



## **Possible Role for NFA as a Utility for Swap Transactions**

---

### **Introduction**

In recent preliminary discussions, CFTC staff has discussed possible ways in which NFA could act as a utility with respect to swap transactions. Specifically, our discussions have focused on three main issues. First, in order to monitor compliance with aggregate position limits, the CFTC will need data regarding both futures and swaps from contract markets, SEFs and swap data repositories. The Commission has a well-established infrastructure to obtain the necessary information regarding exchange-traded futures. With respect to swaps, though, the Commission will need information from SEFs, contract markets trading swaps and swap data repositories. The issue we have explored is whether NFA can play a role in gathering and consolidating relevant data from those varied sources and transmitting that information to the Commission. Second, the statute requires each SEF to comply with certain core principles, including requirements to perform basic self-regulatory functions regarding its trading platform. While some potential SEFs may already have SRO infrastructures, others may not. The question arises whether NFA could play a self-regulatory role with respect to such SEFs. Finally, the Act requires the Commission to provide for real time reporting of price and notional value data relating to both cleared and uncleared swap transactions. Commission staff has asked NFA to consider whether there may be a role for NFA in that process.

We have outlined below possible roles that NFA could play in each of these areas. We have not attempted to detail how NFA would perform these functions but have described a conceptual framework for NFA's role. Obviously, any undertakings by NFA in these areas would be subject to approval by NFA's Board. We are confident that NFA's Board would approve these initiatives. For the last 28 years NFA's mission has been to help the Commission in any way possible. That mission will not change.

### **Self-Regulation and SEFs**

The Commission could, by rule, provide that any SEF could satisfy its obligation to comply with specified core principles by becoming a member of a registered futures association that has undertaken to regulate certain activities of SEFs and their participants pursuant to rules adopted by the futures association and approved by the Commission. Successful implementation of such a regulatory program would require:

- a clear delineation by the Commission of which core principles would be the responsibility of the SEF and which would be subject to NFA jurisdiction;
- changes to NFA's governing structure to ensure SEF representation;
- rulemaking by NFA, including incorporation by reference of CFTC rules adopted for SEFs, to cover core principles within NFA's scope of responsibility;
- rules to ensure that NFA has authority over participants trading on the SEF's platform;
- adaptations to NFA's existing Trade Practice and Market Surveillance programs to ensure the capture and analysis of relevant data and to provide real time monitoring of trading;
- hiring and training of additional staff in compliance, information systems and legal departments; and
- development of funding mechanisms, subject to CFTC approval, to recapture NFA's costs of performing these regulatory services.

With respect to the core principles an SEF could satisfy by joining NFA, NFA's role would in some ways be similar to the role NFA has played for new exchanges that have outsourced certain functions to NFA over the last ten years. At a minimum, NFA would be responsible for the core principles set forth in Section 5h(f)(4), (5) and (6) of the Act. It would be NFA's responsibility to monitor trading on the SEF to prevent manipulation and price distortion, to obtain any information to perform those functions, to provide the Commission with information on request and, as described below, to monitor for compliance with position limits established by the Commission. NFA could also have responsibility for Section 5h(f)(2) to enforce SEF trading rules, such as block order rules, to deter trading abuses, though practically speaking, this would require a high degree of uniformity among the rules of the various SEFs. If the registration process for SEFs sets uniform standards for trading rules, NFA could monitor for compliance with those rules.

Contrary to NFA's existing relationship with its exchange clients, however, NFA would not deliver the results of its surveillance and investigations to the SEF. Rather, NFA would have the authority to bring enforcement actions directly against SEF participants that violate NFA rules. NFA would obtain that authority by requiring each SEF member of NFA to require its participants to agree in writing to cooperate with any NFA investigation, to be bound by NFA rules and to submit to NFA jurisdiction with respect to the enforcement of those rules.

We expect that NFA's existing Trade Practice and Market Surveillance programs would be the starting point for the development of a system to receive and analyze audit trail data from SEF members. As the Commission develops specific requirements for SEFs, modifications to the current system may be necessary.

Assumption of these additional responsibilities will certainly require additions to NFA staff in the compliance, information systems and legal departments. The size of staff increases will, of course, depend on the number of SEFs that become members of NFA but NFA is, as always, fully committed to providing whatever resources are necessary to fulfill all of our responsibilities.

### **Surveillance for Compliance with Aggregate Position Limits**

The Commission recently issued for public comment proposed rules regarding account ownership and control reporting by FCMs and discussed in that notice the possibility of each customer being assigned a unique identifying number. That same issue arises in the context of surveillance for compliance with aggregate position limits. To monitor for compliance, each person trading futures contracts through a DCM, cleared swaps through an SEF or DCM or uncleared swaps reported to a swap data repository must have a unique identifying number. These numbers would be the functional equivalent of the NFA ID number that NFA assigns to each registrant. Persons registered as swap dealers or as major swap participants would receive their NFA ID number through the registration process. For non-registrants trading swaps, CFTC rules would require either an FCM, swap dealer, SEF or swap data repository to obtain from NFA an identifying number for each customer whose trades it will process. To avoid confusion over similar names, a social security number or tax identification number would have to be provided when available, similar to the process for obtaining NFA ID numbers for registrants. For traders that are self-clearing members of an exchange, the unique identifying number would have to be obtained by either the appropriate DCM or clearing organization.

Information regarding futures trading on DCMs would be provided to the Commission by the exchanges. The Commission could require each SEF, DCM trading swaps and swap data repository to provide NFA with a daily electronic record of swap trades that included the positions traded and the customer account identifying number. NFA would receive this information and consolidate positions for customers trading swaps on multiple forums according to guidelines set by the Commission and transmit the information to the Commission. The Commission could then combine this information with the data received from the exchanges to monitor overall compliance with aggregate position limits. In performing this function, NFA would not be acting as an SRO but as a delegee of the Commission, just as we do now with respect to registration and CPO/CTA disclosure documents.

## **Real Time Reporting of Swap Transactions**

Under Section 2a(13) of the Act, the Commission is required to provide for the real time reporting of price and notional value information for both cleared and uncleared swaps. Designated contract markets have always provided for the public dissemination of volume and price information for exchange-traded futures. Designated contract markets, SEFs and designated clearing organizations certainly could perform the same function for cleared swaps. With respect to uncleared swaps, the Commission could require each swap data repository to make publicly available price and notional value information for each swap transaction reported to the depository, using the same product description provided to the repository by the parties. For uncleared swaps for which there is no repository, the statute provides that the required information be reported by the parties to the Commission. The Commission could delegate that function to NFA by requiring the parties to submit the required data to NFA, which would then make it publicly available.

If the Commission decided to centralize the public reporting of information regarding uncleared swaps, it could require each swap data repository to report price and notional value information for each transaction reported to it to NFA. NFA would then disseminate this information along with price and notional value information reported to it as the Commission's delegee. In our preliminary discussions, the Commission staff also raised the possibility of NFA generating a "consolidated tape" of all price and notional value information regarding both cleared and uncleared swap transactions. It was our understanding that such a "consolidated tape" would not be intended to preclude SEFs or designated contract markets from disseminating their own trading data, including price and notional value information. We recognize there may be legal issues regarding the ownership of trading data generated by an SEF or designated contract market. To the extent that NFA were to disseminate only price and notional value data on a slightly delayed basis, such issues may be rendered moot.

## **Costs Associated with NFA Acting as a Swaps Utility**

Construction of the systems to implement the utility functions described above would be a significant undertaking but is well within NFA's demonstrated capabilities. Over the years NFA has designed and built virtually every filing and reporting system used at NFA, including systems for registration, trade practice and market surveillance, financial reporting by FCMs, IBs and CPOs, and CPO and CTA disclosure documents. NFA would be able to leverage its existing technology to design and build the new systems that would be required to perform these additional responsibilities. For example, the surveillance component of NFA's trade practice and market surveillance system would be adapted to perform similar functions regarding swaps and aggregate position limits. Similarly, NFA's forex trade reporting system accepts and consolidates feeds from numerous sources and could provide a building block for real time reporting of swaps trades. Based on our experience, we are confident that NFA could build the systems necessary to perform these functions within one year of being formally requested to do so. In estimating our costs of performing

these functions we have assumed that NFA would be required to construct a back-up data center that would meet the Commission's proposed disaster recovery standards. We have also estimated the costs of adding 15 staff to NFA's Information Systems Department, the cost of new hardware for both NFA's main and backup data centers and the cost of communication lines and equipment. We estimate that the initial cost of establishing systems to perform these functions to be at least \$6.5 million and the annual cost of maintaining and operating these systems to be at least \$3 million. There would, of course, be additional costs related to operational staffing and overhead. These estimates could, of course, change based on decisions ultimately made by the Commission on the scope of NFA's responsibilities and the number and size of SEF members.

Each time NFA has taken on new areas of responsibility, for example, with respect to forex or trade practice surveillance for electronic exchanges, we have attempted to operate as a utility, charging fees and membership dues that are set to recover NFA's costs over time. We would take the same approach with respect to swap transactions. The exact level and structure of fees and dues would be determined by NFA's board, which will be modified to ensure adequate representation of SEFs as well as swap dealers and major swap participants, if they are subject to NFA regulation. Any issues regarding fees and dues will also be reviewed by an advisory committee drawn from members in the affected membership category. NFA rules regarding dues and fees are also subject to the CFTC's review and approval.

F:/djr/cftc swaps SEFs