Dodd-Frank Title VII Compliance:

Optimize Your Investment to Increase Business Value

WHITE PAPER

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Executive Summary

As lawmakers respond to economic events with complex new rules for market participants, regulatory compliance becomes an ever-larger cost of doing business in energy and commodity trading. Some argue that the new regulations and reporting requirements of Title VII of the Dodd-Frank Act have increased the price of admission for swaps trading to the point of being a barrier to entry for small firms.

Consider your own organization's reaction to the burdens imposed by the Dodd-Frank regulations. Are they regarded as an admission fee or a tax – or are they viewed as an opportunity to derive more business benefit? It is clear that Dodd-Frank compliance represents a significant investment of funds and resources. Firms that fail to take advantage of the business improvements enabled by these mandated compliance investments are overlooking the opportunity to bring added efficiency and risk control to their trading operations.

New Regulatory Regime Equals New Business Reality

If you want to trade commodity swaps, you have to pay for compliance to get in the game. Emerging Commodity Futures Trading Commission (CFTC) rules and the industry infrastructure being created to facilitate compliance will force many trading operations to reinvent their technology, their workflows and even their portfolio choices.

As final Dodd-Frank regulations for the swaps market come into effect during 2012, market participants will face a new operational environment that is far from business as usual. Batch processes commonly used in the past, such as T+1 confirmations and end-of-day (EOD) broker checkouts, will not serve a trading organization's compliance needs under the new reporting rules. Real-time (or near-time) workflows, deal data aggregation and enterprise business intelligence are prerequisites to comply with CFTC reporting and record-keeping regulations.

Adjusting to – and prospering in – this new compliance environment requires proper forethought and an unprecedented level of collaboration between IT, risk management and compliance executives. This transformation to the Dodd-Frank regulatory reality is the ideal time to build new functionality into compliance tasks that can bring added business benefits to trading and risk operations.

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The key areas in which firms can extract more business value are:

- Real-time (or near-time) process flows.
- Enterprise aggregation of deal data.
- Compliance cost analysis (activity-based costing).
- Trade surveillance.

Real-time Processes and Workflows
Enables back office to detect errors, minimize losses or decreased profits

Enterprise Aggregation of Deal Data
Optimizes compliance costs through centralized, aggregated data model

Trade Surveillance
Detects illicit trade patterns for CFTC reporting

Compliance Cost Analysis
Incorporates regulatory costs at deal level for invoicing, P&L accounting

Figure 1: Opportunities to Harness Dodd-Frank Act (DFA) mandates.

Get Real

Many confirmations in the bilateral over-the-counter (OTC) market are exchanged in an EOD process and even verified the next day. Some systems create the confirmation as a byproduct of accounting batch entries that post in overnight general ledger processes. That time delay creates an unnecessary window of risk. If a trade is booked incorrectly and is not detected until confirmations are exchanged and checked by both parties, unexpected trading losses can be generated through human error. While it may seem surprising, many firms follow that exact operating model. These firms operate every day with a time-delayed workflow of checks and balances. If they have not suffered trading losses (or decreased profit) from trade-entry errors, they are lucky gamblers.

Real-time CFTC reporting[1] will put stress on that operating model and expose its weakness and the regulatory risk it creates. Dodd-Frank compliance will compel a trading organization (or its technology vendor) to create a real-time confirmation workflow so that real-time reporting can be achieved concurrently with bilateral confirmations and broker checkouts. Moving this operational event from an EOD to a real-time process will have business benefits beyond the compliance requirement. It will speed up the back-office process for detecting trade-entry errors, mitigating the financial trading losses that such human errors can cause.

For example, suppose a deal is booked with some error to the primary economic terms. If it is detected quickly, the traders will have more time and therefore more options for how and when to correct or react to the trade. When commodity prices are volatile, traders want to have flexibility about when to get in and out of a position to recover from a booking error. An error that happens at 10 a.m. and is detected within 30 minutes affords traders more options to buy into or sell out of that position. If the error is detected at 4 p.m. during a broker checkout, traders must maneuver in a market with fewer choices and less liquidity. In that case, the operational time delay will severely limit the traders' choices.

1 The term "real time" also refers to "near time," meaning an acceptable and practical window of 15 minutes from deal execution to the start of the regulatory reporting workflow.

Deal entry errors also have a compounding effect. The longer a trade error remains undetected, the longer the firm's position is incorrectly represented to others on the trade floor, where trading decisions are being made against faulty position information.

Giving traders more time to react in the market is critical to preventing a human error from becoming a trade loss. It is also a matter of service level agreements (SLAs) and support standards between front and back office. Interestingly, some firms' SLAs contain a policy about whose budget (front versus back office) pays for the human errors. Typically, trading losses are charged to the front office when the error is detected on T+0. After that, the blame and the expense rest on the back office for its failure to detect the problem promptly.

Aggregate for Success

Most utility and energy firms have trading data spread across disparate systems that, over time, have become entrenched silos. These data silos have evolved as a result of many things: mergers and acquisitions; FERC Affiliate Restrictions regulations that separate regulated from unregulated operational data; and the occasional or incidental currency swaps or interest rate swaps relegated to spreadsheets instead of the firm's core energy trading and risk management (ETRM) systems.

These silos of data will interfere with an organization's ability to provide CFTC reporting mandated to be delivered at the enterprise level rather than at the subsidiary level. The firm may also be unwittingly duplicating its compliance costs by solving the same Dodd-Frank reporting problem in each of these silos. A trading organization with separate ETRM systems for power and natural gas must retrofit each system for reporting swaps in real time. That approach not only results in more expensive compliance, but it also diverts already scarce resource bandwidth and capital funds.

A more successful response is to use this compliance requirement as an opportunity to aggregate the disparate data into a centralized data model – one with minimal intrusion to those incumbent ETRM systems and silos of data. Such an aggregation of swap trading data will optimize compliance investments and provide a data framework for added business intelligence beyond the regulatory mandate. Much business value can be derived from capturing overall gross and net positions based on a singular, aggregated view of the truth across all asset classes.

One area market participants must not overlook is the new trade-level data that Dodd-Frank introduces. These new data fields – unique product identifier (UPI), unique counterparty identifier (UCI) and unique swap identifier (USI) files, to name a few – must be linked to the individual swap record. While linking these unique identifiers to their respective trades imposes a new reporting burden, proper use of these new conventions also creates an opportunity to optimize the use of regulatory capital.

Inaccurate identification of counterparties could lead a firm to put too much capital aside as part of its Basel II capital adequacy requirements because it could not accurately identify the issuer of the position of the holdings within the firm. As a result, the firm might be forced to apply 100-percent risk weighting to these positions rather than recognizing offsets that would provide a lower risk weighting. To mitigate the risk of that counterparty position, the higher risk-weighting calculation must be used – and a larger amount of capital must be set aside. That idle capital could be put to productive use to benefit the business if the proper issuer identification could be made.

Aggregating swap deal data provides several substantial benefits. Among other things, it:

- Simplifies the CFTC reporting burden.
- Reduces duplication of compliance workflows and investments.
- Provides enterprise views of credit, risk metrics and data governance.
- Minimizes intrusion into sensitive incumbent ETRM environments.

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If You Knew the Cost, Would You Do the Same Deal?

The Dodd-Frank Act is forcing organizations to rethink the portfolio mix between bilateral OTC and exchange trades. The new costs of maintaining margin and securing credit lines – as well as the added regulatory transaction fees associated with reporting – may turn some deals that are only marginally profitable into losses after all costs are allocated. The industry makes a standard practice of tracking transportation costs, storage fees, transmission costs and even broker fees at the deal level for invoicing and profit and loss (P&L) accounting. In the new regulatory climate, it has become prudent to do the same for regulatory costs.

In the days before the Dodd-Frank Act, compliance and reporting were viewed as infrastructure and administration overhead. Now the cost to business has increased, and it must be measured and monitored. As the axiom says, "we cannot manage what we do not measure." Regulatory transaction costs must be allocated at the deal level to achieve an accurate rendering of deal profitability.

One tried-and-tested approach to capturing such regulatory transaction costs is the discipline of activity-based costing (ABC). This entails using financial business intelligence at an operational level, and it is achieved by leveraging aggregated accounting data and operational data. ABC provides a more accurate account of the regulatory costs by trade and trade type, and empowers management with both the information to determine which trades are truly profitable and the means to optimize the use of margin and capital lines.

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Whistle (Blower) Where You Work

One other critical aspect must be factored into this new world of regulatory risk; the Dodd-Frank Act added new teeth to existing laws and regulations governing whistle-blowers. The whistle-blower risk facing swap market participants should not be underestimated. Besides legal protection from retaliation, the Dodd-Frank Act offers generous monetary rewards to "eligible" whistle-blowers – a lucrative bounty that ranges from 10 to 30 percent of the sanctions that regulators collect. These new teeth have already bitten; the first of these substantial monetary rewards will be paid out in early 2012, based on information whistle-blowers provided immediately after the Dodd-Frank Act was signed into law.

A whistle-blower could be an internal staff member, an investor, a private investigator, an academic, a consultant, a laid-off employee or a former spouse. Once the rewards start paying out in 2012 and generating media attention, the race is on. Market participants must shore up their existing efforts and be more proactive in this area. Maintaining a paper file of ethical conduct signatures and scheduling awareness training programs will not suffice. This whistle-blower risk can only be mitigated by implementing real-time surveillance, alerts and reporting.

What impact can the whistle-blower actually have on a trading organization? On April 29, 2010, the CFTC fined Morgan Stanley $14 million and UBS $200,000 for an allegedly deliberate delay in reporting of a large block trade of crude oil futures contracts. The NYMEX rule requires both buyer and seller to ensure that each block trade is reported to the exchange within five minutes of the time of execution, but the CFTC maintains that traders on both sides agreed to conceal the trade until after that market closed. In another recent case on Jan. 9, 2012, the CFTC fined Newedge USA $700,000 for submitting inaccurate large trader reports over a five-month period. The inaccuracies included the use of incorrect commodity codes, incorrect gross versus net position reporting and other anomalies.

These are just two examples where real-time surveillance could have protected a firm from such malfeasance and inaccuracies. Failure to be proactive and vigilant will inevitably lead to one result: a whistle-blower seeking the lucrative rewards offered by regulators will do that job for you.

The same data aggregation prescribed previously for CFTC reporting and enterprise position monitoring can be leveraged as the data model for conducting trade surveillance. This confluence of deal data allows analytical models to perform surveillance and detect patterns of trading behavior that expose noncompliance. For example:

- "Banging" at the close or "marking" the close in an attempt to manipulate settlement prices. These are typically late trades and block trades (trades at settlement).
- "Washing" or fictitious sales prearranged between buyer and seller to negate price discovery and competition.
- Delayed reporting to deliberately conceal trades until after the market closes.

Conclusion

Dodd-Frank compliance is compulsory and imminent. Firms and their vendors should already be mobilized and actively preparing their systems and processes for the necessary changes. This is the ideal time to take advantage of the Dodd-Frank compliance investment as a way to bring added efficiency and risk control to trading operations. The CFTC's issuance of final rules has been delayed several times due to effective lobbying, calls for extended public comment periods and the diversion of CFTC attention to market-disrupting events such as the October 2011 bankruptcy of major international derivatives broker MF Global. It is vital that market participants not squander the opportunity these delays have provided. These delays provide additional time to think through compliance design and get more out of Dodd-Frank compliance efforts than merely attempting to avoid fines and other consequences of noncompliance.

Each of the four key areas involved in successful compliance – real-time workflows, data aggregation, activity-based costing and trade surveillance – requires a genuine collaboration among managers in the front office, middle office and back office – and an equally critical collaboration between those groups and the IT organization. All these parties are integral to the compliance equation. Each of them can extract additional value from mandated compliance initiatives.

Learn more

To learn more about how your organization can benefit from your compliance investment, please contact RiskAdvisory@SAS.com. View our Dodd-Frank solution information and on-demand webcast at RiskAdvisory.com.

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