

December 06, 2012

Dodd Frank: Treasury Exempts FX Swaps and FX Forwards

On November 16, 2012, the Department of the Treasury (“Treasury”) issued a determination (“Determination”) that both foreign exchange (“FX”) swaps and FX forwards should not be regulated under the Commodity Exchange Act (“CEA”) and therefore should be exempted from the definition of “swap” under the CEA as amended by the Dodd Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank”).¹ The Determination is a wholesale adoption of the proposed determination issued by the Treasury last year.² The Determination is effective immediately.

Overview

Key takeaways for market participants are:

- FX swaps and FX forwards are exempt from the trade execution, mandatory clearing and margin requirements under Dodd-Frank;
- Many commonly used FX derivatives, including foreign currency options, currency swaps and non-deliverable forwards are not exempt;
- Exempt FX swaps and FX forwards are still subject to Dodd-Frank’s reporting requirements, and swap dealers must still comply with external business conduct rules in connection with such transactions, with compliance being required as soon as December 31, 2012.

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

¹ Press Release, US Department of the Treasury, Fact Sheet: Final Determination on Foreign Exchange Swaps and Forwards (Nov. 16, 2012) <http://www.treasury.gov/press-center/press-releases/Pages/tg1773.aspx>.

² For further information you may wish to refer to our publication on this proposed determination, available at: <http://www.shearman.com/doddfrank--treasury-secretary-proposes-to-exempt-fx-swaps-and-forwards-05-04-2011/>.

Scope of Exemption³

FX Swaps and FX Forwards Excluded From Swap Definition

The scope of the exemption in the Determination is limited to FX swaps and FX forwards and does not extend to other FX derivatives.⁴ The CEA narrowly defines an FX swap as a transaction that solely involves:

- an exchange of two 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 two currencies at a later date and at a fixed rate that is agreed at the inception of the contract covering the exchange.⁵

Similarly, the CEA narrowly defines an FX forward as a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed at the inception of the contract covering the exchange.⁶ Many commonly used FX derivatives, including foreign currency options, currency swaps (also known as cross currency basis swaps) and non-deliverable forwards, would not be exempt from the definition of swap pursuant to the Determination since they do not satisfy the statutory definitions of either an FX swap or FX forward.

³ In making its Determination, the factors that the Secretary considered are:

- 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 United States;
- 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 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 FX forwards to evade otherwise applicable regulatory requirements.

The Secretary weighed each of the above considerations and justified the exemption based mainly on the following characteristics of the FX swaps and FX forwards market:

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

⁴ Commodity Exchange Act § 1a(47)(E), 7 USC. § 1a(47)(E).

⁵ Commodity Exchange Act § 1a(25), 7 USC. § 1a(25).

⁶ Commodity Exchange Act § 1a(24), 7 USC. § 1a(24).

Non-Deliverable Forwards (NDFs) Not Exempted

The Commodity Futures Trading Commission (“CFTC”) has expressly declined to include non-deliverable forwards involving foreign exchange (“NDF”) in the exemption. In general, an NDF is a swap that is cash-settled between two counterparties, with the value of the contract determined by the movement of exchange rates between two currencies. On the contracted settlement date, the profit to one party is paid by the other based on the difference between the contracted NDF rate (set at the trade’s inception) and the prevailing NDF fix (usually a close approximation of the spot foreign exchange rate) on an agreed notional amount. NDF contracts do not involve an exchange of the agreed upon notional amounts of the currencies involved. Instead, NDFs are cash settled in a single currency, usually a reserve currency. NDFs generally are used when international trading of physical currency is relatively difficult or prohibited.

The Treasury found that NDFs are not FX swaps or FX forwards, emphasizing that NDFs are distinguishable from these products because they do not involve an exchange of currencies. The Treasury also cited to the joint product definitions of the CFTC and Securities and Exchange Commission (“SEC,” and together with the CFTC, the “Commissions”) where the Commissions endorsed this same distinction as set forth in the Treasury’s proposed determination.⁷

The Treasury did, however, clarify that FX swap or FX forward payments made between the same parties on the same day and in the same currency may be netted without impacting the character of the transactions, either through bilateral netting or through an automatic multilateral payment-versus-payment settlement system that permits the final transfer of one currency to take place only if the final transfer of the other currency also takes place, thereby virtually eliminating settlement risk.

Effect of Exemption

The CEA, as modified by Dodd-Frank, generally prohibits persons from engaging in a swap transaction unless the person submits the swap for clearing to a derivatives clearing organization that is registered under the CEA if the CFTC requires the swap or category of swaps to be cleared. The CEA also provides that any swap required to be cleared is subject to certain trade-execution requirements. Uncleared swaps are also subject to margin requirements under the CEA. As a result of the Treasury’s determination that FX swaps and FX forwards should not be regulated as swaps under the CEA, FX swaps and FX forwards would not be subject to the central clearing, exchange trading and margin requirements of the CEA.

Continuing Regulatory Obligations Under Dodd-Frank

Though exempt from many of the requirements of Dodd Frank, including clearing and trading requirements, FX swaps and FX forwards are still subject to the CFTC’s trade reporting (but not real-time reporting) requirements, enhanced anti-evasion authority, and strengthened business conduct standards applicable to registered swap dealers and major swap participants. The Determination does not affect the applicability of the CEA or the jurisdiction of the CFTC with respect to agreements, contracts or transaction in foreign currency pursuant to Section 2(c)(2) of the CEA regarding retail transactions. The

Determination also expressly does not exempt any FX swap or FX forward traded on a designated contract market or swap execution facility from any applicable anti-manipulation provision of the CEA.

Of note, registered swap dealers will be required to comply with the business conduct rules with respect to FX swaps and FX forwards, which will become mandatory for the largest of swap dealers on December 31, 2012.⁸ These business conduct rules include the CFTC's regulations promulgated pursuant to Section 4s of the CEA, including recordkeeping, reporting, external business conduct, swap trading relationship documentation requirements and portfolio reconciliation requirements.⁹ The industry response to this impending deadline has involved a multilateral documentation amendment initiative to publish the ISDA August 2012 Dodd-Frank Protocol, which provides for the amendment of swap documentation by adhering market participants. Without adhering to the August 2012 Dodd-Frank Protocol or bilaterally implementing its equivalent, market participants, including those who solely engage in FX swaps and FX forwards, may find swap dealers unwilling to enter into such transactions as of January 1, 2013.¹⁰

No-Action Relief Relating to FX Swaps and FX Forwards and Registration as a MSP and CPO/CTA

The CFTC and SEC's joint product definitions became effective on October 12, 2012, and because the Determination had not yet been issued, market participants were required to include FX swaps and FX forwards in their swap dealer de minimis calculations and major swap participant calculations of substantial position and substantial counterparty exposure.¹¹ To address this concern, the CFTC's Division of Swap Dealer and Intermediary Oversight issued a no-action letter¹² that provided that it would not recommend an enforcement action for failure to so register as a swap dealer or major swap participant against those entities that are required to register solely as a result of their FX swap and FX forward trading activity, provided that the Secretary of the Treasury (the "Secretary") issues a final determination to exempt FX swaps and FX forwards from the "swap" definition and that such determination becomes effective prior to December 31, 2012. Because

⁷ Further Definition of "Swap," "Security Based Swap," and "Security Based Swap Agreement"; Mixed Swaps; Security Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208, 48255 (August 13, 2012).

⁸ For further information regarding this rule you may wish to refer to our publication on this topic, available at: <http://www.shearman.com/cftc-adopts-registration-rules-and-external-business-conduct-standards-for-swap-dealers-and-major-swap-participants-02-06-2012/>.

⁹ Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012); Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20128 (Apr. 3, 2012); Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (Sept. 11, 2012).

¹⁰ See <http://www2.isda.org/dodd-frank-documentation-initiative/> (last accessed November 14, 2012).

¹¹ "Further Definition of "Swap," "Security Based Swap," and "Security Based Swap Agreement"; Mixed Swaps; Security Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208, 48255 (August 13, 2012).

¹² Time Limited No-action Relief: Foreign Exchange Swaps and Foreign Exchange Forwards Not to be Considered in Calculating Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception or in Calculating Substantial Position in Swaps or Substantial Counterparty Exposure for Purposes of the Major Swap Participant Definition; Time-Limited No-action Relief for persons that meet the definitions of Commodity Pool Operators and Commodity Trading Advisors Solely as a Result of their Foreign Exchange Swap and Foreign Exchange Forward Activities, CFTC No-Action Letter No. 12-21 (October 12, 2012).

this condition has been satisfied, this no-action relief has become effective and market participants will not have to consider FX swaps and FX forwards entered into since October 12, 2012, in their swap dealer and major swap participant calculations.

The no-action letter also relieved a commodity pool operator or commodity trading advisor of the need to register in such capacity if such need arose solely as a result of such entity's FX swap or FX forward trading activity or advisory activities (as applicable), provided that the Secretary issues a final determination to exempt FX swaps and FX forwards from the "swap" definition and that such determination becomes effective prior to December 31, 2012.

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:

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Geoffrey B. Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Donald N. Lamson
Washington, D.C.
+1.202.508.8130
donald.lamson@shearman.com

John W. Finley III
New York
+1.212.848.4346
sean.finley@shearman.com

Jared R. Gianatasio
New York
+1.212.848.4384
jared.gianatasio@shearman.com

Nhung Pham
New York
+1.212.848.7885
nhung.pham@shearman.com