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SDRs: A modern day fairy tale

Allan D. Grody looks at how to overcome the challenges of fragmented Swaps Data Repositories in a global environment.

Sometime not so long ago a regulator and a financial market utility (FMU) determined that one Swaps Data Repository (SDR) for all the world's swaps transactions would be good for regulators and good for the business of the financial market utility.

Not only would there be one SDR there would be one LEI (Legal Entity Identifier) Utility to assign unique codes to all the world's financial market participants in swaps transactions. The FMU could "own" both on behalf of the "industry" and on behalf of all the world's regulators.

That nearly 20 SDRs and seven LOUs (Local Operating Units for issuance of LEIs) have been approved globally so far is not surprising. Anyone who has been around the financial industry for any length of time knows that one of anything centralised under the control of a single entity does not float in international waters.

The argument made by the FMU (in this case DTCC) is that in order to give the regulators (in this case the CFTC) what they want, that is an ability to monitor systemic risk, all must adhere to a centralised data concept. All the world's regulators and counterparties would send information to a centralised LEI Utility and SDR.

The argument is made that fragmentation of the data will lead to an inability to see the contagion of systemic risk building up in the derivatives industry and elsewhere in the interconnected financial system.

Industry representatives, most notably the former CEO of SIFMA, the current CEO of DTCC and the Chairman of ISDA, all have stated publically that they believe progress is at risk as it has become apparent that there will not be one central information warehouse that collects all derivatives market data, nor stores all LEIs.

Perhaps the most important of these issues is related to the concerns of fragmentation of trade reporting by swaps market participants. At one end of the argument is that a major achievement to date has been the establishment of global trade databases, or swaps data repositories. The level of information they contain is comprehensive although limited to participation by the prior bi-lateral swaps world dominated by a few major dealers.

This data, now part of the new world view of multiple actors interacting through execution infrastructure, clearing entities, trade reporting platforms and central counterparties could be dispersed through multiple facility operators to multiple on-shore and off-shore data repositories --- the fragmentation issue. It is felt that multiple regulators in each sovereign jurisdiction would need to inquire of and transfer information from each SDR to aggregate exposures, as they do now in collecting data from each firm.

That the US industry was split on this issue did not go unnoticed by the CFTC in reviewing the 27 comment letters that were submitted pro and con on the CME's request for its own SDR. The CME had requested that the CFTC allow novated and cleared transactions at the CME to flow into its own SDR, rather than the DTCC's SDR (DDR – DTCC's Derivatives Repository). The CME's petition was approved on March 6, 2013. In the US alone there are now three approved SDRs and two SDRs awaiting approval.

Foreign regulators have also had to contend with in-development SDRs in their own jurisdictions. They have argued that they must be able to maintain control of their domiciled counterparty data. They have further argued that the CFTC accept substitute compliance as a standard appropriate to the circumstance of global compliance while respecting sovereignty. The SEC has endorsed such a standard for their data collection needs.The CFTC still is working this through.

Now DTCC, through its council is inferring that even substitute compliance would not work. The example given is that transactions between counterparties in two separate sovereign jurisdictions that are conditioned on performance by reference to a third party in another sovereign jurisdiction would not be visible to that third party's sovereign regulator.

It is only when all the sovereign regulators can access the same data base that all can see the same transaction. The theme of global centralisation in order to prevent fragmentation is again apparent. No matter that reference entities are not a party to the transaction and so are not privileged or private information.

To this same end, a House Finance Committee measure to remove the indemnification clause from Dodd-Frank Swaps regulations is moving out of committee. The proposed legislation substitutes a less onerous non-disclosure requirement. It is thought that in this way foreign regulators would be more comfortable leaving their data with a US utility under a US regulatory regime.

They would have access to the data without having to indemnify any US entity for disclosing non-public information about a counterparty domiciled in the US doing business with a counterparty domiciled in another sovereign jurisdiction. Again the same theme emerges, clear the way for all swaps creation and continuation data to be kept in a central store, presumably to be kept by DTCC.

There is another way. The missing piece to the puzzle is how to let multiple SDRs in a globally connected financial system keep its own piece of the transaction while allowing a global view of all the data. To quote the Chairman of the Financial Stability Board "*....cross-border issues with respect to conflicts, inconsistencies, overlaps and gaps in these rules need to be addressed and resolved. In particular, more work is needed on .....the definition of standardised, access to data in trade repositories, and compatible formats for data aggregation.*"

The solution is federation not centralisation and can be found in very familiar search technology on the internet. It is the exact way the global LEI project sponsored by the G20 and overseen by the Financial Stability Board has been designed not withstanding that DTCC is still arguing for a centralized LEI solution as is the case with the SDR issue.

Fragmentation did get us in a pickle around the National Market System, but that was conceived in another era. Time to leave old ideas behind and get on with the new, especially as the world of federated networks and low latency, high frequency globally accessible Big Data beckons us.

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