

CLIENT UPDATE

TREASURY SECRETARY EXEMPTS CERTAIN FOREIGN EXCHANGE SWAPS AND FORWARDS FROM THE SWAP DEFINITION

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On November 16, 2012, the Secretary of the Treasury (the “Secretary”) issued a final determination (the “Final Determination”) exempting both foreign exchange swaps and foreign exchange forwards from the definition of “swap” under Section 1a(47) of the Commodity Exchange Act (the “CEA”) and Section 1.3(xxx) of the regulations of the Commodity Futures Trading Commission (the “CFTC”).

BACKGROUND

The terms “foreign exchange forward” and “foreign exchange swap” are narrowly defined under the CEA. A “foreign exchange forward” is a transaction that solely involves the exchange of two different currencies on a specific date at a fixed rate agreed upon at the inception of the contract. A “foreign exchange swap” is a transaction that solely involves (1) the exchange of two different currencies on a specific date at a fixed rate agreed upon at the inception of the contract and (2) a reverse exchange of the currencies involved in the contract at a later date at a fixed rate agreed upon at the inception of the contract.

Section 1a(47)(E) of the CEA authorizes the Secretary to make a written determination that foreign exchange forwards and swaps:

- should not be regulated as swaps under the CEA; and

- are not structured to evade the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) in violation of any rule promulgated by the CFTC pursuant to section 721(c) of the Dodd-Frank Act.

Absent any determination by the Secretary to exempt foreign exchange forwards and foreign exchange swaps (together, the “Excluded FX Products”) from being regulated as swaps, parties to such transactions would be required under Section 2(h)(1) of the CEA to submit such Excluded FX Products to a derivatives clearing organization registered under the CEA for clearing and, if applicable, to execute the transaction on a designated contract market or swap execution facility. Finally, absent the Secretary’s exemption, Excluded FX Products would be subject to margin requirements under Section 4s(e) of the CEA.

FINAL DETERMINATION OF EXEMPTION FROM SWAP DEFINITION

The Secretary determined to exempt the Excluded FX Products from the swap definition. We note that the Secretary has no authority to exempt any other type of foreign exchange derivatives contract from the swap definition. Therefore, the Final Determination does not exempt cash-settled (or non-deliverable) foreign exchange swaps or forwards.¹

In the release accompanying the Final Determination (the “Release”), the Secretary notes that the Final Determination is based on several distinguishing characteristics of Excluded FX Products. Specifically, unlike most other swaps, Excluded FX Products have fixed payment obligations, are settled by the exchange of actual currency and are predominantly short-term instruments.

In the Release, the Secretary notes that counterparty credit risk prior to settlement is significantly reduced by the structure of an Excluded FX Product, particularly because the term of such transactions is generally very short. Therefore, the Secretary concludes, for the vast majority of Excluded FX Products, the risk profile is centered on settlement risk.

The Secretary also states that requiring central clearing and trading under the CEA with respect to Excluded FX Products would potentially introduce operational risks and challenges to the current settlement process. Specifically, if central clearing were to be required, the central clearing facility would be effectively guaranteeing both settlement

¹ Given the significance of full physical settlement in reaching the Final Determination, a foreign exchange swap or forward that provides for full settlement in the relevant contract but is rolled over or settled in cash at maturity will most likely not be excluded from the swap definition. While not directly relevant to the Final Determination, the CFTC issued an interpretation of the phrase “actual delivery” for purposes of retail commodity transactions, under which a roll-over of a physical delivery contract would render such contract a cash-settlement contract in certain circumstances. 76 Fed. Reg 77670 (December 14, 2011).

and market exposure to replacement cost. The Secretary anticipates that combining clearing and settlement in a market that involves settlement of the full principal amounts of the contracts would require capital backing, in a very large number of currencies, significantly exceeding the capital backing that would be required for swaps that are settled on a “net” basis. Finally, the Secretary notes that requiring Excluded FX Products to be cleared and settled through the use of new systems and technologies could introduce new, unforeseen risks in this market.

CERTAIN SWAPS REGULATIONS CONTINUE TO APPLY

Notwithstanding the Final Determination, Excluded FX Products will be subject to certain regulatory and historic reporting requirements under Section 4r of the CEA. Specifically, each Excluded FX Product must be reported to either a swap data repository (“SDR”) or, if no SDR will accept such Excluded FX Product, to the CFTC, within such time period as the CFTC may prescribe.

Additionally, notwithstanding the Final Determination, any party to an Excluded FX Product that is a swap dealer or major swap participant under the CEA and the CFTC Regulations must comply with the business conduct standards contained in Section 4s(h) of the CEA.

Lastly, the Final Determination does not exempt any Excluded FX Product traded on a DCM or SEF from any applicable anti-manipulation provision of the CEA.

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Please do not hesitate to contact us with any questions.

November 20, 2012