Treasury Department Issues Final Determination Exempting Foreign Exchange Swaps and Certain Foreign Exchange Forwards from the Definition of "Swap"

Introduction

On November 16, 2012, the United States Department of the Treasury (the "Treasury Department") issued a final determination (the "Final Determination") regarding the treatment of foreign exchange swaps and certain foreign exchange forwards under the Commodity Exchange Act (the "CEA"). When adding "swaps" to the list of commodity interests regulated under the CEA, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") defined "swaps" broadly to encompass most over-the-counter derivatives contracts, including foreign exchange swaps and foreign exchange forwards. However, the Dodd-Frank Act also authorized the Treasury Department to determine that foreign exchange swaps, certain foreign exchange forwards, or both, should not be regulated as swaps under the CEA. In the Final Determination, the Treasury Department exercised the authority granted by the Dodd-Frank Act to exempt both foreign exchange swaps and certain foreign exchange forwards from the definition of "swap." The Final Determination will be effective upon publication in the Federal Register, which is expected within the next few weeks.

Defining Foreign Exchange Forwards and Swaps

The exemption established by the Final Determination only covers foreign exchange swaps and *deliverable* foreign exchange forwards, and does *not* extend to other foreign exchange derivatives, including foreign exchange options, currency swaps, and non-deliverable foreign exchange forwards. The CEA defines foreign exchange forwards as transactions that involve the "exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange." Similarly, a foreign exchange swap is defined as "a transaction that solely involves (A) an exchange of 2 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 [those two currencies] at a later date and at a fixed rate that is agreed upon the inception of the contract covering the exchange." Non-deliverable foreign exchange forwards, on the other hand, do not involve an actual exchange of the agreed notional amounts of the two different currencies involved, and instead are ultimately settled on a net basis in a single currency. In distinguishing deliverable foreign exchange forwards and foreign exchange swaps from other foreign exchange derivatives, the Treasury Department noted that, "unlike most other swaps, foreign exchange swaps and forwards have fixed payment obligations, *are settled by the exchange of actual currency*,[1] and are predominantly short-term instruments" (emphasis added).

Effects on CPO/CTA Registration Requirements

Entities that transact in deliverable foreign exchange swaps and forwards, but no other commodity interests (e.g., futures contracts, options on futures contracts and commodities, and other swaps) -- As foreign exchange swaps and forwards are no longer considered "commodity interests" for purposes of the CEA, fund sponsors or advisers that would have been deemed commodity pool operators ("CPOs") or commodity trading advisors ("CTAs"), respectively, solely because of the use of such instruments will no longer be deemed CPOs and CTAs, and will not be required to register as such or file with the National Futures Association ("NFA") for an exemption from registration. Any such fund sponsors or advisers that have previously filed with the NFA based on the exemption from CPO

[1] The Treasury Department clarified in the Final Determination that the requirement to exchange two currencies does not mean that each foreign exchange swap or forward must be settled independently. An entity that settles a series of these transactions "may use appropriate mechanisms to net transactions involving the same parties and the same currencies, and deliver each of the currencies to the respective parties."

registration provided by Commodity Futures Trading Commission ("CFTC") Rule 4.13(a)(3), or the exemption from CTA registration provided by CFTC Rule 4.14(a)(8), may withdraw the applicable exemption. In order to withdraw an exemption filing, an unregistered CPO or CTA should send an email to the NFA requesting that the NFA withdraw the exemption (and, in the case of a CPO, including the name of the exempt pool and the pool identification number). A registered CPO may withdraw an exemption by deleting the exemption from its online account.

Entities that use commodity interests in addition to foreign exchange swaps and forwards -- CPOs will now be able to disregard these foreign exchange transactions when calculating their level of commodity interest trading for purposes of the CPO exemptions under CFTC Rule 4.13(a)(3) and Rule 4.5 (for sponsors of private funds and mutual funds, respectively, with *de minimis* commodity interest trading). Registered CPOs will be able to disregard these foreign exchange transactions from testing for purposes of Rule 4.12 (providing certain relief to a registered CPO of a pool with *de minimis* commodity interest trading). CTAs will now be able to disregard these foreign exchange transactions when considering whether they can meet the requirements of the CTA exemptions under CFTC Rule 4.14(a)(8) (requiring, among other things, commodity interest trading advice to be "solely incidental" to the business of providing securities or other investment advice) and Section 4m(3) of the CEA (requiring, among other things, that the CTA neither have a business that will "consist primarily" of acting as a CTA nor act as a CTA to a fund that is "engaged primarily" in trading commodity interests).

Effects on Foreign Exchange Transactions

As a result of the Final Determination, foreign exchange swaps and forwards will not be subject to a number of the new derivatives requirements under the Dodd-Frank Act, including the requirements that certain types of swaps be (i) cleared and (ii) traded on a board of trade designated as a contract market ("DCM"), securities exchange, or swap execution facility ("SEF") unless no DCM, securities exchange, or SEF accepts the swap for trading. Similarly, foreign exchange swaps and forwards will not be subject to mandatory minimum margin requirements that will apply to all cleared and uncleared swaps, pursuant to which many buy-side counterparties will be required to post margin to their counterparties that are swap dealers, security-based swap dealers, major swap participants, or major security-based swap participants (referred to collectively as "swap dealers"). In addition, funds will be able to exclude foreign exchange swaps and forwards for purposes of determining whether the fund is an "active fund" under the CFTC's rules governing phased-in compliance with the mandatory clearing requirement.[2]

However, notwithstanding the Final Determination, certain rules under the Dodd-Frank Act will apply to foreign exchange swaps and forwards, including reporting obligations and external business conduct standards that apply to swap dealers. Pursuant to the CFTC's swap reporting rules, for example, certain information regarding each swap (whether cleared or uncleared) will be required to be reported to a swap data repository, which will make the information available to regulators, and also make the information (other than the identity of the parties) available to the public. Furthermore, it is likely that swap dealers will expect their buy-side counterparties to enter into the ISDA Dodd-Frank Protocol in order to amend existing trading documentation to incorporate certain of the provisions being sought by swap dealers in response to the rules governing external business conduct standards, even in cases where the parties only trade foreign exchange swaps and forwards.

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[2] An "active fund" is an entity that would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 that executes an average of 200 or more "swaps" per month over a 12-month period. Active funds will be subject to the mandatory clearing requirement with respect to interest rate swaps and certain credit default index swaps 90 days following the CFTC's publication of a mandatory clearing determination in the Federal Register, whereas funds other than active funds will be subject to the mandatory clearing requirement 180 days following publication of the mandatory clearing determination.