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Department of Treasury Proposes to Exempt FX Swaps and FX Forwards from the definition of “swap” under the Commodity Exchange Act

On April 29, 2011, the Department of the Treasury (the “Treasury”) issued a Notice of Proposed Determination (the “Proposed Determination”) to exempt foreign exchange swaps (“FX Swaps”) and foreign exchange forwards (“FX Forwards”) from the definition of “swap” under the Commodity Exchange Act (the “CEA”). Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) introduced a comprehensive set of reforms of the over-the-counter derivatives markets intended to reduce risk, increase transparency and provide accountability for market participants. These reforms include real-time public reporting of swap trade data, mandatory central clearing and exchange trading of eligible swaps, capital and margin requirements applicable to swaps, and business conduct rules. The Proposed Determination would exempt FX Swaps and FX Forwards from many of these requirements.

Background

Section 721 of the Dodd-Frank Act amends section 1a of the CEA to define the term “swap” (which definition includes FX Swaps and FX Forwards) and specifically authorizes the Secretary of the Treasury to make a written determination that FX Swaps, FX Forwards, or both, (i) should not be regulated as “swaps” under the CEA and (ii) are not structured so as to avoid any rules promulgated by the Commodity Futures Trading Commission under the Dodd-Frank Act.¹ On October 28, 2010, the Treasury published a Notice and Request for Comments² on issues relating to the exemption of FX Swaps and FX Forwards from the definition of “swap” under the CEA. The comments received reflected strong public support for such an exemption.

Scope of Exemption

The Secretary of the Treasury’s authority to issue a determination to exempt derivatives from the definition of “swap” under the CEA is limited to FX Swaps and FX Forwards. FX Swap and FX Forward are narrowly defined under Section 721 of the Dodd-Frank Act.

- **FX Swap** is defined to mean a transaction that involves (i) a physical exchange of two different currencies on a specific date and at a fixed rate that is agreed to at the

¹ See section 1a(47)(E)(i) of the CEA, section 721(a)(21) of the Dodd-Frank Act.

² See 75 FR 66426 (October 28, 2010).

inception of the trade, and (ii) a reverse exchange of the same two currencies on a later date and at a fixed rate that is also agreed to at the inception of the trade.³

- **FX Forward** is similarly defined to mean a physical exchange of two different currencies on a specific date and at a fixed rate that is agreed to at the inception of the trade.⁴

Other types of derivatives, including other foreign exchange derivatives such as currency swaps and non-deliverable forwards, may not be exempted from the definition of “swap”. FX Swaps and FX Forwards will remain subject to real-time public reporting of swap trade data, business conduct standards applicable to swap dealers and major swap participants, and anti-fraud and anti-manipulation provisions under the Dodd-Frank Act.⁵

Considerations

Pursuant to section 1b of the CEA, the Secretary of the Treasury is required to consider the following factors in making the determination whether to exempt FX Swaps and FX Forwards from the definition of “swap”:

- whether the required trading and clearing of FX Swaps and FX Forwards would create systemic risk, lower transparency, or threaten the financial stability of the U.S.;
- whether FX Swaps and FX Forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps;
- the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements;
- the extent of adequate payment and settlement systems; and
- the use of a potential exemption of FX Swaps and FX Forwards to evade otherwise applicable regulatory requirements.

Systemic Risk, Financial Stability and Transparency – In the Proposed Determination, the Secretary of the Treasury justifies the exemption of FX Swaps and FX Forwards based upon the unique characteristics of these products and the markets in which they are traded. Payment obligations under FX Swaps and FX Forwards are physically settled, fixed upon entry into the trade and do not vary based on actual changes in the exchange rate. The mark-to-market value of FX Swaps and FX Forwards may vary based on changes in the market but actual settlement amounts remain unchanged. All payment obligations are known at the outset of the trade. Payment obligations of other derivatives fluctuate with the market. Due to the physical settlement of FX Swaps and FX Forwards, the primary risk in these markets is the risk that one party will not deliver the currency it owes to its counterparty (settlement risk). Settlement risk is addressed by the extensive use of payment-versus-payment (“PVP”)

³ See section 1a(25) of the CEA, section 721(a)(12) of the Dodd-Frank Act.

⁴ See section 1a(24) of the CEA, section 721(a)(12) of the Dodd-Frank Act.

⁵ See sections 1a(47)(E)(iii), (iv) and section 1b(c) of the CEA, sections 721(a)(21) and 722(h) of the Dodd-Frank Act.

settlement arrangements in the FX Swap and FX Forward markets. In contrast, the primary risk facing other types of derivatives is the risk that a party will default on its obligations (counterparty credit risk). Counterparty credit risk is lessened in the FX Swap and FX Forward markets by the significantly shorter duration of these contracts as compared to other types of derivatives and the widespread use of bilateral agreements such as the ISDA Master Agreement (the "ISDA") and the Credit Support Annex to the ISDA. FX Swaps and FX Forwards already trade in a highly liquid, transparent market. Pricing is readily available from a number of sources and a great number of trades are already executed on electronic platforms. The Secretary of the Treasury is of the view that mandating central clearing of FX Swaps and FX Forwards will not increase the financial stability of an already stable market.

Regulatory Scheme Comparable to that of the CEA – The predominant system used for settlement of FX Swaps and FX Forwards, CLS Bank International ("CLS"), is overseen by a committee consisting of 22 central banks, with the Federal Reserve acting as primary regulator. These regulators have established tests that reduce credit, market and liquidity risks associated with FX Swaps and FX Forwards and encourage the use of master netting agreements and credit support annexes to further reduce counterparty credit risk. The Secretary of the Treasury believes that the applicable regulatory regimes yield comparable regulations to those mandated under the Dodd-Frank Act.

Adequacy of Oversight – The Secretary of the Treasury highlights that activity in the FX Swap and FX Forward markets, unlike in the markets for other derivatives, is dominated by banks or bank affiliates currently subject to comprehensive oversight by central banks and prudential regulators. Approximately 95% of FX Swap and FX Forward transactions occur between banks acting either on their own behalf or as agent on behalf of their clients. These banks have access to CLS and are uniquely positioned to provide the liquidity required by these physically settled trades. Prudential supervisors regularly monitor the activities, internal controls, risk management and exposures of banks in the FX Swap and FX Forward markets and actively take steps to mitigate risk (e.g. by imposing capital and margin requirements on market participants).

Adequacy of Payment and Settlement Systems – In the Proposed Determination, the Secretary of the Treasury concludes that the widespread use of PVP settlement arrangements virtually eliminates the settlement risk associated with FX Swaps and FX Forwards. These settlement arrangements are the functional equivalent of escrows and provide for the transfer of one currency only if the transfer of the other currency also takes place. CLS settles 17 currencies which account for 94% of daily FX Swap and FX Forward trading volume.

Possible Use of Exemption to Evade Regulatory Requirements – The Secretary of the Treasury is of the belief that due to the narrow definitions of FX Swap and FX Forward in the CEA, avoidance of regulation under the Dodd-Frank Act through creative structuring of transactions is unlikely.

Looking Forward

Comments on the Proposed Determination must be received by the Treasury on or before June 6, 2011. The Secretary of the Treasury must notify the appropriate committees of

Congress, including the Committee on Agriculture, Nutrition, and Forestry of the Senate and the Committee on Agriculture of the House of Representatives, of a final determination to exempt FX Swaps and FX Forwards from the definition of “swap” under the CEA.⁶ Upon issuance of a final written determination, FX Swaps and FX Forwards will not be subject to the central clearing and exchange trading requirements under the Dodd-Frank Act. These products will remain subject to the trade reporting requirements, anti-fraud and anti-manipulation provisions and the enhanced anti-evasion authority under the Dodd-Frank Act.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. For questions or further information concerning the issues addressed in this memorandum, please contact Manuel S. Frey ((212) 373-3127), or Elanit A. Snow ((212) 373-3673).

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⁶ See section 1a(47)(E)(ii) of the CEA, sections 721(a)(21) of the Dodd-Frank Act.