



## Recent Action by the Department of the Treasury Regarding Foreign Exchange Swaps and Foreign Exchange Forwards

On October 28, 2010, the Department of the Treasury (the “Treasury”) published in the Federal Register<sup>1</sup> a notice and request for comments (the “Notice”) relating to the authority of the Secretary of the Treasury (the “Secretary”) to make a written determination that foreign exchange swaps, foreign exchange forwards, or both, should not be regulated as swaps under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).<sup>2</sup> In the Notice, the Treasury states that the Secretary has made no determination yet as to whether an exemption is warranted.

The Treasury solicited comments on whether an exemption for foreign exchange swaps, foreign exchange forwards, or both, is warranted and on the application of the factors described below that the Secretary is required to consider in making any such determination. The Treasury also solicited comments on the questions attached as [Appendix A](#) to this client alert and encouraged commenters to submit supporting materials, including relevant transactional data, that would assist the Secretary’s consideration of the issues relating to any exemption. Written comments must be received by the Treasury on or before November 29, 2010 to be assured of consideration.

### Foreign Exchange Swaps and Foreign Exchange Forwards Under the Dodd-Frank Act

Section 721 of the Dodd-Frank Act amends section 1a of the Commodity Exchange Act (the “CEA”)<sup>3</sup> to include, among other things, the new definitions of “swap,” “foreign exchange swap,” and “foreign exchange forward.”<sup>4</sup> Foreign exchange swaps and foreign exchange forwards are expressly included in the definition of swap. However, the Secretary may make a written determination that either foreign exchange swaps or foreign exchange forwards, or both, should not be regulated as swaps under the CEA and are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the Commodity Futures Trading Commission.<sup>5</sup> In making any such determination, the Secretary must consider the following factors:

1. Whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States;

<sup>1</sup> 75 Fed. Reg. 66426 (Oct. 28, 2010).

<sup>2</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>3</sup> 7 U.S.C. § 1, *et seq.*

<sup>4</sup> The amendments creating the new definitions are effective July 16, 2011.

<sup>5</sup> 7 U.S.C. § 1a(47)(E)(i). Note that this exemptive authority is potentially limited by the rather narrow definitions of foreign exchange swap and foreign exchange forward. A “foreign exchange swap” is a transaction that *solely* involves (a) an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and (b) a reverse exchange of the those two currencies at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange. 7 U.S.C. § 1a(25). A “foreign exchange forward” is a transaction that *solely* involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange. 7 U.S.C. § 1a(24).

2. Whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps;
3. The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements;
4. The extent of adequate payment and settlement systems; and
5. The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.<sup>6</sup>

If the Secretary determines to exempt foreign exchange swaps and foreign exchange forwards from the swap definition, the Secretary must submit a detailed written determination to the appropriate Congressional committees, including the Committee on Agriculture, Nutrition, and Forestry of the Senate and the Committee on Agriculture of the House of Representatives. Specifically, the Secretary's determination must contain the following information:

1. An explanation regarding why foreign exchange swaps and foreign exchange forwards are qualitatively different from other classes of swaps in a way that would make the foreign exchange swaps and foreign exchange forwards ill-suited for regulation as swaps; and
2. An identification of the objective differences of foreign exchange swaps and foreign exchange forwards with respect to standard swaps that warrant an exempted status.<sup>7</sup>

Note, however, that there is no requirement that the appropriate Congressional committees approve or otherwise affirm the Secretary's determination. Section 1a(47)(E)(ii) of the CEA provides that the Secretary's determination is not effective until it is submitted to the appropriate Congressional committees. Thus, although the process for preparing and submitting a determination to exempt foreign exchange swaps and foreign exchange forwards from regulation as swaps may be somewhat burdensome for the Secretary, it appears that once the written determination is submitted to the appropriate Congressional committees, it becomes effective and any exemption contained in the determination will apply.

Notwithstanding any written determination that the Secretary makes under section 1a(47)(E)(i) of the CEA, the swap reporting obligations and, to the extent that a counterparty to a foreign exchange swap or a foreign exchange forward is a swap dealer or major swap participant, the business conduct standards under the Dodd-Frank Act will apply to foreign exchange swaps and foreign exchange forwards.<sup>8</sup>

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<sup>6</sup> 7 U.S.C. § 1b, as added by section 722(h) of the Dodd-Frank Act, effective July 16, 2011.

<sup>7</sup> *Id.*

<sup>8</sup> 7 U.S.C. § 1a(47)(E)(iii) and (iv).

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*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*

## APPENDIX A

## Treasury Questions

1. Are foreign exchange swaps and/or foreign exchange forwards qualitatively different from other classes of swaps in a way that makes them ill-suited for regulation as “swaps” under the CEA?<sup>9</sup> Are there similarities between foreign exchange swaps and/or foreign exchange forwards and other products not defined as swaps under the CEA?
2. Are there objective differences between swaps and foreign exchange swaps and/or foreign exchange forwards that warrant an exemption for either or both of these instruments?<sup>10</sup>
3. Are there objective differences between long-dated and short-dated foreign exchange forwards and swaps such that one class may be less suited to regulation as “swaps” under the CEA than the other? Is the same true for dealer to dealer transactions versus transactions where one counterparty is a non-dealer? Similarly, does one or more of the above-referenced, five statutory factors support the application of certain requirements set forth in the CEA, but not others (e.g., centralized clearing, but not exchange trading), to foreign exchange swaps and/or foreign exchange forwards?
4. What are the primary risks in the foreign exchange swaps and forwards market, how significant are these risks, and how are these risks currently managed by market participants? Would centralized clearing and exchange trading address these risks? To what extent do current payment-versus-payment settlement arrangements address settlement risk?
5. To what extent is counterparty credit risk a significant concern in the foreign exchange swaps and forwards markets? If so, to what extent do current market practices (including netting and bilateral collateral support arrangements) mitigate these risks? What evidence, particularly during the period between 2007 and present, illustrate how current market practices have either addressed, or failed to respond, to these risks?
6. Are there ways to mitigate the risks posed by the trading of foreign exchange swaps or foreign exchange forwards without subjecting these instruments to regulation under the CEA?
7. Are there existing safeguards or systems that should be enhanced in order to protect against systemic or other risks in the foreign exchange swaps and forwards markets? What considerations are relevant to the application of Title VIII of the Dodd-Frank Act to the foreign exchange swaps and forwards markets, specifically to enhance supervision, strengthen risk management, and lower systemic risk?
8. Given that the Dodd-Frank Act requires all foreign exchange swaps and forwards be reported to a swap data repository, what is the current standard or practice in the foreign exchange market for reporting trades?
9. What would be the likely effects of mandatory U.S. clearing of foreign exchange swaps and/or forwards on foreign exchange market liquidity in the U.S. dollar? What would be the impact on the operations of U.S. end-users and U.S. dealers?

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<sup>9</sup> 7 U.S.C. § 1b(b)(1).

<sup>10</sup> 7 U.S.C. § 1b(b)(2).