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Update on NFA's Swap Dealer Examinations and Upcoming Priorities

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1. Introduction

Both the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA), the self-regulatory organization for the US derivatives industry, have signaled their expectation—now nearly four years after swap dealers first became provisionally registered—that firms have had sufficient time to implement fully the CFTC's swap regulations. This alert updates recent changes in NFA's approval process, provides a status report on NFA's current examination schedule and previews what changes swap dealers may expect in future NFA examinations.

Most notably, NFA is likely to begin conducting examinations of non-US swap dealers for the first time. In addition, during the course of its future examinations, NFA is likely to evaluate whether firms have taken appropriate corrective action based on prior feedback.

2. Background

In January 2012, the CFTC adopted final rules regarding the registration of swap dealers and major swap participants[1] and delegated responsibility for the registration process to NFA.[2] Swap dealers began filing applications for registration and became provisionally registered beginning on December 31, 2012.

As of October 2016, 104 firms are provisionally registered as swap dealers. Approximately half are located in the United States; the rest are located in jurisdictions including Australia, Canada, the European Union, Japan, Mexico, Singapore and Switzerland. NFA is currently working to complete its second cycle of swap dealer examinations and is in the process of preparing its third cycle of swap dealer examinations, to commence in 2017.

Since initiating its program, NFA's swap dealer registration approval process has undergone a number of significant changes. Moreover, there have been significant shortcomings noted in

[1] Performance of Registration Functions by National Futures Association With Respect to Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2708 (Jan. 19, 2012).

[2] Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 (Jan. 19, 2012).

NFA's current examination cycle. Finally, NFA has unveiled its priorities relating to the CFTC's new margin rules.[3]

3. Changes to Section 4s Review Process

NFA evaluates each swap dealer application, together with the swap dealer's policies, procedures, and other required documentation (Section 4s Submission), to determine the firm's ability to comply with its swap dealer obligations.

After a swap dealer applicant becomes provisionally registered, NFA conducts a substantive review of the Section 4s Submission, in coordination with the CFTC. Prior to January 2016, if NFA determined there were deficiencies in the submission, it would provide the swap dealer with a Feedback Letter and require it to submit additional information and/or revised policies and procedures in response, which NFA would then review.

In January 2016, the CFTC approved modifications to NFA's Section 4s review process permitting firms to submit an attestation to NFA instead of providing revised or additional documentation or information. Each swap dealer must now submit an attestation signed by a principal attesting that the swap dealer has updated its policies and procedures to address comments in NFA's Feedback Letter within the time frame specified in the letter. After the swap dealer provides the attestation to NFA, NFA issues an Acknowledgement Letter informing the swap dealer that NFA does not at that time have any further inquiry regarding the Section 4s topic area to which the attestation relates.[4]

Failure by a swap dealer to attest as to its remediation of any deficiencies noted in the Feedback Letter after the compliance date of a particular requirement has passed will result in notification by NFA that the application is deficient and must be withdrawn. That firm will no longer be provisionally registered and may not conduct any new swap dealing activity. A provisional swap dealer will become fully registered after it has received Acknowledgement Letters for each Section 4s topic area. Although swap dealers are no longer required to submit revised or additional documentation in response to Feedback Letters, NFA will review a firm's compliance with its policies and procedures as part of its regulatory oversight processes.[5]

4. NFA Examinations

Overview. NFA commenced a program of on-site examinations to evaluate the implementation of the swap dealer requirements and related firm policies and procedures beginning in the summer of 2014. During the first cycle of examinations, conducted between 2014 and early 2015, NFA focused on the key requirements and procedures governing chief compliance officer (CCO) programs for US swap dealers. Since the CFTC has granted substituted compliance for virtually all the CCO requirements,[6] non-US swap dealers relying on substituted compliance were not examined during this cycle.[7]

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[3] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

[4] Notice I-16-01, Revised SD and MSP 4s review process (Jan. 6, 2016).

[5] Notice I-16-01.

[6] Substituted compliance was not granted for certification and submission to the CFTC of the CCO annual report.

[7] For a more detailed discussion of recent NFA examinations of CCO programs, *see* Dan M. Berkovitz and Gail Bernstein, *Swap Dealer Chief Compliance Officer Requirements—Recent Developments*, 49 Review of Securities & Commodities Regulation, No. 4, at 41 (Feb. 24, 2016).

The second cycle of examinations, which commenced in 2015 and continues as of the date of this update, has focused on risk management and market practices. Similarly, since substituted compliance has been granted for swap dealer risk management requirements, this cycle has focused on US firms and has excluded non-US swap dealers relying on substituted compliance. NFA is conducting this second cycle in three rounds. It has completed the first two rounds and is well into the third, which it expects to complete by spring 2017 with the issuance of reports to the examined swap dealers.

In contrast to the first cycle, which reviewed the relatively narrow set of CCO requirements, this cycle has captured a wider range of regulatory expectations. NFA has adopted a risk-based approach to this examination cycle, focusing its attention on particular areas based on the inherent risk of specific rules and relevant market developments, informed by news events as well as NFA's observations gleaned through its Continuous Monitoring Program (CMP) discussed below.

With respect to risk management, NFA is evaluating issues, including risk governance, market risk, credit risk, business unit responsibilities and annual testing of the risk management program. Regarding market practices, examinations have focused on surveillance, fraud, manipulation and other abusive practices.

Status and Key Findings. As a general matter, based on the first two rounds of this second cycle, NFA has identified three key areas of concern: (1) recordkeeping; (2) risk management programs; and (3) risk governance.

Recordkeeping. Consistent with the CFTC's regulations, NFA expects that swap dealers will maintain full, complete and systematic records of all swaps activities, including daily trading records of all executed swaps. The examinations so far have found that several swap dealers have failed to maintain adequate records necessary to conduct a comprehensive and accurate trade reconstruction for each swap as required by Regulation 23.202. In particular, NFA has uncovered deficiencies relating to the ability to recreate pre-trade positions.

Risk Management Program. Under Regulation 23.600, each swap dealer must establish and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with its swaps activities (Risk Management Program). NFA's examinations have revealed certain shortcomings with respect to swap dealers' Risk Management Programs. For example, NFA has found that several firms have failed to conduct adequate annual testing regarding their adherence to, and the effectiveness of, their respective Risk Management Programs. NFA has also found that other firms have failed to report the results of such annual reviews to the CCO, senior management and governing body, as required by the rules.

Risk Governance. NFA has found that, although most firms generally have in place adequate processes to manage risk, there are a number of discrete structural and technical gaps relating to risk governance in some swap dealers. For example, NFA has found that because some firms have not properly established senior management and governing bodies for their swap dealers, they could not demonstrate that certain duties enumerated in the regulations were being carried out.

Among the challenges NFA is facing in its swap dealer examinations relate to its access to a firm's records. NFA is sometimes provided with documents that have been redacted on the basis that the information is privileged, not relevant to the swap dealer, proprietary or subject to supervisory information deemed confidential by a federal bank regulator (CSI). NFA has stated that, in its view, the only reason it will consider it acceptable to redact information is CSI, and then only after the firm has sought and been refused permission from the relevant bank regulator to provide the information to NFA. With respect to documents that might be attorney-client privileged, firms should be aware that disclosure to NFA could result in the loss of the privilege. This should be weighed against the possible consequences of resisting disclosure in an examination.

A separate challenge relates to the large size and complexities of some of the swap dealers subject to NFA examination. Because NFA has been examining U.S. swap dealers on a consolidated corporate group basis (i.e., one examination per family of affiliates in the United States), the SRO has found that some of its member firms have challenges scheduling meetings with key stakeholders or providing certain requested documents without delays. It remains to be seen whether NFA will continue to see similar deficiencies and challenges in its third round of this examination cycle and whether it will identify additional significant concerns.

Third Examination Cycle. Looking ahead to 2017, NFA is in the process of preparing its third cycle of swap dealer examinations and expects to share more details with market participants next year. Although NFA has not yet finalized the scope of its upcoming examinations, it is likely to conduct examinations of non-US swap dealers for the first time. In addition, during the course of its future examinations, NFA is likely to evaluate whether firms have taken appropriate corrective action based on prior feedback.

5. Continuous Monitoring Program

NFA introduced the CMP in the spring of 2015, with an aim to keep abreast of industry developments and areas of concern. The CMP's activities, which are separate and apart from NFA's on-site examinations, occur through a combination of periodic meetings with the swap dealer CCO and other key personnel, reviews of swap dealers' responses to NFA's annual questionnaire and other reports, and assessments of broader events or trends that could impact the swaps market more generally. The CMP's outreach has included non-US swap dealers that have elected substituted compliance, giving NFA a view into these firms even though it has not yet examined any such firms. Consistent with NFA's risk-based approach to examinations, the CMP is designed to inform NFA and focus its attention on key areas of concern. Input from the CMP has informed and is expected to continue to inform NFA's risk-based approach to its swap dealer examinations. As a result of the CMP, NFA added market practices and pre-trade recordkeeping to its risk management examination cycle.

6. Margin Rules

In January 2016, the CFTC adopted final rules establishing initial and variation margin requirements for uncleared swaps entered into by swap dealers for which the CFTC is the primary financial regulator—in general, non-bank swap dealers.[8] The CFTC's margin requirements do not apply to swap dealers subject to supervision by a Prudential Regulator.[9] The CFTC's margin rules permit a covered swap dealer to determine its initial margin requirements based on a standardized grid-based calculation or an internal risk-based model approved by the CFTC or NFA. The CFTC has delegated to NFA the authority to review and approve such internal risk-based initial margin models for compliance with the quantitative and qualitative standards set forth in the margin rules. In this regard, NFA has outlined a multistep evaluation process involving exploratory discussions, submission of margin model proposals,

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[8] Margin Requirements Adopting Release, *supra* n.3.

[9] The Prudential Regulators, which have adopted their own final margin rules, include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

review and assessment, and, ultimately, approval.[10] To the extent permitted under the applicable legal frameworks, NFA has worked to coordinate with the Prudential Regulators to ensure consistency in approach to internal model evaluation and to avoid duplicative efforts.

On an ongoing basis, NFA will actively monitor firms' margin models and overall compliance with margin regulations as part of its general examination authority. The CFTC has adopted a phased-in implementation schedule requiring swap dealers to come into compliance with the margin rules over the next four years, beginning with compliance by the largest swap dealers on September 1, 2016. All covered swap dealers (and all counterparties affected by the rules) will need to comply with the variation margin requirements beginning on March 1, 2017. The CFTC will allow substituted compliance for certain of the margin rules for jurisdictions it determines have comparable rules. On September 8, 2016, the CFTC made its first comparability determination for margin and granted substituted compliance for all of Japan's margin requirements for uncleared swaps except for requirements relating to the treatment of inter-affiliate swaps.[11]

[10] *See* Notice I-16-13, NFA approval process for risk-based initial margin models for uncleared swaps for certain SDs and MSPs (Apr. 14, 2016).

[11] Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 63376 (Sep. 15, 2016).

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