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Technology and the Politics of Swaps Data Repository Issues

Financial Intergroup Holding's Allan D. Grody on how technology can provide simpler, cost effective and geopolitically savvy solutions to reporting swaps data.

In order to observe risk in the OTC markets, the CFTC focused on regulating global swaps activity. It set itself on a course that parallels existing trading markets, a reasonable approach at the time.

It begins with the concentration of swaps trading on trading venues similar to those that exists for listed securities and futures. The concept is called a swaps execution facility (SEF). For the moment they resemble a price dissemination service rather than a trade execution facility. Voice brokers and dealer trading systems interact to set prices, execute trades and report them to an SEF.

Swaps-like futures products have traded on existing derivatives exchanges for some time now and more are expected, actually more are being precipitated by the CFTC's new swaps regulations. It is expected this will bring transparency to swaps prices and perhaps spur new forms of liquidity creation in traded swaps markets.

The CFTC also enlisted the basic notion of clearing, and particularly the concept of central counterparties that has existed in the commodities markets for over a century for use in clearing and settling swaps contracts.

A final infrastructure component, a swaps data repository (SDR) was added to the mix by the CFTC when it was thought that was the only way creation and continuation data was to be reported both to industry members and the CFTC. A centralised, global SDR was expected to be the mechanism that would allow aggregation of data across both singular and central counterparties for systemic risk analysis.

It can now be seen by all that the global swaps market is currently being structurally reframed and risk adjusted against the backdrop of a financial system evolving as a complex of globally interconnected information processing and communications systems. What was not even in the frame of regulators thinking back when the financial crisis began in 2007 now presents opportunities for simpler and more doable solutions in reengineering OTC markets.

A Useful Alternative - Using Federated Technology

Using the new technologies made possible by federated networks, the World Wide Web being a prime example, federated technology can offer more robust and simpler solutions. Under current CFTC regulation, swaps data reporting for systemic risk analysis is to be built around a notion of centralization, placed in but a few swaps data repository (SDR) concentration points.

However, federated technology advances have not been considered in solutions that have been proposed by the CFTC nor by those in the industry, both existing OTC members and operators of derivatives exchanges and clearing houses. This is so even though a companion project for all global swaps data reporting needs, the G20's Financial Stability Board's (FSB's) Legal Entity Identifier (LEI) initiative is deploying federated technology.[1]

More importantly the LEI initiative is intended as the globally unique identifier code for any and all swaps counterparties. The use of the LEI will make the aggregation of swaps data for risk assessment much easier if left in place as many new and existing market participants, both domestically and globally, bring on board their own SDRs.

In fact, the notion of a SDR may be completely unnecessary in those entities which already clear swaps or swaps-like transactions. They already gather this information at creation time, so it would be a relatively simple technical revision or upgrade to their systems to add SDR type functions. Industry members are already connected to them.

In order to observe risk in global swaps activity the CFTC presumed on an approach that requires concentration of swaps creation and continuation data in a single SDR at least here in the US. There were few SDR-like facilities at the time of CFTC's first drafting of its Swaps Data and Reporting rules, one run by Tri-Optima and the other by DTCC.

DTCC was winning bids from others, particularly ISDA and LCH.Clearnet to be a central concentration point for swaps transaction data as industry members themselves wished to understand their risk exposures in these products. At the time the large derivatives dealers thought that a single point of concentration of data in a global swaps data repository (SDR) was necessary and supported DTCC over Tri-Optima.

The CFTC presumably picked up on the momentum of this centralization approach and saw it as a reasonable approach where they could look to one facility to observe global swaps counterparty risk.

Subsequently, new CFTC regulations presented opportunities for others to enter the swaps market, as SEFs (Swaps Execution Facilities), as Derivatives Clearing Organizations (DCOs), as Major Swaps Dealers (MSDs) and as SDRs. Competition in establishing multiple SDRs has won out over the earlier notion of singularity of a global SDR that all would participate in.

Circumstances have obviously changed such that concentration of swaps creation and continuation data is not necessary. It would engender more risk in the system by concentrating data in a facility that can be a single point of failure.

This is in contrast to a federated approach which disburses the risk across many potential points of failure, thus lessening the overall impact of any one failure.

Now with competition increased in all aspects of the swaps markets, the idea of concentration of data in any facility within a single sovereign country that represents global interests has been set back. The CFTC has received significant push back by foreign regulators and financial institutions on this concentration concept. This, in part, is due to what is seen as extraterritorial overreach of the CFTC's rule making.

The CFTC's interests have apparently changed as indicated by the exemptive relief and no-action letters that the CFTC authored in the last two weeks of this past year. Those letters postponed the CFTC's mandate for foreign entities to register with the CFTC and thus relieved them of a duty to send data to any US based SDR.[2]

The Companion Federated Model of the G20's Financial Stability Board

In a closely allied activity, the legal entity identification (LEI) system for counterparties to swaps transactions, initially designed as a US centric but global initiative has been superseded as a CFTC initiative by the G20 to accommodate global regulatory needs.

Legal Entity Identifiers (LEIs) are required to be used by swaps counterparties to report data to each SDR. At this moment DTCC has been given temporary status by the CFTC to assign such identifiers through their CICI (CFTC Interim Compliant Identifier) Utility but only to be used by US counterparties.

The CFTC has obligated itself to wait for the "the establishment of the Global LEI system" as stated in their Order before finalizing the CICI as the LEI[3]. This temporary status is due to the parallel activity of the G20's Financial Stability Board creating a global identification system for the same function. It is also due, in part, to the CFTC's recent postponement of its rule making covering non-US counterparties.

This FSB's project, known as GLEIS, the Global Legal Entity Identification System, has not been designed in a centralized fashion where one entity or one sovereign jurisdiction or one single point of concentration prevails. Rather it has been designed as a federated networked model. Federation is the modern technology version of inter-operability, a concept that had previously been used, and still remains, for accommodating fragmentation.

The GLEIS federated model parallels how the federated World Wide Web functions over the Internet. The global system is to be approved at month's end (January, 2013) by the G20's Financial Stability Board and later in March, 2013 by the G20 itself. The expectation is that the CFTC will yield to the FSB's prescribed federated model and its legal entity identification standard.[4]

Retaining At-Source Provenance over Data

Each regulator in each sovereign jurisdiction in the GLEIS (there are currently 45 members and 15 others with observer status)[5] will assign and retain its own data for registering counterparties as legal identities.

The data will contain such information as the globally unique number (the LEI) assigned to every counterparty, its name and address, its parent entity, etc. Each regulator will allow the data to be left in place in the local jurisdiction of its creation. The creator of the LEI can transfer it to another LEI registry of its choosing.

This data will be used to report swaps creation and continuation data to multiple SDRs. The set of globally distributed LEI registries will be viewed as a contiguous set of data, not centrally controlled but rather as a federated virtual data base

This federated approach is being followed by the FSB after arguing against centralization. The FSB saw a centralized solution as a single point of concentration of risk. The FSB favored competition and the reduction of risk through a networked solution that has no single point of failure. It is also an elegant solution and counterpoint to any concern of any one regulator or entity exercising extraterritorial overreach.

It would be a reasonable next step for the CFTC to follow the FSB's lead and create a public-private entity, a non-profit foundation as the FSB is doing for its GLEIS, to own and operate an electronic network to federate multiple SDR data bases.[6] The capability of such a federated network to aggregate data seamlessly is enabled by each unique counterparty being required to have the same unique identifier. This obtains even though they are represented in different SDRs.

What To Do Next?

It is apparent that US rule making did not fully consider implications to the ecosystem of foreign regulators' interests and the competitive nature of existing market participants. It did not contemplate using the most advanced commercially available federated network, the Internet, to overlay a secure private network to federate SDRs as we have advised to both the CFTC and the FSB in their Legal Entity Identification initiatives.

We have also advised regulators and private sector swaps market participants in academic papers and the trade press on this approach.[7]

Financial institutions, financial market utilities and regulators, all with good intentions jumped ahead of considerations of the federated model. This model would be the lowest cost global solution, especially if considered alongside the FSB's GLEIS implementation.

The globally unique identification of swaps market participants allows a different concept for aggregating data from disparate and geographically disbursed data bases. Disjointed and non-standard data that would first have to be normalized in a central data warehouse for aggregation and analysis can now be seamlessly viewed as a single, virtual data base without collecting the data centrally.

The available technology and example of the FSB's LEI initiative should be taken into account by the CFTC in viewing its next steps in regard to SDR creation.

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