

January 22, 2021

CFTC Approves NFA's Swap Dealer Model Review Process

CFTC Issues Letter Authorizing the NFA's Review Process for Approving Swap Dealer Internal Models

SUMMARY

On January 12, 2021, the Market Participants Division ("MPD") of the Commodity Futures Trading Commission (the "CFTC") issued a letter approving the National Futures Association's (the "NFA") swap dealer ("SD") capital model requirements and review program. The MPD staff concluded that the NFA's model requirements and review process are comparable to those of the CFTC. Accordingly, SDs can obtain approval from either the CFTC or the NFA for internal models to be used in computing their regulatory capital under the CFTC's rules.

BACKGROUND

In July 2020, the CFTC adopted a final rule implementing capital requirements (the "Final Rule") for SDs and major swap participants that are not subject to the capital requirements of a prudential regulator.¹ The Final Rule allows SDs to choose from three alternative methods for compliance with minimum capital requirements.² Registered futures commission merchants ("FCMs") that are also SDs ("FCM-SDs") fall under one approach,³ but SDs that are not also registered FCMs can choose to be regulated under the "bank-based" approach⁴ or the "net liquid" approach.⁵ Market participants are required to be in compliance with the Final Rule by October 6, 2021.⁶

The Final Rule also noted that the CFTC will work with the NFA to establish a comprehensive ongoing examination program for the capital models used by SDs.⁷ To that end, CFTC Regulation 23.102 generally permits an SD to apply to the CFTC or to the registered futures association of which it is a member to obtain approval to use internal market risk and/or credit risk models in computing its regulatory capital under the

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CFTC's rules.⁸ In the latter case, the CFTC must first determine that the registered futures association's model requirements and review process are comparable to those of the CFTC in order for the association's approval to be sufficient as an alternative means of compliance.⁹ The NFA is the only registered futures association under the Commodity Exchange Act.¹⁰

The January 12 letter determined that the NFA's proposed capital model requirements and review process are comparable to those of the CFTC.¹¹ Accordingly, the MPD approved NFA Compliance Rule 2-49, and concluded that a model approved by the NFA would be acceptable as an alternative means of compliance under CFTC Regulation 23.102.¹²

The letter concluded by noting that the MPD staff expects to engage in further discussions with the NFA regarding the implementation of the capital model program as a matter of routine oversight.¹³ However, the letter did note that any anticipated material changes to the processes or requirements of the NFA SD capital model approval program must be communicated to MPD staff prior to their implementation, in order for the MPD staff to ensure that the anticipated changes do not alter the NFA program to an extent such that it is no longer comparable to the CFTC regulations.¹⁴

GENERAL REQUIREMENTS

Under CFTC Regulation 23.102, when an SD applies for capital model approval to either the CFTC or the NFA, the SD must provide a description of critical model components.¹⁵ In particular, the SD must furnish, among other things: (i) a list of categories of positions that the SD holds in its proprietary accounts and a brief description of the methods the SD would use to calculate market risk and credit risk charges; (ii) a description of the mathematical models to be used to price positions and to compute market risk and credit risk; (iii) a description of how the SD would calculate current exposure and potential future exposure for its credit risk charges; and (iv) a description of how the SD would determine internal credit risk-weights of counterparties, if applicable.¹⁶ In addition, if the CFTC or the NFA requests further documentation in order to complete its review, then the SD must supplement its application with other information relating to its internal risk management control system, mathematical models and financial position.¹⁷ Given that NFA Compliance Rule 2-49 automatically incorporates all of these requirements by reference, an SD applying to the NFA for model approval would generally be required to supply the same information that it would if it had applied to the CFTC.¹⁸

To address concerns with completing the review of internal models by the CFTC and the NFA before the compliance date of October 1, 2021, the Final Rule allows an SD to use capital models that are pending approval by the CFTC or the NFA, provided that the SD submits a certification to the CFTC and to the NFA certifying that the models have been approved for use by the SD or an affiliate of the SD by the Securities and Exchange Commission, a prudential regulator, a foreign regulatory authority in a jurisdiction that the CFTC has found to be eligible for substituted compliance, or a foreign regulatory authority whose capital

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adequacy requirements are consistent with the Basel Committee on Banking Supervision bank capital requirements.¹⁹

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ENDNOTES

- 1 See 85 Fed. Reg. 57462 (Sept. 15, 2020) (“Final Rule”), available at <https://www.cftc.gov/sites/default/files/2020/09/2020-16492a.pdf>. For further information, see our Client Memorandum, CFTC Capital Requirements: CFTC Adopts Final Rule Implementing Capital Requirements for Swap Dealers and Major Swap Participants (Sept. 9, 2020), available at <https://www.sullcrom.com/files/upload/SC-Publication-CFTC-Adopts-Final-Rule-Capital-Requirements.pdf>.
- 2 See Final Rule at 57467.
- 3 See 17 CFR 1.17(a)(1)(i).
- 4 See 12 CFR 217.100 *et al.*
- 5 See Appendix A to Subpart E of 17 CFR Part 23.
- 6 See Final Rule at 57525.
- 7 See *id.* at 57509.
- 8 See 17 CFR 23.102(a).
- 9 See *id.*
- 10 See Final Rule at 57464 n.19.
- 11 See CFTC Staff Letter 21-03 (Jan 12, 2021), available at <https://www.cftc.gov/node/236276>.
- 12 See *id.*
- 13 See *id.*
- 14 See *id.*
- 15 See 17 CFR 23.102.
- 16 See Paragraph (a) of Appendix A to Subpart E of 17 CFR Part 23.
- 17 See Paragraph (b) of Appendix A to Subpart E of 17 CFR Part 23.
- 18 See NFA Compliance Rule 2-49.
- 19 See Final Rule at 57509.

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