News Bulletin

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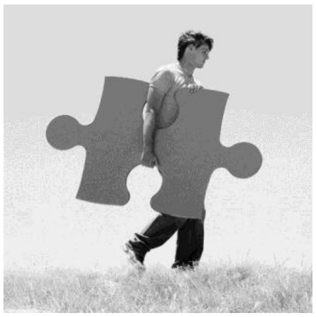

"If It Ain't Broke, Don't Fix It": Treasury Exempts Foreign Exchange Swaps and Forwards from Dodd-Frank Swaps Regulation Requirements

Last Friday, the Secretary of the U.S. Treasury Department issued a formal determination (Determination) to exempt foreign exchange swaps and foreign exchange forward contracts from regulation as "swaps" under the Commodity Exchange Act (CEA), as amended by Title VII of the Dodd-Frank Act. The Secretary's action, which was taken under sections 721 and 722 of the Dodd-Frank Act, is not unexpected but will be welcomed by the financial services industry.

The Statutory Framework

Title VII of the Dodd Frank Act created a comprehensive regime for the regulation of over-the-counter swaps, including registration, regulatory, central clearing and trading requirements that the federal financial regulatory agencies have been implementing over the past two years. Section 721 of the Dodd-Frank Act amended the definition of "swap" to include foreign exchange swaps, forward and futures contracts, but gave the Secretary the authority, by specific determination, to exempt foreign exchange swaps and forward contracts from the definition of "swap" under the CEA and thus exclude such instruments from swaps regulation under the CEA.

In so acting, the Secretary is required to determine specifically that foreign exchange swaps and/or forward contracts (i) should be not be regulated as swaps under the Dodd-Frank Act, and (ii) are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the Commodity Futures Trading Commission (CFTC) pursuant to section 721 of the Dodd-Frank Act. In making this determination, the Secretary must consider (i) whether the required trading and clearing of foreign exchange swaps and forward contracts would create systemic risk, lower transparency, or threaten the financial stability of the United States; (ii) whether such contracts are already subject to a regulatory scheme that is materially comparable to that established by the CFTC for other classes of swaps; (iii) the extent to which bank regulators of foreign exchange market participants provide adequate supervision, including capital and margin requirements; (iv) the extent of adequate payment and settlement systems; and (v) the use of a possible exemption to evade otherwise applicable regulatory requirements.

Following an October 2010 request for public comment on the CEA exclusion issue,[1] the Secretary issued a Notice of Proposed Determination (NPD) in late April 2011 in which the Secretary proposed to exclude foreign exchange swaps and forward contracts from regulation as swaps under the Dodd-Frank Act.[2] Last Friday's final action, which becomes effective upon its publication in the *Federal Register*, is the culmination of this regulatory process, although the Secretary is also required under section 722 to report to Congress on the nature and basis for its exclusion determination.

[1] 75 Fed. Reg. 66426 (October 28, 2010).
[2] 76 Fed. Reg. 25774 (May 5, 2011).

The Secretary's Determination

The relatively long period of time between the issuance of the NPD, which was supported by the financial services industry but attracted meaningful opposition from public interest groups as well as some members of Congress, led some industry observers to question whether the Secretary might be reconsidering its initial proposal. The final Determination, of course, puts those concerns to rest.

In substance, the Determination was based on the Secretary's conclusion that the foreign exchange markets did not present the types of counterparty credit and market risks present in other swaps markets, and that the one type of risk associated with the foreign exchange markets, namely, settlement risk, was effectively mitigated through various measures, including the predominance of payment-versus-payment (PvP) settlement arrangements, and the activities of the Continuous Linked Settlement (CLS) system in the settlement of transactions in major currencies. The Determination noted that several "unique" factors differentiated the foreign exchange swaps and forward contract markets from other swaps markets, including (i) the fact that such contracts require a physical exchange of a fixed principal amount of currencies, (ii) the fact that such contracts are not structured to evade regulatory requirements applicable to other types of swaps, (iii) a well-functioning settlement process for these markets that relies on several established payment systems, (iv) a "highly transparent and liquid market" for such instruments, and (v) the predominance of short-duration contracts in these markets. In addition, the Determination observed that foreign exchange swaps and forward contracts have been subject to "strong, comprehensive oversight" for several decades, and that the Dodd-Frank Act strengthens the authority of the federal financial regulatory agencies to oversee these products.

Stated in more prosaic terms, the Determination's conclusions and reasoning were primarily based on the classic "if it ain't broke, don't fix it" chestnut that, in our view, has been too frequently absent from the overall Dodd-Frank Act regulatory process. In addition, the Secretary plainly was concerned about the implications of subjecting what is a very large trading and clearing market to the CEA's centralized clearing and trading requirements, including the creation of a central counterparty (CCP) that by all accounts would be an "instant" systemically significant financial market utility (FMU) under Title VIII of the Dodd-Frank Act. As the Determination stated, "combining [the trading and clearing] functions in a market that involves settlement of the full principal amounts of the contracts would require massive capital backing in a very large number of currencies, representing a much greater commitment for a CCP in the foreign exchange swaps and forwards market than for any other type of derivatives market."

A Few Observations

The Secretary's Determination represents, in our view, a sensible and welcome outcome to a regulatory process that, had it been decided otherwise, could well have injected significant and unnecessary additional costs and complexity into the foreign exchange markets, as well as, ironically, substantially increased systemic risk. That being said, the exclusion of foreign exchange swaps and forward contracts from regulation under the CEA is not absolute. The CFTC still retains the express statutory authority to apply business conduct standards to foreign exchange swaps and forward contracts, exercise its anti-evasion authority over these instruments, and require the reporting of foreign exchange swap and forward contract trade data to a swaps data repository (SDR), which already is in development by the Depository Trust & Clearing Corporation. And, last but not least, readers are reminded that the Determination acts only to exclude foreign exchange swaps and forward contracts from regulation under the CEA; other foreign exchange instruments such as foreign exchange options, currency swaps and non-deliverable forwards continue to be included in the CEA definition of "swap" and therefore regulated under the CEA.

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