NFA

March 2, 2020

Mr. Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: RIN 3038-AD54: Capital Requirements of Swap Dealers and Major Swap Participants

Dear Mr. Kirkpatrick:

National Futures Association (NFA) appreciates the opportunity to respond to the Commodity Futures Trading Commission's (Commission) request for additional comments on its proposed rulemaking regarding capital requirements for swap dealers (SDs) and major swap participants. As discussed more fully below, NFA's comments will focus primarily on one aspect of the proposal—the capital model review and approval process (including the compliance date). Given NFA's contemplated role in this process, as well as our experience in approving SD internal models for calculating initial margin for uncleared swaps under Commission Regulation 23.154, NFA believes that we have a unique perspective on the capital model review process, and we encourage the Commission to carefully consider our comments outlining a practical, meaningful framework for the review and approval process. NFA will also briefly comment on another aspect of the proposal where it is contemplated that NFA will play a role – the financial recordkeeping, reporting and notification requirements.

The Model Review and Approval Process

A. Background

Under the Commission's proposal, SDs that are not subject to the capital requirements of a prudential regulator (Covered SDs) must meet the Commission's capital requirements and may elect a bank-based capital approach, a net liquid assets capital approach or a tangible net worth capital approach to calculating regulatory capital. Each of these approaches requires SDs to take market risk charges to protect against potential losses in the value of their proprietary trading positions and to take credit risk charges to protect against potential counterparty credit risk. The Commission's proposal permits a Covered SD to use internal models for purposes of calculating these market risk and credit risk capital charges in lieu of using standardized rule-based capital charges, provided the Commission or a registered futures association of which the SD is a member (*i.e.*, NFA) has approved the Covered SD's use of internal

models to calculate market and credit risk capital charges. For the reasons outlined by the Commission in its request for additional comments and its 2016 capital proposal, NFA fully supports the Commission's proposal that permits Covered SDs to appropriately use internal market and credit risk models.

At the outset, NFA again expresses its willingness to undertake the review of these models for compliance with the Commission's requirements. NFA currently has a team with significant model experience that has been focused on the review, approval and on-going monitoring of SD initial margin models (*i.e.*, ISDA SIMM) for uncleared swaps. NFA's initial margin (IM) model team works very closely with the CFTC's Division of Swap Dealer and Intermediary Oversight to ensure that SD IM models meet the CFTC's initial margin requirements. If the Commission's final capital rules provide that NFA conduct the review and approval of Covered SD market and credit risk capital models, we will leverage the experience gained in reviewing and approving SD initial margin models, and we will allocate similar resources to review Covered SDs' internal capital models to determine whether each model complies with the Commission's final capital requirements.

While NFA can certainly leverage our experience in reviewing SD initial margin models, as discussed in our May 15, 2017 comment letter (2017 Comment Letter) and recognized by the Commission in its 2016 capital proposal, the capital model review process will be significantly more complex than the process conducted for initial margin models. Several reasons for this complexity include the following:

- There is no industry-wide standardized internal capital model similar to the ISDA SIMM model for initial margin;
- Capital model reviews could involve multiple models that cover different aspects of market risk and credit risk (*e.g.*, VaR and stressed VaR) for each Covered SD; and
- Unlike the multiyear phased-in approach for initial margin, the timing of the final capital rule's compliance date is uncertain, and it appears likely that all Covered SDs will be required to comply with the Commission's capital rules on the same date.

Based on NFA's estimates, as many as 51 Covered SDs[1] (from 21 corporate families) could be subject to the CFTC's capital rules and may seek review and approval of multiple market and credit risk models prior to the compliance date.

[1] NFA currently has 106 SD Members and one SD Member pending (107 SDs total provisionally registered). Based on our estimates, 52 of those SDs are prudentially regulated banks that will not be subject to the Commission's capital requirements and four SDs are also registered broker-dealers and futures commission merchants that will continue to be subject to the capital requirements under CFTC Regulation 1.17 (ANC firms) and will use capital models approved by the SEC, leaving 51 Covered SDs subject to the Commission's requirements.

Given this number and the aforementioned complexities, NFA continues to believe that a practical review framework similar to the one set forth in our 2017 Comment Letter is necessary to meet the Commission's goal of ensuring that the review process for capital models is effective and meaningful, and at the same time is efficient by significantly reducing the likelihood that regulatory resources are wasted through duplication of effort.

B. Recommended Framework

The Commission's request for additional comments specifically requests input on a framework that would permit SDs to use internal market risk and/or credit risk models without obtaining prior written approval of the Commission or NFA if the relevant model has been approved by a prudential regulator or a foreign regulator for the Covered SD or an SD affiliate. NFA's 2017 Comment Letter proposed a capital model approval framework designed to allow NFA to better focus our resources on Covered SDs that plan to use models that have not been previously reviewed by other regulators. This framework, in part, leverages prior reviews of existing models completed by prudential regulators and thus minimizes duplication with prudential regulators. We firmly believe this approach is critical and provides the only viable approach to meet the Commission's goals.

Specifically, NFA proposed that for a Covered SD electing a bank-based capital approach that uses internal market and credit risk capital models previously reviewed by a prudential regulator for an affiliated SD (*e.g.*, a bank holding company), neither the CFTC nor NFA would formally review or approve the Covered SD's capital models prior to the compliance date of the CFTC's capital rules. It is NFA's understanding that the Commission received other comments in response to its 2016 proposal supporting a similar framework for Covered SDs that are affiliates of prudentially regulated SDs. At this time, NFA also believes that the Commission should consider implementing a similar review process for Covered SDs that use internal market and credit risk models that have been reviewed or approved for their use or an affiliate's use by a foreign regulator in a jurisdiction that has implemented the Basel III capital standards (Qualifying Foreign Regulator).[2]

As outlined in our 2017 Comment Letter, for those Covered SDs that NFA does not conduct a pre-compliance date approval, NFA would review the SDs' overall capital compliance including their use of models after the compliance date

[2] The Commission's request for additional comments included one commenter's proposed amendment regarding models approved by a Qualifying Foreign Regulator that would require the Covered SD to submit a description of how the relevant foreign jurisdiction capital adequacy framework addresses the elements of the Commission's capital requirements. NFA questions the need for this submission. Since those models were approved in accordance with Basel III standards, NFA believes that should be sufficient to not require a pre-compliance date review. The model, would of course, be subject to review through NFA's examination process and subject to our ongoing monitoring program.

through NFA's examination process and ongoing compliance monitoring program. To make the post-compliance date framework effective, since NFA will not formally approve a Covered SDs use of market and credit risk models previously reviewed by a prudential regulator or a Qualifying Foreign Regulator, we believe that it is important that the Commission and/or NFA have the authority to require that a Covered SD cease at any time using internal models to compute its market and credit risk charges if the SD is not in compliance with the Commission's capital requirements. Therefore, we recommend that the Commission consider whether it needs to modify Commission Regulation 23.102(e) to clarify the CFTC's and NFA's authority to rescind a Covered SD's use of models that were not formally "approved" prior to the requirements' compliance date.[3]

If the above framework is implemented, NFA will work with the Commission to develop a pre-compliance date model review and approval process, including appropriate information gathering and certification requirements, for Covered SDs with models that have not been reviewed by a prudential regulator or a Qualifying Foreign Regulator, as well as an appropriate post-compliance date model review and monitoring process. Under the above framework, post compliance date, NFA is committed to monitoring the overall governance and use of market and credit risk models by all Covered SDs that are subject to a model pre-approval process or post-compliance model review. This monitoring will include, at a minimum, assessing model performance test results and monitoring for compliance with the Commission's SD capital rules.

In discussing this type of capital model approval/review framework, the Commission's request for additional comments notes that a Covered SD may have swaps positions materially different than those of its prudentially regulated or Qualifying Foreign Regulator affiliate that obtained model approval and seeks input on how the Commission or NFA should address these Covered SDs. NFA agrees with the Commission's observation that materially different swaps positions may present model fit issues for these Covered SDs, and we recognize that no model is a perfect fit in all circumstances. However, based on NFA's experience with the ISDA SIMM, SDs can effectively identify model fit issues, including those arising from materially different portfolios, through model performance monitoring and governance protocols and can adequately address those issues through the use of compensating controls (*e.g.*, adding a multiplier to adjust VaR based on backtesting results or implementing portfolio restrictions). SDs are responsible for ensuring that their models perform well for their portfolios and, when necessary, address any issues through the use of compensating controls. NFA is willing to work with the Commission to collect information to identify Covered SDs that have materially different portfolios than their prudentially regulated or Qualifying Foreign Regulator affiliates, assess whether these firms are experiencing

[3] Specifically, the CFTC proposed Appendix A to CFTC Regulation 23.102, which provides that the CFTC or a registered futures association may revoke a Covered SD's internal market and credit risk models. *See* Appendix A, subsection (h). However, this provision needs to be worded differently if there is no "approval" for these Covered SDs' models.

model fit issues and, if so, review their implementation of appropriate compensating controls. Further, NFA is willing to prioritize Covered SDs with potential model fit issues in performing post-compliance date examinations and, if appropriate, perform enhanced monitoring of these firms.

C. Impact of Substituted Compliance Comparability Determinations

Although the Commission does not seek comments on the substituted compliance framework, NFA understands that the Commission may afford non-US Covered SDs in certain jurisdictions substituted compliance relief from the CFTC's capital requirements. While NFA defers to the Commission on making substituted compliance comparability determinations, we encourage the Commission to issue these determinations well in advance of the CFTC's requirements' capital compliance date. Failing to provide clarity on whether a particular jurisdiction has comparable capital requirements in a timely manner could cause non-US SDs to seek model approval even though they will ultimately be able to rely on substituted compliance, which could place unnecessary burdens upon the Covered SDs and result in an inefficient use of regulatory resources.

The number of non-US Covered SDs potentially impacted by substituted compliance is not insignificant. For example, if the Commission determines that it is appropriate to issue comparability determinations for the EU, Australia, Japan and the United Kingdom, it may be possible for the Commission and NFA to avoid duplicating the model review, approval and monitoring work performed by the Prudential Regulators and Qualifying Foreign Regulators for 20 Covered SDs (including 16 affiliates of prudentially regulated firms) located in those jurisdictions.

NFA also encourages the Commission to reconsider the framework set forth in proposed Commission Regulation 23.106(a)(4), which provides that a Covered SD that intends to comply with the capital adequacy and financial reporting requirements of a foreign jurisdiction that has received a capital comparability determination must file a notice with NFA. The proposal further contemplates that NFA confirm that the SD may comply with the adequacy and financial reporting requirements of the foreign jurisdiction in lieu of some or all of the Commission's requirements. While NFA supports substituted compliance, we question whether it is an appropriate role for NFA to confirm that an SD may comply with the obligations of a foreign jurisdiction in lieu of the Commission's requirements. We encourage the Commission to review whether this aspect of the proposal could be amended to require that a non-US Covered SD make only a notice filing similar to the substituted compliance process for margin and entity-level requirements.

D. Compliance Date

If the Commission adopts the aforementioned model review framework and makes timely comparability determinations, NFA estimates that 12 of the 51

Covered SDs will likely seek approval of multiple market and credit risk models from the Commission or NFA prior to the compliance date. Of the remaining 39 Covered SDs, we expect—14 US SDs to implement models that have been approved by a prudential regulator for an affiliate; 5 US SDs (affiliates of non-US firms) to implement models that have been reviewed/approved by a Qualifying Foreign Regulator for the SD or one of its affiliates; and as many as 20 non-US SDs (located in the EU, Australia, Japan or the United Kingdom) to rely on substituted compliance.

For the reasons stated above relating to the complexity of the market and credit risk models, NFA's review and approval of Covered SD capital models will need to occur over a period of time. NFA initially will need to build systems and processes to receive the requisite model information from SDs and, once these systems are available, SDs will need a reasonable period of time to gather and submit information related to their models. Afterwards, with a mix of NFA staff and consultants, NFA will need to review and approve the Covered SDs' models for compliance with the Commission's final capital requirements. Given these tasks and assuming that NFA will review and approve capital models for 12 Covered SDs, we recommend that the Commission establish a compliance date that is no earlier than 15 months following the effective date of the final rules.

NFA encourages the Commission to seek feedback from Covered SDs as to a workable compliance date to ensure that they have adequate time to configure capital models to conform to the final rules and obtain any necessary internal approvals. In our view, two material changes could impact the 15 month period noted above. First, if NFA needs to review and approve capital models for more than 12 Covered SDs, then significant timing and resource implications will negatively impact the time frame for NFA to complete model approvals. Second, NFA believes the Commission needs to be cognizant of the fact that several of the 12 Covered SDs requiring a pre-compliance date review and approval of their capital models are also firms that will be subject to the Commission's Phase VI initial margin compliance date of September 1, 2021. Therefore, both NFA and these firms will experience resource constraints in meeting both these deadlines at a concomitant time.

Financial Recordkeeping, Reporting and Notification Requirements

Finally, as to the financial recordkeeping, reporting and notification requirements set forth in the proposed rule, NFA generally supports these proposed requirements for Covered SDs but encourages the Commission to consider two changes. NFA recommends that the Commission either implement standardized reporting forms or mandate that financial filings be accomplished in a form and manner prescribed by a registered futures association. NFA strongly believes a meaningful starting point for either of these alternatives is the SEC's recent amendments to the FOCUS Report, which could be further amended by the CFTC or NFA with

supplemental schedules (likely applicable mostly to non-financial Covered SDs).[4] NFA also encourages the Commission to parallel any financial reporting requirements for prudentially regulated SDs and those relying on substituted compliance with the SEC's filing requirements for these firms. The Commission and NFA, however, should receive from all SDs applicable notice filings and, therefore, these proposed requirements should be retained.

Conclusion

As previously noted, if the Commission adopts Commission Regulation 23.102, NFA is certainly willing to assist the Commission to undertake a review of SDs' internal models for calculating market and credit risk exposures to determine the models' compliance with requirements adopted by the Commission. We appreciate the opportunity to provide these additional comments proposing a practical, meaningful model review and approval framework and are available to discuss this topic further with Commission staff. If you have any questions concerning this letter, please contact Mike Otten, Vice President, OTC Derivatives at (212) 513-6046 or motten@nfa.futures.org or me at (312) 781-1409 or cwooding@nfa.futures.org.

Very truly yours,

Carol A. Wooding

Carol A. Wooding
Senior Vice President,
General Counsel and Secretary

[4] NFA's electronic filing system is already equipped to receive SEC FOCUS Reports from FCMs and IBs that are also registered as broker-dealers.