act that would exclude transactions with MDBs.

Based on the discussion at the March 22 meeting, our understanding is that this letter will be considered confidential. We look forward to discussing this matter further with you and your colleagues, at which point we may further supplement the information set forth herein.

Sincerely,

John F. Gandolfo,
Acting Vice President & Treasurer

Attachment

Potential Exclusion to the Definition of Swap

Commodity Exchange Act § 1a(47)

(47) Swap.—

(A) In general.—Except as provided in subparagraph (B), the term "swap" means any agreement, contract, or transaction—

(i) . . .

(B) Exclusions.—The term "swap" does not include—

(i) . . .

(xi) any agreement, contract, or transaction a counterparty of which is a multilateral development institution, as defined in section 1701(c)(3) of the International Financial Institutions Act (22 U.S.C. 262r(c)(3)).