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Security-based Swap Reporting

Too little too late?

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November 8, 2021, marks an important milestone. Almost a decade after the first reporting rules for over-the-counter derivatives came into force, the U.S. Securities and Exchange Commission (SEC) rules for the reporting of security-based swaps (SBS) will become effective. This is the impetus for Synechron to evaluate the current regulatory reporting landscape in a series of thought leadership articles. In this first article we elaborate on the need for transparency in over-the-counter derivatives markets and illustrate what can go wrong if complex financial products remain out of sight of regulatory authorities.

The Lesson From the Collapse of Archegos

In March 2021, a family office by the name of Archegos Capital Management was faced with several margin calls (with the total sum of over US$2.7 billion) and ended up being unable to meet its financial obligations. This was predominantly because it was heavily involved in security-based swaps known as 'Total Return Swaps'. Total Return Swaps provide investors with exposure to the profits or losses of stocks or other assets, without the investor actually holding the underlying shares. The use of Total Return Swaps allowed Archegos to take huge positions while posting limited funds up front; technically by borrowing funds from the bank and leveraging the investment. These banks, several of the largest banks in the world, in turn suffered multibillion dollar losses, not only from their lending to Archegos, but also as a result of the fire sale of Archegos' positions.

By using Total Return Swaps instead of buying the actual underlying shares, Archegos was able to stay under the radar, since the SEC does not (yet) oblige investors of Total Return Swaps to publicly disclose their stakes (i.e., more than 5%) in the underlying companies.

It was a missed opportunity that the US regulatory authorities were not able to see these huge derivatives positions, while in all other major financial markets these kinds of derivatives transactions must be reported already for a number of years. Had the SBS regulatory framework been finalized and implemented more quickly by the SEC, these Total Return Swaps would have been reportable under the Security-based Swap Reporting (SBSR) rules and would have allowed regulatory authorities to monitor this unusual market behavior and act upon it. In particular, they could have seen that multiple large banks had huge derivatives positions against the same counterparty, and they could have required those banks to reduce their respective exposures.

Exposing OTC Markets Opacity

One of the major weaknesses exposed by the global financial crisis of 2007/2008 was that in the over-the-counter (OTC) derivatives market [1], large counterparty exposures between market participants were not adequately managed. In addition, the appropriate level of transparency of the activity in the derivatives market was lacking.

In response to the financial crisis, and with the aim to strengthen financial markets as well as to increase the level of transparency, the US Congress passed legislation tasking the SEC and the Commodity Futures Trading Commission (CFTC) with creating a regulatory regime to govern the OTC derivatives market. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) assigned the CFTC the responsibility for 'swaps' and the SEC was tasked with responsibility for a portion of the market known as 'security-based swaps' (SBS) which include, for example, swaps based on a security (i.e., a stock or a bond) or credit default swaps. [2]

The New Security-based Swaps Reporting Regime

While the CFTC was relatively quick to finalize and implement a regulatory framework governing swaps subject to its jurisdiction (already in 2012), it took the SEC considerably longer as it only recently finalized the SBS regulatory regime, well over 10 years after the DFA was signed into law.

Under the new SBS regime, the SEC will regulate a variety of market participants including:

1. Dealers and major players in the security-based swap market
2. Trading platforms and exchanges on which security-based swaps are transacted
3. Clearing agencies that generally step into the place of the original counterparties and effectively assume the risk should there be a default
4. Swap data repositories (SDRs) which collect data on security-based swaps as they are transacted by counterparties, and must make that information available to regulators, and disseminate certain data to the general public.

An important component of the SBS regulatory regime is the set of requirements (SBSR) to report SBS transactions to SDRs on a T+1 basis, shedding more light on this relatively opaque market. The SBSR requires market participants to report security-based swap information to registered SDRs and for public dissemination of transaction, volume, and pricing information with the goal of making the SBS market more transparent, efficient and accessible - right in line with the overarching DFA goals.

What can Synechron offer?

Synechron has, on multiple occasions, been tasked with setting up and improving transaction reporting processes for our financial services industry clients. This provides us with an excellent understanding and vision of the most relevant pain points and improvements needed to ensure a proper Transaction Reporting implementation - from the regulation all the way to system implementation. This includes control frameworks and creating data hubs. With our industry-focused regulatory domain knowledge, hands-on change specialists and technology leadership, we are uniquely positioned to assist you in any capacity - from analysis to implementation, and program management to development.

Want further, in-depth information and insight about our capabilities and vision on Transaction Reporting?

Connect with us and let's talk:

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[1] An over-the-counter (OTC) derivatives market is a decentralized market in which derivatives are traded directly between two market participants and without a central exchange or broker.
[2] Swaps are financial contracts (derivatives) in which two market participants agree to exchange or 'swap' payments with each other as a result of changes in the underlying value such as a stock price, interest rate or commodity price.