



NATIONAL FUTURES ASSOCIATION

NFA Regulatory Services for Swap Execution Facilities Overview

February, 2016

Overview and Background

This document summarizes the regulatory services NFA provides to Swap Execution Facilities ("SEFs") on an outsourced basis based on final rules (CFTC Regulation 37.204 pursuant to the *Core Principles and Other Requirements for Swap Execution Facilities* 78 FR 33476 (June 4, 2013)) adopted by the Commission to implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). It describes what is and is not included in the NFA oversight program.

Just as it has for CFTC designated contract markets since 2000, NFA offers regulatory services to SEFs operating electronic trading systems and platforms. The NFA oversight program includes review of all trading activity, monitoring of market participant's positions, price movements in the market, and preparing subsequent investigations as required by those activities. The program does not include real-time market monitoring (as required by CFTC Regulation 37.203 (c)) or a live help desk to aid operational procedures of the markets. NFA does have staff, however, that on a daily basis observe the real-time trading activity that occurs on the market by monitoring the SEF's view-only screens. These screens provide NFA staff an inside look at the market. NFA also monitors real-time activity in similar or related products by watching and charting the information provided through various third party vendor services.

At the end of each day NFA also obtains a complete audit trail of all activity that occurs on a market (often referred to T+1 activity). To the full extent possible, the activity analyzed includes all participant related messages, deals, price activity, and connection activity. Moreover, NFA analyzes this activity in conjunction with identifiable participant information and participant relationship details. NFA has additionally developed an audit trail review program based on CFTC requirements for the SEFs that also wish to outsource this service.

While the SEF retains responsibility for compliance with the core principles as required by the Dodd-Frank Act and CFTC Regulation 37.204(a), NFA will be working with and on behalf of the SEF under contract to provide the following services:

Trade Practice Surveillance

Trade Practice Surveillance is handled through two different methods. As noted earlier, NFA has real-time access to trading activity that is occurring on a particular market. As a second set of eyes, NFA monitors trading as it occurs and contacts the SEF's Help Desk in instances that are identified on a real-time basis that might warrant contacting the participant. In addition, NFA has the ability to recreate (i.e. look back at) the audit trail on a T+1 basis to identify instances that might be potential rule violations of the SEF.

NFA has developed a new state of the art in-house surveillance system known as Sophisticated Warning Analysis Profiling System ("SWAPS"). The new system, *SWAPS*, is an analytical tool used by staff to effectively and efficiently profile markets, profile participants, retrieve market activity, analyze automated exception reports, and recreate a market's order book. With regard to trade practice, market surveillance and profiles, NFA has expanded upon its previously used surveillance system for designated contract markets to include features such as roll-up aggregation of information and dashboard summaries. *SWAPS* is currently being tailored for production with SEFs and DCMs offering swaps contracts.

Included in its many functionalities, *SWAPS* includes an automated trade surveillance system (as required by CFTC Regulation 37.203 (d)) that creates exception reports detailing CFTC mandated trading abuses as well as exceptions and alerts that are deemed abusive to the trading environment and potential violations of specific SEF rules and requirements. NFA staff will on a daily basis look at *SWAPS* generated exception reports designed to identify various types of potential trading abuses and other anomalous trading activity. The types of exceptions noted include, among others, those abuses prohibited by proposed CFTC Regulation 37.203(a) such as front-running, wash trading, pre-arranged trading, fraudulent trading, money passes. In addition to conducting an exception report review, staff also uses *SWAPS* to conduct customized ad hoc searches or reviews of a SEF's audit trail data. This is done to further refine the data and help staff to focus on identified areas of concern. Staff has the flexibility to tailor queries based on, for example, account number, the times of a transaction, order type, quantity or price.

SWAPS maintains participant profiles, which includes the participant's market activity in the context of volume, orders, platform type, execution method, clearing choice, product history, and relationships with other participants. This helps staff to gather and understand the factors surrounding the execution of trades. The *SWAPS* exception reports also alert staff to deviations from a trader's profile, such as those involving unusual profit patterns, significant changes in volume, and unusual concentrations of trading activity between the same counterparties.

In addition to those trades that are executed through the SEF's clearable method of price discovery, certain types of transactions are permitted outside the SEF's trading system or platform. These types of trades include block trades, swaps not subject to the Act's clearing and execution requirements and certain illiquid or 'bespoke' transactions. These types of trades are considered "permitted" on all SEFs based on the Commission's final rules for SEFs (CFTC Regulation 37.9). These

trades will be required to be reported within a predetermined timeframe as set forth within each SEF's rules. As such, NFA will review these trades as part of our surveillance program. NFA will look at the timing of the trades, the pricing relative to related markets and other swap transactions executed on or through the SEF.

Market Surveillance

For Market Surveillance, NFA staff is focused on detecting potential manipulations and price distortions and ensuring the orderly liquidation of any physically delivered expiring swaps. In performing this responsibility, staff uses online quotation systems, computer-generated reports and other tools to conduct daily monitoring of prices, volume, clearing member large trader positions, and market news for all contracts "made available to trade" on the SEF pursuant to CFTC Regulation 37.10. Each day this information is analyzed by *SWAPS* and generates alerts that are looked at by staff. Included on the system are a contract's historical price record and exception report alerts that indicate whenever upward or downward price moves exceed preset parameters. Staff also reviews various metrics for each tradable instrument to help determine unusual activity and manipulative patterns where NFA can expand their scope and build an investigation. *SWAPS* enables staff to view these market analytics by clearing member, trader, counterparty, or by firm. The system logically ranks positions in each contract over a period of time to best help staff identify high risk areas. *SWAPS* sends an alert to staff if any participant has a significant percentage of either volume or creates a material position beyond NFA's preset risk parameters.

A SEF's large trader positions are an integral function of *SWAPS* functionality. The system has preset alerts that inform staff whenever a trader has met the threshold for large trader status. NFA then obtains a large trader report from the trader, and enters the information into *SWAPS'* large traders list, which has the capability of aggregating all positions held by related parties. Once this information is compiled, staff monitors large trader positions for concentrations of ownership and potential collusive or concerted activity by market participants. If it appears that any one trader or account controller has a concentration in a given market, staff will contact the trader or controller to determine the reasons for the concentration. *SWAPS* also enables NFA staff to view complete information regarding each large trader's trading history at any time¹.

Investigations/Disciplinary

As noted earlier, if it appears that more information is required due to a review of the *SWAPS* exception reports, staffs' observation of the market, or customer complaint, staff will gather additional information and prepare a summary of its findings. If NFA staff receives approval from the SEF upon determining that trading activity requires further scrutiny, staff will initiate an investigation. If in the NFA staff's view the facts warrant formal disciplinary charges, staff will prepare a report that is forwarded to the SEF. If the SEF's compliance department concurs with staff's analysis, then the action will proceed to the SEF's disciplinary committee for resolution. NFA staff works closely to coordinate its trade practice

¹ Currently all SEFs are operating under the premise that Position Limits and Accountability Levels are not necessary or appropriate for swaps contracts. As such there is no large trader reporting for SEFs.

and market surveillance activities with the SEF's staff and can make necessary information (such as audit trail) available to the SEF upon request. As previously noted the SEF is ultimately responsible for fulfilling its self-regulatory obligations. The SEF also has market supervision responsibilities and an obligation to closely monitor the daily activities on its market.

Audit Trail Review Program

On an annual basis NFA will conduct reviews of all members and market participants to verify their compliance with the swap execution facility's audit trail and recordkeeping requirements. Such reviews must include, but are not limited to, reviews of randomly selected samples of front-end audit trail data for order routing systems; a review of the process by which user identifications are assigned and user identification records are maintained; a review of usage patterns associated with user identifications to monitor for violations of user identification rules; and reviews of account numbers and customer type indicator codes in trade records to test for accuracy and improper use.