FS Regulatory Brief

Derivatives: Relief for documenting FX trading relationships? – It's complicated

June 2013

On June 27, 2013, the Commodity Futures Trading Commission (CFTC) provided welcome, if partial, relief from its swap documentation requirements. The relief extends the July 1, 2013 deadline for swap dealers (SDs) and major swap participants (MSPs) for putting swap trading relationship documentation in place with counterparties. However, the relief comes with some caveats – it is temporary, only applies to trades with foreign exchange (FX) counterparties, and only applies to transactions with non-SD/MSP counterparties.

Background

At issue are the CFTC's "swap trading relationship documentation" rules that require SDs and MSPs to have in place not only documentation that meets minimum standards governing the terms of their trading relationships with counterparties, but also policies and procedures designed to ensure that such documentation is executed. After first providing for a phased-in implementation of the rule, the CFTC later set July 1st as the date by which SDs and MSPs had to have such documentation and policies in place with all counterparties with regard to all asset classes. The rule hit a snag, however, with FX transactions because FX has customarily traded without the type of trading relationship documentation the CFTC is now requiring. Whereas other products in a dealer's portfolio likely traded under ISDA master agreements or other forms of documentation, many dealers had to start from scratch or update existing FX agreements in order to meet the more rigorous CFTC documentation standards.

The industry asked for relief from the July 1st deadline with regard to FX transactions, arguing primarily that most FX transactions affected by the rule had not traditionally been covered by ISDA master agreements or equivalent types of relationship documentation. The industry also argued that there had been an "initial lack of awareness" that swap trading relationship documentation rules applied to all FX derivatives.[1]

Targeted and temporary relief …

The CFTC was swayed by the industry arguments – to a degree. The no action relief provided by the CFTC is based on counterparty type, restricted to FX trading relationships, and requires compliance with various conditions. Specifically, an SD or MSP may continue to trade foreign exchange options, swaps, forwards and non-deliverable forwards with a non-SD/MSP counterparty even though the required swap documentation is not in place until:

- September 1, 2013 for "active funds,"[2] and
- December 31, 2013 for all other counterparties that are not swap dealers or MSPs.

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[1] Under Dodd-Frank, business conduct rules including swap relationship documentation rules apply to all FX swaps, including those deemed exempt by the Secretary of the Treasury. This means that (1) non-deliverable forwards (NDFs) involving foreign exchange and foreign currency options (cross-currency swaps are not foreign exchange transactions) and (2) physically-settled FX forwards and swap agreements that were exempted from the definition of swap by Treasury last December, are both subject to the swap documentation requirements ("covered FX transactions").

[2] For the purposes of the no-action letter, an "active fund" is defined as a private fund that is not a third-party subaccount and that executes 200 or more covered FX transactions per month based on a monthly average over the past 12 months.

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The CFTC letter does not relieve SD/MSPs from the obligation to have relationship documentation in place with other SDs and MSPs with whom they trade FX derivatives.

... with conditions attached

In addition to the limitations discussed above, the no-action relief comes with the following conditions, all of which must be met in order for an SD/MSP to rely on the relief:

- The SD or MSP has established and maintains the required written policies and procedures regarding swap relationship documentation;
- The only swaps that are currently in effect between the SD or MSP and the counterparty as of the date of the no-action letter are the covered FX transactions;
- From the date of the no-action letter until the expiration of the relief, the SD or MSP only enters into swaps with the counterparty that are the covered FX transactions; and
- As of the date of the no-action letter, the covered FX transactions currently in effect between the SD or MSP and the counterparty are not governed by relationship documentation that is, or is substantially similar to, an ISDA master agreement.

Practical implications

As outlined above, the relief provided in the no-action letter comes with several strings attached; therefore, SDs or MSPs wishing to take advantage of the relief will have to take a quick inventory to ensure that they can meet the conditions as of July 1st. For example, because the no-action letter does not provide relief from the requirement that policies and procedures be in place, SDs and MSPs should proceed with filing evidence of compliance with the swap documentation requirement with the National Futures Association (as required for all Commodity Exchange Act Section 4s requirements) by July 1st, if they have not already completed this step.

Moreover, if an SD/MSP trades both FX and other types of swaps with a counterparty, the relief does not appear to apply. Accordingly, an SD/MSP must have fully compliant documentation in place for counterparties with whom they trade both FX derivatives *and* other products.

The condition that the relief applies only where FX derivatives currently in effect between an SD/MSP and a counterparty are not otherwise governed by an ISDA master agreement (or "substantially similar" documentation) may prove challenging. While one would expect that most SD/MSPs have already made some determination as to the existence of documentation with their counterparties, determining whether such documentation is "substantially similar" to an ISDA master adds an additional layer of analysis, and one that must be performed in a very short period of time.

Finally, while various industry groups initially requested relief from the documentation requirements for all swap counterparties, the CFTC held firm on the July 1st deadline for all other asset classes, demonstrating what appears to be an increasing unease with extensions of deadlines. That the FX industry succeeded in obtaining some relief is likely attributable to the anomalous manner in which FX instruments have traditionally been traded and relationships documented. Nevertheless, the extension of time for compliance – just six months at the outside – does not provide a great deal of time to obtain the required documentation with all counterparties, and SD/MSPs will have to move with alacrity to comply.

Additional information

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