Special Considerations in Dealing with Non-Dealer Counterparties
An overview

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Non-Dealer Counterparties

Non-Dealers Market Participants

According to the most recent BIS Central Bank Survey published February 2014, non-dealer institutions are not only the largest segment of the $5.3 trillion daily FX Market, they constitute the majority of it.

- Non-reporting dealer financial institution, local and cross border (covering customer needs; proprietary targets)
- Non-reporting banks institutional investors hedge funds and PTFs official sector (speculation and hedging)
- Non-financial customers, local and cross-border (buying/selling currency; hedging currency risk)
Non-Dealer Counterparties – Current considerations for US Swap Dealer

**Entity Classification - Counterparty Types**

- Swap Dealer / Major Swap Participant
- Financial Entity
- Eligible Contract Participant (ECP)
- Special Entity – Governmental; ERISA plans; Non-ERISA (QIR); Endowments includes endowments that are 501(c)(3) non-profits; Advisors (Best Interest / Capacity Disclosure)
- U.S. Person / Non-U.S. Person Designation
- End-user exemption (financial v. non-financial entities)
- Financial end-users (with and without material swap exposure)
Client Account Set-Up at U.S. Dealer - examples

- **Dodd-Frank requirements driving new changes to the onboarding process and new documentation include:**
  - Entity Classification (e.g., Swap Dealer, Major Swap Participant)
  - Know Your Customer (KYC) - true name and owner/ address, principal business, name / address of guarantors
  - Verification of counterparty eligibility
    - Eligibility (ECP verification)
    - Special entity and treatment election
    - Safe harbors
  - Institutional Suitability
  - Communications, marketing
  - End-user exemption (financial v. non-financial entities)
  - Regulatory Reporting / Real-time Reporting
  - LEI
  - Relationship Documents (STRD, authority)
  - Clearing Docs
  - Disclosures: Choice of DCO, Right to Segregate IA, Daily Mark, Scenario Analyses, Material Risks, Conflicts of Interest (Pre-Trade Mark), Material Characteristics
  - Regulatory notices: where to complain, consent to record, right to clear, right to select DCO, right to segregate IA
  - Tax Forms
  - Counterparty Status / Representations
  - Jurisdictional diligence; netting and enforceability
  - Counterparty and Credit Due Diligence
  - Client Preferences; SSIs; settlement arrangements
Foreign Exchange Transactions: Execution to Settlement
Recommendations for Non-Dealer Participants
The New York Foreign Exchange Committee

- Originally drafted as an operational guide in 1999, the 2015 update supersedes prior versions.

- Will be conformed to the “Global Preamble” and other guidelines prior

- Drafting group consists of both sell- and buy-side market participants

- 22 highlighted issues that promote risk awareness for Non-Dealers Participants and provide "best practice" recommendations

- Addresses all 6 stages of trade process flow in order to ensure safe and sound conduct of business

- 2015 updates observe global regulatory market reform, but do not restate or align with particular regional rules

- Most notable new changes relate to confirmation practices, reconciliation, discrepancy resolution, trade allocation, documentation and more.
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<thead>
<tr>
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<th>US</th>
<th>EU</th>
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<tr>
<td><strong>Clearing</strong></td>
<td>Once made mandatory, all must clear absent exemption.</td>
<td>• EC and ESMA technical standards</td>
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<td>• non financial entities</td>
<td>• If an NFC- is a counterparty, trade will not be subject to the</td>
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<td></td>
<td>• small depository institutions</td>
<td>clearing obligation.</td>
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<td>• captive finance co hedging risk</td>
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<td>• majority-owned affiliates</td>
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<td>Use of exceptions requires regulatory reporting of use, and basis</td>
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<td>basis for qualification.</td>
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<td><strong>Trade Execution</strong></td>
<td>Mandatory SEF/DCM trading (MAT) = centralized order book on SEF/</td>
<td>EMIR does not impose mandatory venue execution requirements.</td>
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<td>DCM or through a “request for quote system” on a SEF.</td>
<td>ESMA (MIFID II)</td>
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<td>Permitted SEF/DCM trading</td>
<td>Inapplicable when a NFC- is a counterparty</td>
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<td>Footnote 195</td>
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<td><strong>Trade Reporting</strong></td>
<td>All swaps (cleared and uncleared) must be reported to SDR</td>
<td>FCs, NFCs and CCPs must report</td>
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<td>Single CP reports bilateral swaps</td>
<td>All parties have reporting responsibility</td>
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<td>SEF and DCO</td>
<td>Delegated reporting</td>
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<td><strong>Uncleared Swap Margining and Segregation</strong></td>
<td>CFTC margin requirements</td>
<td>FCs and NFC+s</td>
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<td>Initial margin segregation and notification requirement</td>
<td>ESMA - technical standards for implementing the BCBS IOSCO</td>
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<td>Proposed carve-outs for non-financial entities</td>
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<td>Prudential regulators – BCBS IOSCO</td>
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<td><strong>Customer Documentation</strong></td>
<td>Relationship Doc, Valuation Procedures, Confirmations, Portfolio</td>
<td>Confirmations</td>
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<td>Recon, Portfolio Compression</td>
<td>Portfolio Recon</td>
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<td>Dispute Resolution. Reporting to trade repositories</td>
<td>Portfolio Compression</td>
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<td>*May apply outside of EMIR</td>
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<td><strong>Business Conduct</strong></td>
<td>Know Your Customer, Confidentiality, Risk and Other Disclosures</td>
<td>Daily valuation</td>
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<td>Pre-Trade Marks, Scenario Analysis, Suitability, Special Entities</td>
<td>*May apply outside of EMIR</td>
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What is Next for End-Users?

“We will continue to look at ways that we can make sure commercial end-users can use these markets effectively, and to make sure that the new regulatory framework for swaps does not impose unintended consequences or burdens for them.” Chairman Timothy Massad before the Natural Gas Roundtable (Washington, D.C.) May 26, 2015

“Non-financial firms make up a significant part of the OTC derivatives markets but EMIR recognises that this does not necessarily make them systemic.” Jonathan Hill, European Commissioner for financial stability, financial services and capital markets union, EMIR public hearing (Brussels) 29 May 201

Stated goal to ensure commercial end-users can continue to hedge risk effectively in the markets

- Contracts with Embedded Volumetric Optionality
- Trade Options – requirement modifications
- Utility Special Entities
- Treasury Affiliates
- Some RT Reporting Relief (long-dated, less-liquid swaps)
- Position regarding Clearing, Trade Execution, Reporting and Uncleared Swap Margining