

## **Commentary: Swaps Reporting is a Flawed Response to a Pressing Need**

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Our last column explored the role swaps played in the financial crisis precipitated by the collapse of Bear Stearns and then Lehman Brothers in 2008.

In brief, swaps were unregulated in 2008. As a result, banking and securities regulators had no way of determining the swaps positions held by counterparties of Bear Stearns. Months of hard work enabled the regulators to understand the swaps book of Lehman Brothers, but the regulators had no information about the positions in credit default swaps on Lehman Brothers debt. In the case of Bear Stearns, this lack of knowledge caused the Fed to expose \$30 billion of taxpayer money to avoid an economic collapse. The Fed's incomplete knowledge led it to allow Lehman Brothers to declare bankruptcy, resulting in a global financial panic that was much more costly to bring under control.

This experience inspired Congress to regulate swaps. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to work together in the regulation of swaps. The SEC will regulate "securities-based swaps" and share with the CFTC the regulation of "mixed swaps," while the CFTC will regulate all other swaps. Each agency is required to promulgate rules that will require participants in the swaps market to report their swaps transactions and positions so that regulators have a much better idea what will happen if they decide to allow a major financial institution to fail.

However, the type of reporting required under Dodd-Frank and proposed by the SEC goes way beyond the minimalist objective of providing accurate information to regulators. Most swap transactions will be reported to public information vendors on a real-time basis for distribution to the investing public. These public reports are likely to increase transparency and promote competition among swaps dealers. These are worthy goals, but not strictly necessary to avoid the next global financial panic.

We note in passing that while competition and transparency benefit the investing public and ultimately the great mass of consumers by reducing transactions costs, they also deal a blow to securities industry profits. And swaps have been the source of enormous profits.

It is worth observing at the outset that swaps are not currently subject to any sort of reporting requirement. There are robust real-time systems for reporting transactions in equities and options that were developed over many years. Transactions in debt securities are reported through TRACE, which is much less sophisticated than existing equity reporting systems. Private vendors have developed sophisticated order management systems that, among other things, facilitate automated reporting of equity transactions. The logic of these systems has not been readily transferable to transactions in debt instruments. As a result, transactions in debt securities are often reported by manual entries into TRACE, which is inefficient and labor-intensive.

Dodd-Frank attempts to fill this void by decreeing that there shall be something called a “security-based swap data repository” or “SDR.” “Security-based swap dealers” and “major security-based swap participants” will report their transactions to the SDR, which will then disseminate information derived from these reports to the public and make them available to regulators.

The difficulty is that SDRs do not exist at the present time. And, while Congress has legislative power, it so far cannot simply pronounce like the Creator in Genesis: “Let light come to be,” and expect that light will in fact be produced. Congress nonetheless has the authority to delegate nasty problems like this to the SEC.

The discussion about possible business models for SDRs in the SEC’s November 19<sup>th</sup> proposal is simply fascinating. The SEC asks for public input on the question of whether SDRs ought to provide basic services and access to data on an at-cost public utility basis. Or, would it be better to allow SDRs to be competitive profit maximizers, operating on a fee-based service model? Perhaps, the SEC ponders, the entity can provide other services in addition to the basic duties of a data repository, which involve obtaining reports from its participants, storing information and disseminating information to the regulation and the public.

This sort of “business building” is new for the SEC. In the past, the SEC’s regulatory efforts generally involved modifications to existing enterprises or duplicating prior successful regulatory institutions. In 1934, for example, the New York Stock Exchange (NYSE) already existed. The SEC simply declared that the NYSE would henceforth be a self-regulatory organization and required it to institute rules to govern the conduct of its members. In 1938, Congress contemplated the formation of one or more “national securities associations” to serve as self-regulatory organizations for the over-the-counter (OTC) market. The 1939 institution of the National Association of Securities Dealers, Inc. (NASD) essentially emulated the SEC’s earlier success in transforming the NYSE into a self-regulatory model. In any event, there was an unregulated industry association – The Investment Bankers Association of America -- that already existed to serve this role.

In any event, it seems to me that the SEC is asking entirely the wrong questions. There are undoubtedly a number of businesses interested in providing SDR services. But, all of them will want to know something about competition. The public utility model insulates providers from competition. If SDRs are allowed to compete, then some will fail. Investors in would-be SDRs would have to consider the risks of failure in determining whether or not to support such a venture.

If the SEC decides to go with the public utility model, then it must also immerse itself in rate-setting procedures. The agencies that regulate public utilities hold lengthy hearings and consider volumes of evidence to make sure the utility is abiding by the “at-cost” model. The SEC does not have any experience with rate-setting. The SEC’s proposal glaringly omits to state whether it is willing to commit itself to this process and whether Congress has authorized it to engage in rate-setting activity.

If, on the other hand, the SEC goes with the profit-maximizing model, then it is important to know whether it is willing to allow unbridled competition or limit access by, for example, only granting approval to a limited number of otherwise qualified applicants. If competition is permitted, which will encourage more efficient and less-costly systems, some SDRs will inevitably fail, causing pain and suffering, and probably reporting interruptions, for the market participants that use those particular SDRs’ services. Some sort of liquidation process, such as the SIPC process, would be necessary to avoid market disruption. Nothing in the SEC’s proposal suggests that any sort of liquidation process is being contemplated.

The closest analog to the proposed SDRs would be the OTC Reporting Facility (ORF), which is used by dealers to report OTC equity trades in real time. But ORF is a system owned and operated by the NASD’s successor, The Financial Industry Regulatory Authority (FINRA), and not a stand-alone business. Access to it and the fees it charges are regulated by the SEC through the self-regulatory rule-making process.

Since FINRA has experience in this area, it would be one logical provider of a similar trade reporting system for swaps. However, FINRA is not seeking this role – the SEC, and perhaps Congress, would have to impose this role on FINRA. Such a mandate would require security-based swap dealers and major security-based swaps participants to be members of FINRA. Unlike OTC dealers, who are required by the Securities Exchange Act of 1934 to belong to FINRA, Dodd-Frank apparently did not contemplate that participants in the swaps markets should be members of FINRA or any self-regulatory organization.

FINRA also has enforcement capacity. Without regulatory enforcement powers, all an SDR can do to when participants fail to provide timely and accurate reports is

complain to the SEC or commence litigation in civil courts. My guess is the SEC has no plans to allocate any of its scarce enforcement resources to deal with security-based swaps dealers and major security-based swaps participants who fail to make accurate, timely reports voluntarily. SDRs will therefore be required to launch civil actions or face regulatory penalties for failing to require their participants to behave. The civil courts are ill-equipped to handle such disputes, and any such litigation would be lengthy, expensive and unlikely to achieve predictable results. Anyone thinking about financing an SDR will have to consider these costs and risks before making an investment.

A cursory evaluation of the history of industry compliance with prior reporting mandates demonstrates that active enforcement and the imposition of large penalties will be required to obtain compliance with the new reporting obligations. In the case of OATS, the most recently mandated reporting obligation, the industry was accustomed to reporting obligations, and numerous vendors were available to supply systems for the purpose. Nonetheless, it was necessary for FINRA to bring many enforcement actions before the industry finally decided to comply, but not before FINRA collected millions in fines from recalcitrant industry participants.

The swaps industry has never confronted reporting obligations. It is not clear that the systems used for equity trade reporting will be readily convertible to the more complex swaps transactions. Complying institutions will likely find that the design and installation of required systems is an expensive ordeal. Compliance will result in increased competition and reduce profits. So, compliance represents a double hit on profitability. We can expect that many participants will be reluctant to comply and will do so only when it is certain that enforcement will be brought to bear to enforce compliance. Unless SDRs have teeth, compliance will be haphazard at best, and it may be years before anything like reliable reports are made available to anyone, as contemplated by Dodd-Frank.

The Panic of 2008 made abundantly clear the need for regulation of the swaps markets. Regulators must have at their fingertips accurate information about swaps positions and transactions to avoid ever again requiring the taxpayers to support financial institutions and the frightening damage to our economy that systemic failure promises. In light of this obvious public need, and the industry's history in dealing with reporting obligations, we would have hoped that the SEC had more carefully and thoroughly considered the practical realities in promulgating its proposals for SDRs.

One solution would be to ask Congress to require one of the existing self-regulatory organizations with experience implementing and enforcing reporting obligations to perform the SDR role. Another alternative would be to ensure potential registrants that the SEC's enforcement powers would be readily available to deal with miscreant participants. Of course, Congress would have to fund that effort.

As the new Congress opens this week, it seems less and less likely that the SEC can count on receiving the necessary legislative support for patching up the holes in the Dodd-Frank mandate. And if the SEC oversteps the incomplete statutory structure erected by Dodd-Frank, it risks having the entire swaps reporting apparatus tossed out by the courts, leaving us right back where we started in 2008.

There are undoubtedly some who think it wouldn't be so terrible if things change so gradually that there is no change at all. With all due respect for all my brethren on swaps desks, count me among those who would rather not see another crisis like 2008, resulting in a horribly depressed economy and painful, widespread unemployment, anytime soon.

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