

# ***FS Regulatory Brief***

## ***Treasury exempts FX swaps and forwards from most derivatives regulation***

November 2012

The US Treasury Department issued a final determination that exempts foreign exchange (FX) swaps and forwards from most of the requirements in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), effective November 20, 2012. This FX exemption, which has long been expected but delayed due to the election, permits all types of counterparties to engage in FX swaps and forwards transactions without having to register as swap dealers or major swap participants (MSPs), or having to comply with the requirements for central execution, central clearing, margin or real-time public reporting of swap data. The exemption is not a blanket pass on all regulation, however. Swap dealers still must comply with business conduct standards, and all counterparties must report data for confidential regulatory purposes, when trading FX swaps and forwards.

This ***FS Reg Brief*** describes the new Treasury exemption for FX swaps and forwards and offers insights as to its expected impact.

### ***What is exempt?***

The Treasury determination exempts FX swaps and forwards from the definition of “swap” in the Commodity Exchange Act (CEA). In accordance with the relevant language of the CEA, the Treasury exemption is limited in scope. It defines FX swaps and forwards narrowly and speaks specifically about the types of FX derivatives that are not within the exemption, *i.e.*, foreign exchange options, currency swaps and nondeliverable forwards (NDFs).

The Treasury took this step after characterizing FX swaps and forwards as unique instruments that do not pose risks addressed by Dodd-Frank. It noted that, “unlike most other swaps, [FX swaps and forwards] have fixed payment obligations, are settled by the exchange of actual currency, and are predominantly short-term instruments.” Other reasons cited were that FX swaps and forwards primarily pose settlement risk, which is addressed by payment-versus-payment settlement arrangements, and trade in a highly liquid, efficient and transparent inter-bank market.<sup>1</sup> Adding Dodd-Frank’s other protections, such as clearing, could disrupt a market that does not present significant counterparty credit risk. Treasury also stated that most counterparties are banks or their affiliates which already are subject to regulatory oversight. Opponents of the exemption argued that the exemption would preserve an “opaque, unregulated and under-capitalized market.” They also argued that the exemption would make evasion highly likely.

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<sup>1</sup> The trades settle predominantly through CLS Bank International which has been designated by the Financial Stability Oversight Council as a systemically important financial market utility subject to enhanced risk management and other standards under the Dodd-Frank Act.

## Know your FX products

It is important to precisely define the FX instrument traded to know the regulatory implications. According to Treasury, FX swaps and forwards are distinct because they must “(1) involve the exchange of the principal amounts of the two currencies exchanged, as opposed to a set of cash flows based upon some floating reference rate, and (2) be settled on a physical basis.” They provide for a simple exchange of principal at one point in time and a reversal of that exchange at a later date. A fully-regulated swap generally involves a periodic exchange of a floating amount of cash flows between the counterparties based on the value of a reference asset or underlying variable. The “ability to receive periodic payments during the term of a transaction is a significant feature of “swaps,” but not of FX swaps or forwards.

The Treasury determination emphasizes its applicability to FX swaps and forwards and declined to extend an exemption to NDFs. Instead, it deferred to the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) view in their release on swap definitions (Product Release) that other FX derivatives, and NDFs specifically, are fully regulated by Dodd-Frank.<sup>2</sup> Treasury also discussed the risk

<sup>2</sup> Further Definition of “Swap”; “Security-based Swap”; and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48208 (August 13, 2012).

of evasion stemming from mischaracterizing a product as an exempt FX swap or forward, versus a fully-regulated NDF.

## What about FX spot transactions?

Title VII of the Dodd-Frank Act does not regulate trading in the non-retail foreign exchange spot market, but it also does not define “spot.” Although Treasury did not raise this topic, the CFTC and SEC provided interpretive guidance in their Product Release.<sup>3</sup> In general, a foreign currency transaction that settles within T+2 is a spot transaction, so are securities conversion transactions under certain conditions.<sup>4</sup> It may be possible to interpret a longer settlement date as meriting spot treatment for certain transactions and counsel should be consulted.

The Treasury determination effectively splits the regulation of the foreign exchange derivatives markets under Title VII as set forth in the table below:

<sup>3</sup> Other regulators also discussed the definition of spot in connection with the issuance of regulations on retail-foreign exchange transactions. See *e.g.*, Retail Foreign Exchange Transactions (Regulation NN) 76 FR 46652, 46654 (August 3, 2011) (Federal Reserve proposed rule).

<sup>4</sup> The CFTC considers a securities conversion transaction to qualify as bona fide spot if it is entered into solely to effect the purchase or sale of a foreign security and pricing, timing, and delivery conditions are met. See Product Release.

Fully Exempt	Partially Exempt (Exempt from all but swap dealer business conduct, confidential SDR reporting, anti-evasion)	Fully-Regulated (Subject to registration, capital, swap dealer business conduct, documentation central execution, central clearing, cleared margin, uncleared margin and segregation, confidential SDR reporting, real-time public reporting)
FX Spot	FX Swap	Non-deliverable Forward
Securities Conversion Transaction	FX Forward	Cross Currency Swap/Currency Swap
		Foreign Currency Option

Under Title VII

## ***FX swaps and forwards are exempt from all but...***

The Treasury exemption does not exempt a registered swap dealer that deals in FX swaps and forwards from the rigorous swap dealer business conduct rules. These rules seek to reduce operational risk and set standards and disclosure requirements for trading with counterparties.<sup>5</sup>

FX swaps and forwards also must be reported to a swap data repository for confidential regulatory use. Real-time public reporting of swap data for FX swaps and forwards is not required.<sup>6</sup> Note that this data reporting requirement applies even if a counterparty is not a swap dealer. This means that firms that do not register as swap dealer/MSPs and do not trade exempt FX swaps and forwards with a registered swap dealer/MSP, will have to determine how to report the data. In other words, FX swap and forward trades between two “end-users” still must be reported, albeit solely for confidential regulatory use.

The Treasury determination also notes that any FX swap or forward that is “listed and traded on or subject to the rules of a designated contract market or a swap execution facility [SEF], or that is cleared by a derivatives clearing organization” will not be exempt from the anti-manipulation provisions of the CEA.

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<sup>5</sup> For example, internal business conduct rules require a swap dealer to have risk management and conflict of interest programs in place. External business conduct requires verification of eligible contract participant status and provision of disclosures (e.g., material risk, daily mark, scenario analysis, suitability). A footnote in the Treasury determination cites to the recent requirements for swap dealers to have swap documentation in place and observe rules regarding confirmations, compression and reconciliations. confirmations, portfolio compression and reconciliation. This latter point bears close study with counsel.

<sup>6</sup> Treasury states in its release that the Depository Trust and Clearing Corporation (“DTCC”) has applied to register as a swap data repository to receive the confidential data on FX swaps and forwards. It also says that DTCC is “testing a foreign exchange trade repository service through which DTCC intends to provide both public and regulatory reporting, as early as first quarter of 2013.”

## ***Impact on US and foreign banks***

The FX exemption may lead to some less-than-intuitive regulatory results. Since the products are exempt from the definition of swap for all purposes except swap dealer business conduct, SDR reporting and anti-evasion, a firm may exclude FX swaps and forwards from its calculation of dealer status under the swap dealer *de minimis* test for registration. This means that a firm that trades FX swaps and forwards exclusively would not have to register as a swap dealer. If a firm also deals in fully-regulated swaps, it still would not have to register if those fully regulated swaps on a stand-alone basis fall below the *de minimis* threshold. If the firm does not register, then the swap dealer business conduct duties would not apply to any trades, including the FX swaps and forwards. Only the requirement to report to a swap data repository persists for such a firm.

For sell-side firms that are registering as swap dealers anyway (e.g., because they deal in other products at notional amounts above the *de minimis* threshold), a partial compliance structure needs to be built around FX swaps and forwards. FX swaps and forwards must be included in the swap dealer conduct program (e.g., pre-trade verifications, disclosure, daily mark, diligent supervision). However, FX swaps and forwards could be excluded from systems processing for central execution and clearing as well as margining, then brought back into work flows for swap data repository reporting, but not real-time data reporting. From a front-to-back work flow stand point, tracking these products through systems and procedures becomes a bit of a slalom course. FX swaps and forwards trades are in for onboarding and risk, out for trade processing, and back in for reporting.

Fortunately, the first dealers to register are well down the path toward implementing systems and procedures based on anticipation of the proposed Treasury exemption going final. However, explaining the residual regulation of FX swaps and forwards to clients on a go-live basis could cause confusion at the outset.

## ***A word on push outs***

The FX exemption does not address specifically the “push-out” provisions contained in Section 716 of the Dodd-Frank Act, which will become effective on July 16, 2013. These provisions effectively require US banks and US offices of foreign banks that register as swap dealers or MSPs to move -- or push out -- certain derivatives activities deemed overly risky to a nonbank affiliate outside the bank chain of ownership in order to retain access to certain types of Federal assistance.

An important push-out exemption permits an insured depository institution (IDI) to keep certain swaps, including FX swap and forwards, in the bank.<sup>7</sup> However, Dodd-Frank does not provide this exemption for firms that are not “insured depository institutions,” which include many foreign banks with US branch offices. A key question for these non-IDIs that register as swap dealers is what do they have to push out. Given that the FX exemption classifies FX swaps and forwards as “not swaps,” other than for the purposes enumerated above, a question arises as to whether a non-IDI may retain its FX swap and forward transactions because those products are not swaps under the push-out rules. Dodd-Frank appears to be silent on this point, but it seems that an argument could be made in this fashion. Affected firms may wish to approach counsel for definitive guidance on this legal point.

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<sup>7</sup> Other provisions extend the July 2013 compliance deadline for IDIs.

## ***Timing of other key determinations or guidance***

The Treasury determination is particularly significant because it removes some lingering uncertainty over the regulation of FX swaps and forwards. For some firms, excluding these products may allow them to postpone or even avoid registration as a swap dealer or MSP. For those firms that are registering, it narrows the scope of applicable compliance requirements for these transactions and provides time to ensure good-faith processes will be in place to differentiate between those FX transactions that are exempt and those that are not after the first registration deadline of December 31, 2012.

With the Treasury determination now on the books, this leaves the final CFTC regulatory guidance on the cross-border application of Title VII as perhaps the principal “missing link” to determining with more certainty, the types of swaps, counterparties and compliance requirements firms must operate under after December 31, 2012. The release of final cross-border guidance is particularly significant to sell-side firms who would also be able to anticipate which trading strategies and locations will carry Dodd-Frank regulation now -- based on US regulation-- versus later (and potentially much later) when non-US regulatory regimes catch-up with US regulators. Based on remarks made by CFTC Chairman Gary Gensler, this final cross-border guidance is to be released before year-end.

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## Additional information

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