

May 4, 2011

Dodd-Frank: Treasury Secretary Proposes to Exempt FX Swaps and Forwards

Overview

On April 29, 2011, the Department of the Treasury (“Treasury”) issued a notice of proposed determination (“Proposed Determination”) that would exempt both foreign exchange (“FX”) swaps and forwards from the definition of “swap” under the Commodity Exchange Act (“CEA”) as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

Dodd-Frank authorized the Secretary of the Treasury (the “Secretary”) to grant such an exemption. The Proposed Determination justifies the exemption based largely on the following characteristics of the FX swaps and forwards market:

- FX swaps and forwards have fixed payment obligations, are physically settled, and are predominantly short-term instruments
- Settlement risk¹ is already addressed through the use of an efficient, well-functioning payment-versus-payment settlement system
- FX swaps and forwards are subject to less counterparty credit risk than other swaps due to the shorter duration of the contracts
- The FX swaps and forwards market operates with a high level of price transparency and liquidity given the prevalence of electronic trading
- The FX swaps and forwards market and its key participants have been subject to comprehensive oversight by central banks and prudential regulators for many years

¹ The risk that one party to an FX transaction will pay the currency it sold but not receive the currency it bought.

The Proposed Determination is strongly supported by many market participants, who have argued that applying clearing and trading requirements to FX swaps and forwards would increase costs and ultimately have an adverse affect on U.S. business and discourage hedging activity.

Comments to the Proposed Determination are due within 30 days following publication in the Federal Register.

Scope of Exemption

The scope of the exemption in the Proposed Determination is limited to FX swaps and forwards. The CEA narrowly defines an FX swap as a transaction that solely involves:

- an exchange of 2 different currencies on a specific date at a fixed rate that is agreed at the inception of the contract covering the exchange; and
- a reverse exchange of the 2 currencies at a later date and at a fixed rate that is agreed at the inception of the contract covering the exchange.

Similarly, the CEA narrowly defines an FX forward as a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed at the inception of the contract covering the exchange. Many commonly used FX derivatives, including foreign currency options, currency swaps and non-deliverable forwards, would not be exempt from the definition of swap pursuant to the Proposed Determination since they do not satisfy the statutory definitions of either an FX swap or forward.

Though exempt from many of the requirements of Dodd-Frank, including clearing and trading requirements, FX swaps and forwards would still be subject to the trade reporting requirements to swap data repositories, enhanced anti-evasion authority, and strengthened business conduct standards applicable to registered swap dealers and major swap participants.

Background

Title VII of Dodd-Frank amended the CEA to provide for, among other things, a comprehensive regulatory regime of the swaps market, including foreign exchange derivatives such as swaps, options, currency swaps and non-deliverable forwards. Section 721 of Dodd-Frank provides that the definition of “swap” includes “foreign exchange swaps” and “foreign exchange forwards” unless the Secretary makes a contrary determination that FX swaps and forwards are exempt from the definition of swap. Section 1a(47)(E) of the CEA authorizes the Secretary to make a written determination that either FX swaps or forwards, or both:

- should be not be regulated as swaps under the CEA, and
- are not structured to evade Dodd-Frank in violation of any rule promulgated by the Commodity Futures Trading Commission pursuant to section 721(c) of Dodd-Frank.²

² The CEA makes clear that the Secretary’s determination to exempt FX swaps and forwards from the definition of swap under the CEA will not exempt such transactions from the anti-fraud provisions with respect to swaps under the CEA.

In making the determination to exempt FX swaps and forwards from the swap definition, Section 1b of the CEA requires that the Secretary consider certain enumerated factors:

- 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 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 FX 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 forwards to evade otherwise applicable regulatory requirements.

Proposed Determination to Exempt FX Swaps and Forwards from Regulation as Swaps under the CEA

In justifying an exemption for FX swaps and forwards, the Proposed Determination focuses on the unique characteristics of these classes of swaps and forwards as well as the market in which they are traded, in accordance with the required factors set out in Dodd-Frank.

FX Swaps and Forwards Are Distinguishable from other Swaps

Among other reasons, the Secretary supported his decision to propose an exemption for FX swaps and forwards on the basis that FX swaps and forwards are distinct from other derivatives that are to be regulated as swaps. Unlike many FX derivatives, FX swaps and forwards involve the actual exchange of the principal amounts of the two currencies on a physical basis. Market participants know the full extent of their payment obligations and exposure during the term of the contract. Payment obligations on most other derivative instruments, however, may fluctuate in response to the changing value of an underlying asset to which the derivative is linked. In addition, unlike most swaps, FX swaps and forwards are short-term contracts which pose significantly less counterparty credit risk than some other derivatives with longer maturities. The Proposed Determination notes that over 98 percent of FX swaps and forwards mature in less than one year, and 68 percent mature in less than one week. Accordingly, due to the short duration of most FX swaps and forwards, the Secretary concluded that imposing central clearing and other requirements on these contracts would not significantly reduce counterparty credit exposures.

The Proposed Determination also distinguishes FX swaps and forwards from other derivatives on the basis of their uses. The Proposed Determination states that FX swaps and forwards are used primarily as short-term instruments for hedging FX exposure while other types of derivatives are used for a wider variety of purposes. In addition, FX swaps and forwards already trade in a highly transparent and liquid market through electronic trading platforms. Accordingly, the Secretary

views the mandatory exchange trading requirements of Dodd-Frank as doing little to improve price transparency significantly.

The Proposed Determination also notes that FX swaps and forwards have a risk profile which is more focused on settlement risk than on counterparty credit risk. The Proposed Determination further mentions that the FX swaps and forwards market has adequately addressed such risk by the extensive use of payment-versus-payment settlement through CLS Bank International, the predominant settlement system in the FX swaps and forwards market³.

Systemic Risk, Transparency and Financial Stability Considerations

As is required under Dodd-Frank, the Proposed Determination examines whether the required trading and clearing of FX swaps and forwards would create systemic risk, lower transparency or threaten the financial stability of the U.S. While acknowledging that subjecting FX swaps and forwards to the same clearing requirements as other swap instruments could provide additional protection against economic loss, the Proposed Determination states that this marginal benefit would come at too great a cost to market participants. The Proposed Determination explains that the efficiency of payment-versus-payment settlement arrangements could be jeopardized by the inclusion of additional steps between trade execution and settlement in order to accommodate a mandatory clearing requirement. In addition, the introduction of a clearing system into a well-functioning settlement system could create significant operational burdens for the market. The Proposed Determination made further note of the concerns made by many commenters in response to the Treasury's Notice and Request for Comment on this topic published on October 28, 2010. Many end-user commenters were of the view that the additional costs associated with collateral, margin and capital requirements required by a central counterparty would potentially reduce or offset any benefit of clearing in actively managing or hedging foreign exchange exposures.

The Secretary concluded that the FX swaps and forwards market is one of the most transparent and liquid derivatives markets given the high level of both pre- and post-trade price transparency achieved through electronic trading systems and other sources. Accordingly, the Secretary found that the introduction of clearing into the FX swaps and forwards market would introduce significant operational challenges and potentially be disruptive to a well-functioning market which would outweigh any marginal benefits for transparency or reducing risk in these types of transactions.

Regulatory Scheme Comparable to CEA Consideration

A second required consideration is whether FX swaps and forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps. The FX swaps and forwards market is already subject to significant regulation by central banks and regulators. There is also the history of global coordination to reduce risk in the FX market. This includes CLS Bank International, which is subject to oversight by the Federal Reserve Board and an oversight committee of 22 central banks. In addition to the oversight of the market and the settlement systems, many central banks have encouraged the use of master netting arrangements and multi-lateral netting to reduce counterparty credit risk.

³ Payment-versus-payment settlement permits the final transfer of one currency to take place only if the final transfer of the other currency also takes place.

Adequacy of Supervision Consideration

A third required consideration is the extent to which bank regulators of participants in the FX market provide adequate supervision, including margin and capital requirements. The Proposed Determination explains that the oversight role of bank regulators has greatly shaped the functioning of the market for FX swaps and forwards. Of particular note is the fact that the primary actors in this market are banks that have long been subject to prudential supervision. The Proposed Determination attributes the implementation of monitoring systems, limits, internal controls, hedging techniques and similar risk management structures by banks to such prudential regulation.

Adequacy of Payment and Settlement Systems Consideration

A fourth required consideration is the extent of adequate payment and settlement systems in the FX swaps and forwards market. The Proposed Determination assessed the history of reliable performance of the settlement and payment systems for FX swaps and forwards. The Proposed Determination noted that the payment-versus-payment settlement system has largely eliminated settlement risk with respect to FX swaps and forwards. In this regard, the Proposed Determination notes that CLS Bank International is responsible for settling more than 50 percent of FX swaps and forwards subject to settlement risk. The Proposed Determination notes that there are plans to widen the use of such settlement systems to accommodate increased trading volume.

Possible Use of Exemption to Evade Requirements of the CEA Consideration

Finally, the Secretary concluded in the Proposed Determination that the characteristics of FX swaps and forwards make it unlikely that the exemption could be used to evade requirements under the CEA applicable to other derivatives. The Proposed Determination notes that FX swaps could be used by some market participants to replicate the economic exposure to that of an interest rate swap. The Proposed Determination further notes, however, that the operational challenges and transaction costs associated with such replication significantly reduces the likelihood that market participants would seek to evade the regulatory requirements under the CEA in this manner. Moreover, the Proposed Determination emphasizes that FX swaps and forwards remain subject to the enhanced anti-evasion authority set out in the joint product definitions rule proposal released last week by the Commodity Futures Trading Commission and the Securities and Exchange Commission.⁴

Looking Ahead

As noted above, comments to the Proposed Determination must be provided within 30 days of publication in the Federal Register. In addition, as is required by Dodd-Frank, if the Secretary makes a determination to exempt FX swaps and forwards, he must submit a separate written determination to the appropriate committees of Congress, which contains (1) an explanation of why FX swaps and forwards are “qualitatively different from other classes of swaps” such that FX swaps and forwards are “ill-suited for regulation as swaps” and (2) an “identification of the objective differences of FX swaps and forwards with respect to standard swaps that warrant an exempted status.” A key takeaway for market participants from the

⁴ 17 CFR Part 1: Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, available at: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister042711e.pdf>.

Proposed Determination is that exempt FX swaps and forwards would still be subject to the reporting requirements of Section 729 of Dodd-Frank. We will continue to follow these regulatory developments and will provide updates over the coming weeks and months.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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