

CLIENT UPDATE

RELIEF FROM OBLIGATION TO PROVIDE PRE-TRADE MID-MARKET MARK FOR CERTAIN FOREX TRANSACTIONS

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On December 6, 2012, the Commodity Futures Trading Commission (the “CFTC”) granted limited no-action relief to swap dealers (“SDs”) and major swap participants (“MSPs” and, together with SDs, “Swap Entities”) from the obligation under Regulation 23.431(a)(3)(i) to disclose a pre-trade, mid-market mark (“PTM”) to their counterparty when entering into certain foreign exchange (“forex”) transactions.

The relief was granted in response to a letter (the “Request Letter”) from the Foreign Exchange Committee (“FXC”) and the Financial Markets Lawyers Group (“FMLG”) requesting that Swap Entities not be required to disclose PTMs in connection with certain Covered Forex Transactions. The no-action letter defines Covered Forex Transactions as:

- foreign exchange forwards¹ and foreign exchange swaps² (collectively, “forex swaps and forwards”) that, by their terms, are physically settled, where each currency is included among the top 13 deliverable currencies (by volume) described in the Bank for International Settlements’ Triennial Central Bank Survey,

¹ 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.

² 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.

Report on Global Foreign Exchange Market Activity in 2010 (the “BIS 13 Currencies”),³ and where the transaction has a stated maturity of one year or less; and

- vanilla forex options that, by their terms, are physically settled, where each currency is included among the BIS 13 Currencies, and where the option has a stated maturity of six months or less.

BACKGROUND AND REQUEST FOR RELIEF

Pursuant to his authority under Section 1a(47)(E)⁴ of the Commodity Exchange Act (the “CEA”), the Secretary of the Treasury (the “Secretary”) has issued a written determination exempting certain forex swaps and forwards from the definition of “swap” under Section 1a(47) and Regulation 1.3(xxx).⁵ Notwithstanding such determination, any party to a forex swap or forward that is a Swap Entity must comply with the business conduct standards contained in Section 4s(h).

Pursuant to its authority under Section 4s(h)(3)(B), the CFTC has issued final rules prescribing business conduct standards for Swap Entities, including Regulation 23.431, which requires Swap Entities, at a reasonably sufficient time prior to entering into a swap, to disclose to any counterparty to such swap (other than an SD, MSP, security-based swap dealer, or major security-based swap participant) material information concerning the swap, including the price and the PTM of the swap, in a manner reasonably designed to allow the counterparty to assess the material incentives and conflicts of interest that the Swap Entity may have in connection with the swap.⁶

REQUEST FOR RELIEF

In the Request Letter, FXC and FMLG stated that the Covered Forex Transactions “involve highly-liquid currencies, exhibit narrow bid-ask spreads and are widely quoted by [forex dealers] in the marketplace.” With the Request Letter, FXC and FMLG submitted data

³ Excluding the Korean won, which is a restricted currency, the BIS 13 Currencies are the U.S. Dollar, Euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Singapore dollar, Norwegian krone and Mexican peso.

⁴ Unless otherwise stated, all Section references are to sections of the Commodity Exchange Act.

⁵ See our client memorandum “Treasury Secretary Exempts Certain Foreign Exchange Swaps and Forwards from the Swap Definition”: <http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=2b8b2e69-ddd6-4731-8694-146012c12dc7>

⁶ In the release accompanying the final business conduct rules for Swap Entities, the CFTC stated that “the spread between the quote and the mid-market mark is relevant to disclosures regarding material incentives and provides the counterparty with pricing information that facilitates negotiations and balances historical information asymmetry regarding swap pricing.” Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012).

collected from forex dealers and public sources showing that a PTM that would be disclosed by Swap Entities in connection with the Covered Forex Transactions would be substantially similar to publicly available information.

FXC and FMLG asserted that, because reliable and transparent pricing information is readily available in the market and because spreads are competitive and narrow, disclosing a PTM does not provide any significant informational value. The Request Letter indicates that FXC's buy-side institutions believe that a PTM for Covered Forex Transactions is not material and therefore should not be required "as it does not reflect a tradeable price," which is instead primarily based on the "best bid or ask." In the no-action letter, the CFTC notes that it believes real-time tradeable bid and offer prices for each of the Covered Forex Transactions are already available electronically to counterparties in the marketplace.

Additionally, FXC and FMLG noted that disclosing a PTM "would require [forex dealers] to create a new price stream when quotes are provided electronically and would add additional operational requirements for dealers when quotes are conveyed by voice," which requirements may add significant costs.

Finally, FXC and FMLG stated that, because delivery of a PTM must be made "a reasonably sufficient time prior to trading," requiring such delivery for Covered Forex Transactions may delay the trade time, which may adversely affect counterparties.

NO-ACTION RELIEF

The no-action letter provides that, based on the representations made in the Request Letter, the Division of Swap Dealer and Intermediary Oversight of the CFTC ("DSIO") will not recommend that the CFTC commence an enforcement action against any Swap Entity for failure to disclose the PTM of a Covered Forex Transaction, as required by Regulation 43.431(a)(3), to a counterparty, provided that:

- real-time tradeable bid and offer prices for the Covered Forex Transaction are available electronically, in the marketplace, to the counterparty; and
- the counterparty agrees in advance, in writing, that the Swap Entity need not disclose a PTM.

In the no-action letter, the CFTC notes that DSIO will continue to monitor market data with respect to the liquidity, bid and offer spreads, and publicly available information of the Covered Forex Transactions and that, if the circumstances change, DSIO may limit, impose additional or different conditions on, or revoke such relief.

Additionally, the CFTC notes that while this no-action relief is applicable only with respect to the Covered Forex Transactions and does not affect any obligations of Swap Entities to disclose a PTM for other contracts, DSIO may consider extending this relief to other transactions if sufficient data and other relevant information are submitted to DSIO establishing the appropriateness of an extension. The no-action letter provides that any requests to extend this relief to other transactions should be submitted, along with data and other relevant information, in accordance with Regulation 140.99.

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Please do not hesitate to contact us if you have any questions.

December 21, 2012