Investment Funds Alert

Treasury Excludes Certain FX Transactions from Definition of “Swap”

November 20, 2012

On Friday, November 16, 2012, the Secretary of the Treasury, Timothy Geithner, released his determination that “foreign exchange forwards” and “foreign exchange swaps,” as defined by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), should be excluded from the definition of the term “swap.” This determination will be important for many fund managers, as the excluded instruments will not be included in the amount of notional value of commodity interests or initial margin when calculating whether they satisfy the tests in Regulation 4.13(a)(3) or are required to register with the Commodity Futures Trading Commission (CFTC) as commodity pool operators.

It is important to note that the scope of this determination extends only to those interests that fit within the narrow definition of foreign exchange forward and foreign exchange swap found in the Dodd-Frank Act. As defined in the Dodd-Frank Act, a “foreign exchange forward” means a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange. A ”foreign exchange swap” means a transaction that solely involves (i) the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange and (ii) a reverse exchange of such currencies at a later date and at a fixed rate that is agreed upon at the inception of the contract covering the exchange.

Many foreign exchange transactions that funds regularly enter into would not, however, be excluded under the above definitions. For example, foreign exchange options, currency swaps[1] and nondeliverable forwards are not included in the Secretary’s determination. In addition, as the CFTC and the Securities and Exchange Commission stated in their joint release, further defining the term “swap,” other agreements that do not contemplate delivery of the currency, such as contracts for differences related to foreign currency and forward rate agreements, are not subject to exclusion pursuant to the Secretary of the Treasury’s determination.[2]

The Secretary’s determination to exclude foreign exchange forwards and foreign exchange swaps was based on the characteristics of those instruments and the difficulty in arranging for settlement using the Dodd-Frank Act’s model. In particular, the Secretary described foreign exchange forwards and foreign exchange swaps as having lower risk profiles because of their fixed payment obligations, settlement by exchange of actual currency and predominantly short-term nature. In addition, the Secretary believes that the market for foreign exchange forwards and foreign exchange swaps is already transparent and would be negatively impacted by the application of a central counterparty clearing mechanism as contemplated by the Dodd-Frank Act.

[1] A currency swap is generally a swap in which the fixed legs or floating legs based on various interest rates are exchanged in different currencies.

[2] See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208, text at notes 585 to 599 (August 13, 2012) (available at http://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf).

The Secretary's determination will be effective upon publication in the *Federal Register*. As required by the Dodd-Frank Act, foreign exchange forwards and foreign exchange swaps will remain subject to the reporting and business conduct rules applicable to swaps.

See the press release (available here) and the Secretary's final determination (available here) for more information.

CONTACT INFORMATION

If you have any questions concerning this alert, please contact—

David M. Billings
dbillings@akingump.com
44.20.7012.9620
London

J.P. Bruynes
jpbruynes@akingump.com
212.872.7457
New York

Prakash H. Mehta
pmehta@akingump.com
212.872.4370
New York

Eliot D. Raffkind
eraffkind@akingump.com
214.969.4667
Dallas

Stephen M. Vine
svine@akingump.com
212.872.1030
New York