U.S. Treasury Proposal Excludes Certain Foreign Exchange Derivatives from "Swap" Definition

Pursuant to authority granted to it under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"), the U.S. Treasury Department has proposed excluding foreign exchange swaps and forwards from the definition of a "swap" under the Commodity Exchange Act ("CEA").

In its notice, Treasury stresses that the definitions of foreign exchange swap and foreign exchange forward in the CEA are quite narrow. The following types of currency derivatives are covered by the exclusion:

- "Foreign exchange forwards," which involve the physical exchange of two different currencies at a fixed rate on a fixed future date; and
- "Foreign exchange swaps," which involve a physical exchange of two different currencies at a fixed rate on a fixed date, followed by a reverse exchange of these two currencies at a fixed rate at a later date.

The following types of currency derivatives are not covered by the exclusion and would remain "swaps" under the CEA:

- Non-deliverable currency forwards;
- Foreign exchange options;
- Currency swaps that involve a periodic exchange of a floating amount of cash flows based on a notional amount; and
- Any other currency derivatives not explicitly covered by the exclusion.

In explaining its determination, Treasury states in its notice that foreign exchange swaps and foreign exchange forwards are distinguished from other derivatives by certain characteristics, such as fixed payment obligations, physical settlement, and a short term (generally less than one year). As result, the notice states that the risk profile of foreign exchange swaps and foreign exchange forwards is centered on settlement risk, not counterparty risk, and that settlement risk has already been mitigated through the use of payment-versus-payment ("PVP") settlement arrangements.

The impact of Treasury's proposal is that relatively narrow categories of transactions covered by the Treasury notice would be exempt from certain of the new requirements imposed on swaps under the Dodd-Frank Act, including the central clearing requirement, the swap execution facility trading requirement, and minimum margin requirements. One practical consequence arising from excluding foreign exchange swaps and forwards from the clearing requirement, while other derivatives may be required to be cleared, could be the lost benefits of cross-margining and payment netting of all derivatives products with a counterparty under one umbrella ISDA Master Agreement and Credit Support Annex.

Certain other CEA swap rules will apply to the excluded transactions, however, including trade reporting requirements, business conduct standards (including an anti-fraud provision) for swap dealers and major swap participants, and, for those transactions which are traded on a designated contract market or swap execution facility, enhanced anti-fraud and anti-manipulation rules.

The text of the Treasury notice of proposed determination and fact sheet can be found by clicking on the following link.

The deadline for comments is 30 days after the publication of the notice of proposed determination in the Federal Register.

If you have questions about the proposed exclusion or its impact on your business, please contact Ropes & Gray Derivatives Practice co-heads Tim Diggins and Leigh Fraser, Deborah Monson, or your usual contact at the firm.