

MEMO# 26701

November 19, 2012

Treasury Exempts FX Swaps and FX Forwards from the Definition of "Swap"

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 76-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 65-12
INVESTMENT ADVISER MEMBERS No. 44-12
SEC RULES MEMBERS No. 105-12
INTERNATIONAL MEMBERS No. 50-12 RE: TREASURY EXEMPTS FX SWAPS AND FX FORWARDS FROM THE DEFINITION OF "SWAP"

On November 16, 2012, the Department of the Treasury ("Treasury") issued a written determination exempting foreign exchange ("FX") swaps and FX forwards from the definition of "swap," in accordance with the applicable provisions of the Commodity Exchange Act ("CEA"). [\[1\]](#) The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") authorizes the Secretary of the Treasury to issue a written determination that FX swaps, FX forwards or both should not be regulated as swaps under the CEA.

Treasury determined that FX swaps and FX forwards should not be regulated as swaps under the CEA and should be exempted from the definition of the term "swap" because of the distinctive characteristics of these instruments. Moreover, Treasury believed that requiring central clearing and trading under the CEA of FX swaps and FX forwards would potentially introduce operational risks and challenges to the current settlement process. As a result of the Treasury's exemption, FX swaps and FX forwards also will not be subject to margin requirements under the CEA.

Treasury made its final determination based on a number of factors. These include: (1) FX swaps and FX forwards are different in significant ways from other classes of swaps, particularly with respect to the certainty of payment amounts and shorter maturities; (2) the main risk for FX swaps and FX forwards is settlement risk, which is effectively mitigated through various measures; (3) FX swaps and FX forwards are subject to less counterparty credit risk prior to settlement than other derivatives; (4) FX swaps and FX forwards transacted by banks already are subject to oversight; (5) the FX swaps and FX forwards market already is highly transparent and traded over electronic trading platforms; and (6) FX swaps and FX forwards will be subject to oversight under the CEA, including trade reporting requirements and business-conduct standards.

Treasury stated that its determination is limited to FX swaps and FX forwards and not to other FX derivatives. Specifically, FX options, currency swaps, and non-deliverable forwards may not be exempted from the CEA's definition of "swap" because they do not satisfy the statutory definition of an FX swap or FX forward. [2]

Jennifer S. Choi
Senior Associate Counsel – Securities Regulation

endnotes

[1] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act (Nov. 16, 2012) ("Determination"), available at <http://www.treasury.gov/press-center/press-releases/Documents/11-16-2012%20FX%20Swaps%20Determination%20pdf.pdf>.

[2] The definitions of FX swap and FX forward under the CEA both require the "exchange of 2 different currencies." The Determination states, however, that:

The requirement in the definitions of "foreign exchange forward" and "foreign exchange swap," respectively to "exchange" the two currencies should not be interpreted as requiring each foreign exchange swap or forward transaction to be settled independently. Rather, an entity, such as [CLS Bank International] or any other operator of a multilateral [payment-versus-payment] settlement system, that settles a series of foreign exchange swap and forward 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. Applying appropriate mechanisms during the settlement process to net qualifying foreign exchange swap and forward transactions conducted by a group of parties should satisfy the limitations under the CEA because the essential elements of each of those transactions—namely, an exchange of two different currencies at a predefined, fixed rate—are left intact.

Id. at 42. The Determination states in a footnote to this paragraph that nothing herein is "intended to: (1) address transactions described in footnote 539 of the CFTC-SEC Joint Products Rule; or (2) establish a "bookout" right allowing parties to avoid exchanging currencies, each of which, depending on the relevant facts and circumstances, may fall within CFTC regulation 1.3(xxx)(6)(ii) . . ."