August 2014

NFA examination approach

NFA's examination approach for swap dealers and major swap participants

Overview

On 5 June 2014, the National Futures Association (NFA) hosted a teleconference to discuss its plans for commencing examinations of swap dealers (SDs) this summer. NFA is the designated self-regulatory organization for all SDs registered with the Commodity Futures Trading Commission (CFTC). During the teleconference, NFA provided guidance and expectations around the exam process, including timing and scope of exams along with a description of communications from NFA before, during and after exams. NFA announced the first examinations in July, and on-site visits began in August.

Each year, NFA will release a list of topics on which it will focus in its upcoming annual exam cycle. NFA will choose focus areas based on the inherent risk of a rule area, while also considering industry developments.

For NFA's fiscal year 2015, beginning in July 2014, exams will focus on the role and function of the SD chief compliance officer (CCO). Specifically, examiners will review adherence to compliance policies and procedures while also assessing the adequacy of a firm's compliance control environment. Initially, NFA does not plan to conduct detailed technical reviews of SD systems and processes unless specifically prompted by exam findings.

Citing outstanding issues related to substituted compliance with overseas regulators, NFA plans on conducting examinations of US-based SDs in its FY 15. In the future, NFA plans to examine non-US SDs abroad as necessary; however, examinations will likely be conducted at US branch office locations to the extent possible.

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With SD examinations underway, SD CCOs should ask themselves:

- **Have issues raised by NFA during the 4s review process been sufficiently remediated?** NFA regularly targets previously identified deficiencies during its examinations. Given NFA's limited experience with its SD members, previous findings may have an outsized impact on exams. Also, CCOs should consider any changes to policies or procedures related to CCO duties on an ongoing basis.
- **Does documentation provided to NFA during the registration process accurately reflect the SD's current processes?** NFA will leverage information gleaned during the 4s review process in examination scoping and testing. Material discrepancies between previously provided policies/procedures and actual processes may raise questions.
- **How fully do policies and procedures describe the SD's compliance program and supervisory processes?** Since NFA will initially focus on compliance programs, CCOs should make sure they can clearly demonstrate all the efforts the SD is undertaking toward achieving compliance. Given this year's area of focus, SDs should consider conducting a self-assessment of their compliance program and procedures. Specific attention should be paid to the control environment and supervisory program and how these help support compliance with CFTC Regulation 3.3, Chief Compliance Officer.
- **How well can we explain the CCO Report development process?** NFA will seek to gain an understanding of how CCOs went about obtaining and identifying the items included in their annual CCO report. Specifically, NFA may inquire how issues are escalated to compliance and how compliance determines an issue is material enough to be included in the report.
- **Were any areas of material noncompliance identified in the most recent CCO report?** If so, CCOs should expect increased scrutiny of affected areas, SDs should be ready to demonstrate the effectiveness of the remediation activities outlined in the report.

Examination process

Examination time frame

- Roughly 30 days before beginning an exam, NFA will contact the CCO or other listed compliance contact to announce the upcoming examination.
- At this time, NFA will send a "first-day letter" outlining the expected time and duration of the examination, a document request list, and a questionnaire on SD business functions.
- NFA expects examiners to remain on-site for approximately three weeks. However, NFA advised that entities with several affiliated SDs, complex operations or material exam findings may see their on-site visits extended.
- Since the exam process is new for all parties, SDs should be prepared for follow-up visits and additional inquiries from NFA after the on-site portion of the exam has ended.

Examination approach

- NFA examinations of other CFTC registrants — for example, futures commission merchants — are driven directly from specific CFTC regulations and NFA compliance rules.
- NFA examination teams will consist of four to five individuals who will review documents, observe operations and conduct a series of interviews with individuals across departments (e.g., compliance, operations and risk management).
- NFA indicated that the CCO and his or her staff will be the primary points of contact for requests.

Examination closing

- Upon the close of fieldwork, NFA will conduct an exit interview summarizing findings and recommendations.
- NFA will issue an examination report subsequent to fieldwork but will likely have follow-up questions and additional requests during the finalization process.

- To the extent possible, SDs should attempt to remediate findings raised by NFA before the report is issued as it may reduce the response required upon receiving the final exam report.
- Historically, NFA has issued examination reports to its members within 150 days of the commencement of fieldwork.
- NFA will provide the CFTC with copies of the examination reports.

While preparing for an examination, CCOs should:

- Identify employees who are likely to be interviewed by NFA and employees who are responsible for gathering documents requested by NFA
- Confirm that records evidencing compliance with CCO duties are readily available (e.g., annual report supporting documentation, meeting minutes); also, be prepared to discuss any changes to CCO duties policies, and supporting procedures, enacted since NFA's 4s review
- As applicable, confirm employees can access, in a timely fashion, affiliate records related to swap dealing activities (e.g., record of swaps cleared by an affiliated FCM)
- Review applicable SD regulations to anticipate the questions examiners will ask and the documents they will request

Ongoing monitoring

NFA announced that it is implementing a monitoring program to oversee its SD members between examinations. While development of the program remains in the early stages, NFA anticipates that the program will allow NFA and the CFTC to assess the perceived riskiness of SDs, allowing the regulators to prioritize their oversight accordingly. NFA will likely use information gleaned from the monitoring program to prioritize examinations and to conduct ad hoc inquiries or investigations into its SD members. Potential inquiry triggers may include general regulatory trends among SDs or significant developments at a specific SD. The CCO will serve as the primary contact for NFA inquiries. NFA expects to implement the monitoring program in phases over the next two to three years.

To alleviate growing pains as NFA establishes its monitoring program, SD CCOs should:

- Establish a defined process for responding to NFA inquiries in order to provide a timely response and to facilitate coordination with SD business units
- Anticipate potential areas of regulatory interest through both internal and external channels (e.g., significant developments at the SD, new regulations/ interpretations and industry developments)
- Establish open lines of communication, seeking to form a collaborative relationship with NFA, as opposed to an adversarial one

Regulatory cooperation

NFA has initiated dialogue with prudential regulators, foreign regulators and the CFTC to reduce duplication of efforts and conflicts in cases where an SD's swaps business is subject to the oversight of multiple regulators. NFA will work with regulators to identify opportunities for efficiencies; however, each regulator must implement programs to carry out its oversight mandate, and therefore some redundancies will likely be realized.

CCOs responsible for oversight of SDs subject to multiple regulators should:

- Be aware of cross-regulatory impacts (e.g., a change to the risk tolerance at an enterprise level based on prudential regulator feedback requiring modification of the CFTC-mandated risk management program)
- Include in the supervisory program an approach for monitoring global SD business functions and cross-border regulatory considerations and developments

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