FXC – Forum on Dodd-Frank Act & the Foreign Exchange Market

SEF Panel

April 2013
The Panel

Panelists:

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Agenda

• Regulatory Overview

• Products

• Registration and Access

• Execution Alternatives in SEF Proposal

• Impact on Dealer to Client Relationships

• Navigating as a Client
Questions To Consider

• What are the Requirements?

• Which Products will trade on SEFs?

• Alternatives to SEFs?

• How do I access SEFs?

• How do I execute Trades in SEFs?

• Does the client / dealer relationship change with SEF execution?
Regulatory Overview: Current Timeline

*All dates are best approximations as of Apr 2013 and are subject to change.*
How FX Instruments are Impacted

– Products that are being cleared today may be subject to mandatory clearing and trading and SEF Trading

– Products that are not likely to be cleared soon (e.g., bespoke products) will not be subject to SEF Trading

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Reported to Swaps Data Repository (SDR)</th>
<th>Cleared</th>
<th>Traded on Swaps Execution Facility (SEF)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FX Options</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>NDFs</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>FX Swaps</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FX Forwards</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FX Spot</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Blocks are required to trade under SEF rules and be reported to a SEF, but are not subject to specific execution requirements, such as RFQ to a minimum number of providers.
## FX product landscape

<table>
<thead>
<tr>
<th>Out of scope</th>
<th>Currently cleared (primarily D2D)</th>
<th>Expected mandatory for clearing / SEF execution in medium term</th>
<th>Not expected mandatory for clearing / SEF execution in medium term</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Spot</td>
<td>• Liquid NDF currencies (e.g., CNY, INR, KRW, BRL, CLP)</td>
<td>• Liquid NDF currencies</td>
<td>• Illiquid NDF currencies</td>
</tr>
<tr>
<td>• Forwards</td>
<td></td>
<td>• G10 vanilla options (timeframe unclear)</td>
<td>• Exotic options</td>
</tr>
<tr>
<td>• Swaps</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Currently cleared (primarily D2D) is expected to be mandatory for clearing / SEF execution in medium term.
How will NDFs Become Mandatory-Traded on a SEF?

• Pre-requisite: Clearing mandates
  – CFTC, in conjunction with clearinghouses (DCOs), determines which NDF currency pairs are required to be cleared

• SEFs make NDFs ‘available for trading’
  – SEFs independently choose from the mandatory clearing list which NDFs they wish to list
  – Once a SEF lists an NDF pair, that pair can only be traded via SEF (including other competing SEFs)
Registration and Access

– Execution is only limited to ECPs (unlike DCM execution, which is open to retail).
– Buy-side need to register with a SEF -- which may result in buy-side submission to the SEF rules.
– Two potential SEF access modalities (CFTC SEF rulemaking is not yet final).
  • Buy-side direct access to a SEF (requires buy-side to have a relationship with one or more clearing firms).
  • Buy-side interface with single-dealer platform, which is operationally linked to a SEF.
– Why does this matter?
  • Potential for information leakage and conflict of interest
  • Transaction fees
## Trading in a Regulated/Non-regulated platform

Assume a mandatory-cleared, below-block size contract (e.g., 3M BRL/USD)...

<table>
<thead>
<tr>
<th>Regulatory classification</th>
<th>Can trade on a SEF</th>
<th>Can trade on a non-SEF</th>
<th>Caveats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subject to DFA, Joins a SEF</td>
<td>Yes</td>
<td>No</td>
<td>But can trade only with other SEF participants</td>
</tr>
<tr>
<td>Subject to DFA, Does not join a SEF</td>
<td>No</td>
<td>No</td>
<td>Can only trade NDFs under the End User Exemption</td>
</tr>
<tr>
<td>Not subject to DFA, Joins a SEF (to trade with US counterparties)</td>
<td>Yes</td>
<td>Yes</td>
<td>Can trade with anyone, regardless of DFA jurisdiction</td>
</tr>
<tr>
<td>Not subject to DFA, Does not join a SEF</td>
<td>No</td>
<td>Yes</td>
<td>But can trade only with others not subject to DFA</td>
</tr>
</tbody>
</table>
Execution Alternatives in SEF Proposal

– *Execution Alternatives*
  
  • SEF RFQ. Differences from current RFQ.
  • Central limit order book. Post or see interest from the market.
  • Block Trades:
    – CFTC defined sizes to denote “big” trades. Can be executed off SEF platform but subject to SEF rules

– *Constraints*
  
  • Minimum RFQ
  • Block proposals
  • Proposals that affect flow internalization (15 second rule)
  • Voice
  • Liquidity – fragmentation / regionalization
Evolving Services and Relationships

- Access and Aggregation Service
- Single Dealer Platform as gateway to SEFs
- Dealer and Agency models
- Spot, exempt FX, and non-exempt FX could be allocated across platforms
Navigating as a Client

• Precursor to trading on a SEF is clearing
  – Choosing Clearing Broker(s)
  – Choosing Clearing House(s)
• How many SEFS per asset class is enough?
• Aggregated or Direct Access?
• How do you make sure the liquidity is there for you?
• Comparing NDFs and Futures
  – SEF and DCM trading models
Appendix
# Navigating as a Client

## Reporting
- Trades on a SEF (Swap Execution Facility) -> SEF will report
- Non-SEF trades that are cleared -> clearing firm will report
- Non-SEF trades that are not cleared ->
  - SD (Swap Dealer) reports all trades where it is counterparty
  - If there is no SD counterparty, MSP (Major Swap Participant) reports the trade
  - If there is no SD or MSP counterparty, ECP (Eligible Contract Participant) reports the trade
- Regardless of who reports your trades, you must register as an ECP with the DTCC (Depository Trust & Clearing Corporation) and obtain a LEI (Legal Entity Identifier)

## Clearing
- NDF (Non-Deliverable Forward) trades (and in the future, options) in mandatory cleared currency pairs must be cleared, unless you utilize the End User Exception
- If your trades need to be cleared you must establish a relationship with a clearing firm or prime broker
- Non-financial ECPs must decide whether to pursue the End User Exception, which provides relief from mandatory trading and clearing requirements

## SEF Trading
- ECPs that do not qualify as End Users must join a SEF to trade their NDFs (and in the future, options) in mandatory cleared currency pairs
- ECPs that will use the End User Exception for some trades will need to join a SEF. Notify the SEF of clearing and data repository relationships
- If you use a SEF’s RFQ (Request for Quotation) mechanism to trade non-block NDFs, you must RFQ to a minimum number of providers