NFA Swap Dealer Regulatory Workshop
May 10, 2017 | New York
Today’s Agenda

- SD regulatory program background
- Themes from SD risk and market practice examinations
- NFA disciplinary process
- Upcoming SD examinations
- Questions
SD REGULATORY PROGRAM
BACKGROUND
NFA stays informed of significant developments at Member firms and in the industry (e.g. changes in business activities, key personnel)

NFA uses a risk-based approach to examinations and determining examination scope

NFA’s SD regulatory program covers both U.S. and non-U.S. SDs
To stay informed of firm activities, NFA may:

- Hold periodic meetings with Chief Compliance Officers (CCO) and other firm personnel to ascertain their continuing compliance with NFA rules and CFTC regulations
- Review CCO Annual Report and perform due diligence of any material non-compliance issues
THEMES FROM RISK MANAGEMENT AND MARKET PRACTICE EXAMINATIONS
Overview

- Examinations focused on CFTC Regulations 23.600 and 23.410:
  - Risk governance
  - Risk management structure
  - Risk monitoring
  - Annual testing of the Risk Management Program (RMP)
  - Market practice
Risk Governance

- Governing body (GB) and senior management (SM) duties:
  - Approve risk tolerance limits (annually for GB & quarterly for SM)
  - Review quarterly risk exposure reports
  - Review results of annual test of risk management program
  - Approve risk management program (GB only)
  - Be informed of breaches to risk tolerance limits, as appropriate (SM only)
  - Other
Risk Governance Observations

- Governing body (GB) and senior management (SM) composition:
  - Varies from 1 to 20 members
  - Members may include:
    - President, CEO, CCO, CRO, CFO and heads of business units
    - Risk Committee, Management Committee, other committees
    - Board of Directors (GB only)
Senior Management

NFA’s expectation:

- Representation from both the business and control functions
- Sufficient seniority and authority
Findings—Risk Governance

- Duties of governing body (GB) or senior management (SM) not performed
  - Risk Tolerance Limits not approved annually (GB) or quarterly (SM)
  - Not receiving results of the annual testing of risk management program
- Approvals not evidenced
- No representation of control function in senior management
Risk Management Structure

- Large global swap dealers
  - Matrix structure—CROs or risk officers:
    - Firm-wide;
    - Across line of business;
    - Within lines of business;
    - By region; and
    - By legal entity
  - Established legal entity risk limits
- Regional and smaller swap dealers (swap activities focus on one or two asset classes)
  - Designated CRO or other senior individuals such as President or CFO also performing CRO duties
Findings—Risk Monitoring

- Models not reviewed in accordance with policies
- Limits used in risk monitoring reports not consistent with approved limits
- Limit breaches not documented to show proper escalation and resolution
- Certain swap activities excluded from Dodd-Frank monitoring
Findings—Risk Monitoring

- Rules require SDs to provide a Risk Exposure Report to senior management and the governing body (GB) upon detection of a material change in risk exposure
  - Firms did not define what constitutes a material change in risk exposure
  - NFA is therefore unable to determine whether the SDs are meeting this rule requirement
Annual Testing of the RMP Observations

- Most SDs
  - Reliance on a combination of routine audits and a Dodd-Frank risk management program audit
  - Mapped rule areas to audit reports
- Some SDs
  - Single audit focused on Dodd-Frank risk management program
Findings—Annual Testing of the Risk Management Program (RMP)

- Insufficient testing performed
- Rules require SDs to review and test the RMP upon any material change in the business
  - Firms did not define what constitutes a material change in the business
  - NFA is therefore unable to determine if SDs are complying with the rules
- Results of testing not reported to the CCO, governing body (GB) and senior management (SM)
Market Practice
Prohibition On Fraud, Manipulation & Other Abusive Practices

Examinations focused on:

- Communication of policy on prohibition
- E-communications and voice surveillance
- Trade surveillance
- Mandatory vacation
Who is performing surveillance of e-communications and voice calls?
- Primarily compliance
- Business in some instances

Common Practices
- Sampling of voice records
- Using surveillance technology
Observations—Trade Surveillance

Most Common

- Cancel and Corrects
- Usage of Allocation, Wash & Dormant Accounts
- Unusual Volume, Pricing, Commissions or Spreads
- Off Market Transactions
- Large Trades
- Front Running
- Trades Booked by Non-APs

Least Common
Mandatory Consecutive Days Vacation Observations

- Required by most firms
- Required of APs and sensitive persons in operations, finance, back-office
- Consecutive leave varied from five days to two weeks
- Varied from limited access to no access to systems or office
- Monitored using automated system or manual spreadsheet
Findings—Market Practice

- E-communication surveillance:
  - Not performed
  - If performed by the business, no compliance oversight
- Not all associated persons included in e-communication surveillance
- Chat room not included in surveillance
- Limited trade surveillance with respect to the type of surveillance or asset classes covered
Findings Summary

Most Common

- Risk Governance
- Testing of Risk Management Program
- Market Risk
- Market Practice
- Business Unit Responsibilities
- Recordkeeping
- Credit Risk
- Risk Exposure Report
- Operational Risk

Least Common
Self-Reported Issues Metrics

- Issues from January 2016 – March 2017
- Reported throughout the year and in CCO Annual Report as material non-compliance issues

- Recordkeeping and Reporting
  - SDR, LTR, Storage of data in proper format, retrievability of trade data and reconstruction of trades

- Documentation
  - Improper classification of counterparties, onboarding errors, confirmations

- Other category includes:
  - BCDR, Counterparty, Market Practice, Processing, Segregation, and Diligent Supervision
NFA DISCIPLINARY PROCESS
**NFA Disciplinary Process Overview**

- **Examiners**: Identify apparent violations of NFA rules from regular examinations or investigations.

- **Enforcement Attorneys**: Work with examiners to review apparent rule violations and determine whether the matter should be presented to NFA’s Business Conduct Committee (BCC) for formal action.

- **Business Conduct Committee**: Reviews information presented by NFA staff and determines whether to issue a Complaint.

- **Hearing Committee**: Makes final determination of whether rule violations occurred and appropriate penalty.
Identifying apparent rule violations:

- NFA’s disciplinary cases are limited to violations of NFA’s rules
- Potential violations are identified in examinations or investigations
- Examiners work with NFA enforcement attorneys to reach initial conclusion on whether violation has occurred
- Senior staff determine whether to bring matter to the Business Conduct Committee (BCC)
Business Conduct Committee (BCC) overview:

- Background on BCC
- BCC reviews a report prepared by staff on the apparent rule violation(s)
- BCC authorizes a formal Complaint if it believes the evidence provided supports a probable cause determination that an NFA rule(s) has been violated
- Complaint identifies the alleged rule violations and the activity that constitutes the violations
NFA Disciplinary Process

Post Complaint:
- Background on NFA’s Hearing Committee
- Prehearing Conference
- Settlements
- Hearings
- Decision
- Penalties
- Appeals Process
Emergency Disciplinary Action:

- NFA also has authority to take an emergency action known as a Member Responsibility Action (MRA)
- NFA’s Executive Committee will issue an MRA at the recommendation of staff when it believes the action is necessary to protect the markets, customers or other Members
- MRA may summarily suspend a Member, impose restrictions on the Member’s operations or impose other remedial sanctions without a hearing
NFA Disciplinary Process

Emergency Disciplinary Action:

- Member respondent is entitled to a prompt hearing on the MRA
- Three-person Hearing Panel presides over the hearing
- Issues a Decision that may affirm, modify or lift the MRA
- Member respondent may appeal an adverse Decision to the CFTC
UPCOMING SD EXAMINATIONS
Upcoming SD Examinations

- Next round begins May/June 2017
- Cycle lasts 18 to 24 months
- Covers U.S. SDs and several non-U.S. SDs
Examination Process

NFA’s Examination Process

Planning
Advise firm of upcoming examination
Send First Day Letter requesting documents required to start the review

Fieldwork
On-site
Interview key personnel and perform tests

Reporting
Provide preliminary findings at exit meeting
Issue written examination report
Examination Scope

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Note: If necessary, NFA may expand the examination scope to include additional rule areas / matters pursuant to the Commodity Exchange Act, CFTC Regulations or NFA requirements.
Contact Us

If you have questions or would like more information, please contact NFA.

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