



September 29, 2017

Mr. Christopher Kirkpatrick
Secretary
U.S. Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: Commodity Futures Trading Commission Request for Public Input on Simplifying Rules (Project KISS); Risk Management Program Requirements (RIN 3038–AE55)

Dear Mr. Kirkpatrick:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ appreciates the continuing efforts of the Commodity Futures Trading Commission (“CFTC” or “Commission”) and its staff to review rules, regulations and practices to identify those areas that can be simplified and made less burdensome and costly, including as part of the Project KISS initiative.²

One area that would benefit from this review is CFTC Regulations § 23.600 (“Rule 23.600”), which requires swap dealers (“SDs”) and major swap participants (together with SDs, “Swap Entities”) to adopt risk management programs (“RMPs”). For most Swap Entities, Rule 23.600 duplicates existing prudential supervision and regulation. These Swap Entities face undue costs, complexity and uncertainty. The current approach also leads the Commission and National Futures Association (“NFA”) to expend time and resources supervising the details of risk management practices already subject to comprehensive supervision by other regulators.

Rule 23.600 accordingly would benefit from greater regulatory deference. As recently noted by Chairman Giancarlo, “In a time of administrative budget constraints, regulatory deference enables us to work smarter, not harder, in pursuit of common regulatory principles.”³ Consistent with this objective, and for the other reasons described below, the Commission should expand its existing substituted compliance framework to make both U.S. and non-U.S. Swap Entities eligible for substitute compliance in connection with Rule 23.600.

¹ SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$18.5 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

² See *Project KISS*, 82 FR 21494 (May 9, 2017), available at: <https://www.gpo.gov/fdsys/pkg/FR-2017-05-09/pdf/2017-09318.pdf>; and Press Release, available at: <http://www.cftc.gov/PressRoom/PressReleases/pr7555-17>.

³ See J. Christopher Giancarlo, *Deference is the Path Forward in Cross-Border Supervision of CCPs* at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarloped091117>.

A. Background on Rule 23.600

Rule 23.600 implements the requirement in Section 4s(j) of the Commodity Exchange Act (“CEA”) for a Swap Entity to “establish robust and professional risk management systems adequate for managing the day-to-day business of” the Swap Entity. Despite this principles-based statutory mandate, Rule 23.600 is highly prescriptive. It requires a Swap Entity to establish, document, maintain and enforce policies and procedures addressing over 60 different requirements, including multiple components of a swaps-specific governance framework involving 10 different requirements for escalation to or approval by specified senior personnel.

Rule 23.600 applies uniformly across Swap Entities, regardless of business model, prudential oversight by other regulators, or applicable capital rules. It is not harmonized with parallel risk management rules and guidance adopted by the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the Office of the Comptroller of the Currency (“OCC”), the Securities and Exchange Commission (“SEC”) or other regulators, although Rule 23.600 draws from those rules and guidance in certain instances.

The Commission has permitted non-U.S. Swap Entities to substitute compliance with home country risk management rules and guidance for compliance with Rule 23.600.⁴ This substituted compliance framework has generally worked well, except in connection with risk exposure report requirements, which are not currently eligible for substituted compliance.⁵ U.S. Swap Entities, in contrast, have been required to satisfy Rule 23.600 in addition to otherwise applicable risk management rules and guidance.

We also note that the pre-existing prudential oversight framework for swaps activities results in greater potential for regulatory duplication and conflicts in connection with RMP requirements for Swaps Entities—and concomitantly greater benefits for regulatory deference—than the Commission’s separate RMP requirements for futures commission merchants, which address considerations unique to Commission regulation of customer clearing activities (such as segregation risk).

B. Key Issues Posed by Rule 23.600

For Swap Entities already subject to prudential oversight,⁶ the Commission’s current approach to administering Rule 23.600 poses several issues:

⁴ See *Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 45292 (July 26, 2013); see, also *Comparability Determination for Australia: Certain Entity-Level Requirements*, 78 Fed. Reg. 78864, 78869 (Dec. 27, 2013); *Comparability determination for Certain Requirements under the Laws of Canada*, 78 Fed. Reg. 78839, 78843 (Dec. 27, 2013); *Comparability Determination for the European Union: Certain Entity-Level Requirements*, 78 Fed. Reg. 78923, 78928 (Dec. 27, 2013); *Comparability Determination for Hong Kong: Certain Entity-Level Requirements*, 78 Fed. Reg. 78852, 78857 (Dec. 27, 2013); *Comparability Determination for Japan: Certain Entity-Level Requirements*, 78 Fed. Reg. 78910, 78915 (Dec. 27, 2013); and *Comparability Determination for Switzerland: Certain Entity-Level Requirements*, 78 Fed. Reg. 78899, 78903 (Dec. 27, 2013).

⁵ We provide specific comments on risk exposure report requirements below.

⁶ These Swap Entities include bank Swap Entities with a Prudential Regulator (as defined in the CEA), non-bank Swap Entity subsidiaries of U.S. bank holding companies subject to consolidated Federal Reserve supervision and regulation, non-bank Swap Entities dually regulated by the SEC, and non-bank Swap Entity subsidiaries of foreign financial holding companies subject to consolidated supervision and regulation by home country authorities.

1. Unnecessary Overlap, Costs and Complexity.

Because Rule 23.600 is highly prescriptive and not harmonized with other regulators' rules and guidance—and the Commission has not permitted U.S. Swap Entities to rely on substituted compliance—U.S. Swap Entities have had to establish and maintain swap-specific overlays to their pre-existing risk management policies, procedures, systems and controls. The resulting duplication is highly inefficient for registrants and regulators. Also, as the OCC foresaw when it commented on the Commission's RMP proposal, the Commission's approach has "create[d] uncertainty and opportunities for regulatory conflict and control failures."⁷ In the Appendix to this letter, we provide some specific examples of the issues Swap Entities have faced.

2. Inconsistency Between Risk Management and Capital Rules.

Capital rules establish a framework for pricing the risks incurred by a firm and require a firm to maintain resources to absorb losses that might materialize from those risks. Capital and risk management systems typically use common data inputs, risk and pricing models, and related systems, processes and controls. Accordingly, an effective risk management framework must form an integral part of a coordinated approach to evaluating and monitoring capital adequacy.

Rule 23.600 does not satisfy this objective because it does not distinguish among the different capital rules applicable to Swap Entities. Instead, for example, it treats a bank subject to capital rules established by a Prudential Regulator or a subsidiary of a bank holding company subject to consolidated Federal Reserve capital rules the same way as an energy firm for which the Commission is the sole regulator. As reflected in the Commission's 2016 Swap Entity capital proposal (the "2016 Capital Proposal"),⁸ the different business models and regulatory statuses of these firms necessitate different capital rules; complementary risk management rules should also apply.

3. Undue Governance Burdens.

The Treasury Department, in its recent report to the President in response to Executive Order 13772, observed that the volume of regulatory obligations placed on bank boards "crowds out time that should be allocated to oversight of the enterprise's business risk and strategy," and that "there is a considerable volume of non-strategic regulatory matters requiring Board attention that has the impact of blurring the appropriate line between management and Board duties."⁹ By imposing duplicative, swaps-specific governance requirements on Swap Entity governing body members, Rule 23.600 exacerbates the issues described by Treasury.

⁷ Letter from John Walsh, Acting Comptroller of the Currency, to Gary Gensler, Chairman, CFTC, dated June 30, 2011 at: <https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=46733&SearchText=walsh>.

⁸ *Capital Requirements of [Swap Entities]*, 81 Fed. Reg. 91252 (Dec. 16, 2016) at: <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-29368a.pdf>.

⁹ U.S. Treasury Department, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions*, p. 62 (June 2017) at: <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.

4. Cross-Border Disparities.

Since 2013, the Commission has permitted non-U.S. Swap Entities to substitute compliance with home country regulations for compliance with Rule 23.600, subject to an exception for quarterly risk exposure reports.¹⁰ Except for issues posed by the risk exposure report requirement (which we discuss below), this substituted compliance framework has helped to reduce costs and regulatory conflicts for non-U.S. Swap Entities and conserve regulatory resources for the Commission and NFA.

Given the success of this substituted compliance framework, the Commission should expand it to cover U.S. Swap Entities by exercising as much regulatory deference to the OCC, Federal Reserve and SEC as it does to foreign regulators. The current approach, where the Commission exercises more deference to foreign regulators, is highly counterintuitive and causes U.S. Swap Entities to incur greater costs than non-U.S. Swap Entities.

5. Duplicative Risk Exposure Report Requirements.

Rule 23.600(c)(2) requires U.S. and non-U.S. Swap Entities alike to prepare risk exposure reports, quarterly and upon detection of a material change in a Swap Entity's risk exposure, which must set forth: the market, credit, liquidity, foreign currency, legal, operational, settlement and any other applicable risk exposures of the Swap Entity; any recommended or completed changes to the Swap Entity's RMP; the recommended time frame for implementing recommended changes; and the status of any incomplete implementation of previously recommended changes to the RMP. A Swap Entity must provide these risk exposure reports to its governing body and senior management, as well as the Commission and NFA.

One key objective of Rule 23.600(c)(2) is to "provide management with the information necessary to monitor and make adjustments to risk levels in a timely manner."¹¹ For Swap Entities already subject to prudential supervision, however, other processes are already in place to satisfy this objective.¹² By imposing uniform requirements regarding the content and frequency of risk exposure reports specific to swaps activities, Rule 23.600(c)(2) does not provide these Swap Entities with flexibility to tailor their risk exposure reporting processes to their individual business needs and governance structures or to conform to prudential requirements to incorporate swaps and all other risks into a consolidated risk exposure consistent with the firm's risk appetite across the enterprise. For example:

- Creation of a standalone risk exposure report for a Swap Entity typically requires a firm to consolidate information already presented in other risk reports made to the internal governance bodies relevant for the specific types of risks and business lines involved in the

¹⁰ See Note 4, *supra*.

¹¹ See [*Swap Entity*] *Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for [Swap Entities] and Futures Commission Merchants*, 77 Fed. Reg. 20128, 20138 (Apr. 3, 2012).

¹² See, e.g., *Federal Reserve, Trading and Capital-Markets Activities Manual* (Feb. 1998) at Section 2000.1, p. 1 ("[T]he board of directors should be informed regularly of the risk exposure of the institution and should regularly reevaluate the organization's exposure and its risk tolerance regarding these activities").

firm's swaps business. This process results in additional administrative costs without materially enhancing risk governance.

- Requiring a Swap Entity to prepare risk exposure reports corresponding to each risk type enumerated in Rule 23.600(c)(2)—even risks that are immaterial to the Swap Entity—puts an unnecessary drain on the risk management unit's resources and the limited bandwidth of a Swap Entity's governing body and senior management. Similarly, requiring a Swap Entity to prepare and furnish an entire risk exposure report immediately upon detection of a material change in a Swap Entity's exposure to a particular type of risk is unnecessary when an interim report focused solely on the relevant exposure type would suffice.
- Most firms' risk committees set and approve risk tolerance limits on an annual basis, with interim adjustments made by an independent risk function when needed. Also, Rule 23.600(c)(1) only requires annual approval of risk tolerance limits by a Swap Entity's governing body. As a result, requiring quarterly review of risk exposure reports by a Swap Entity's governing body is an inefficient use of the governing body's limited bandwidth.

The other key objective of Rule 23.600(c)(2) is to provide the Commission and NFA with information regarding a Swap Entity's risk exposures to aid in supervision, for example, by enabling the Commission and NFA to identify firms that pose heightened risk in order to allocate regulatory resources appropriately. Since Rule 23.600(c)(2) does not specify the particular risk exposure metrics a Swap Entity must use, however, it has not facilitated this type of horizontal review. To address this gap, NFA recently adopted monthly credit and market risk metric reporting requirements.¹³ These new NFA requirements make the quarterly risk exposure reports that Rule 23.600(c)(2) continues to require Swap Entities to furnish to the Commission and NFA largely superfluous, even as Swap Entities must incur the costs of preparing two slightly different types of reports regarding their risk exposures.

In addition, a Swap Entity subject to prudential supervision already reports extensive information regarding its exposures to its prudential supervisor. Especially where the Commission is not primarily responsible for supervising such a Swap Entity's capital adequacy (*e.g.*, because the Swap Entity has a Prudential Regulator under the CEA or can substitute compliance with home country capital requirements), it is not clear what regulatory benefit justifies requiring the Swap Entity to incur the costs of duplicating this regulatory reporting by preparing and filing additional quarterly risk exposure reports under Rule 23.600(c)(2) or monthly risk metric reports under NFA rules. For example, if those additional reports showed that the Swap Entity had a significant market risk exposure, the Swap Entity's prudential supervisor would already likely be aware of that exposure. Also, given the prudential supervisor's authority over all of the Swap Entity's activities—not just its swaps activities—the prudential supervisor would be in a better position relative to the Commission or NFA to address that exposure as part of its comprehensive supervision of the Swap Entity.

¹³ See NFA, *Monthly Risk Data Reporting Requirements for [SDs]*, Notice I-17-10 (May 30, 2017) at: <https://www.nfa.futures.org/news/NewsNotice.asp?ArticleID=4817>.

C. Proposed Substituted Compliance Framework

To address these issues, we respectfully recommend that the Commission build on the success of its existing substituted compliance framework for non-U.S. Swap Entities by expanding that framework to encompass (1) certain U.S. Swap Entities and (2) risk exposure reports under Rule 23.600(c)(2), each as described below.

1. Substituted Compliance for U.S. Swap Entities.

a. U.S. Swap Entities Subject to Entity-Level Risk Management Supervision and Regulation by the Prudential Regulator or the SEC

Under the CEA, the Prudential Regulators are responsible for establishing capital and margin requirements for Swap Entities that are banks.¹⁴ Similarly, under the 2016 Capital Proposal, the Commission's capital requirements for SDs dually regulated by the SEC as alternative net capital broker-dealers or security-based swap dealers would generally follow SEC net capital requirements.¹⁵ These SDs are also subject to comprehensive risk management supervision and regulation by the Prudential Regulators or the SEC, respectively, including with respect to their swaps activities.¹⁶

Because their supervision and regulation of these Swap Entities already encompasses swaps activities, deference to the Prudential Regulators and the SEC in relation to risk management regulation of these Swap Entities would not present a gap in U.S. regulatory oversight. It would, however, reduce costs and complexity for registrants, promote more efficient use of Commission and NFA resources, and align risk management requirements with the capital frameworks envisioned by Congress (for Swap Entities with a Prudential Regulator) and the Commission (for SDs subject to SEC regulation).

Accordingly, if a U.S. Swap Entity is subject to entity-level risk management supervision and regulation by a Prudential Regulator or the SEC, then the Commission should permit the Swap Entity to substitute compliance with such supervision and regulation for compliance with Rule 23.600, much like the Commission currently permits for non-U.S. Swap Entities subject to home country risk management supervision and regulation. As described in Part C.2. below, this substituted compliance framework should include risk exposure reports under Rule 23.600(c)(2).

b. U.S. Swap Entities Subject to Consolidated Risk Management Supervision and Regulation

If a U.S. Swap Entity is subject to consolidated risk management supervision and regulation by either the Federal Reserve or a foreign regulator whose consolidated capital framework is consistent with the Basel Accords,¹⁷ then the Commission should permit the Swap Entity to

¹⁴ See CEA Section 4s(e).

¹⁵ 2016 Capital Proposal, 81 Fed. Reg. at 91255.

¹⁶ See, e.g., OCC, *Comptroller's Handbook, Risk Management of Financial Derivatives* (Jan. 1997) at: <https://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/risk-mgmt-financial-derivatives/pub-ch-risk-mgmt-financial-derivatives.pdf>. See, also 17 C.F.R. § 240.15c3-4 (SEC risk management requirements).

¹⁷ See Note 6 for examples.

substitute compliance with such consolidated supervision and regulation for compliance with Rule 23.600.¹⁸ However, to ensure that appropriate risk governance is in place at the level of the Swap Entity (in addition to the consolidated level), the Swap Entity's reliance on substituted compliance would be subject to the condition that its consolidated RMP address risk tolerance limits specific to the Swap Entity (as a legal entity) for those risks for which the Swap Entity faces legal-entity level capital requirements (such as market and credit risks). Such risk tolerance limits should be furnished to the Swap Entity's governing body and approved by the Swap Entity's senior management.

This approach is designed to allow a Swap Entity subject to consolidated supervision and regulation to align the substance of its RMP (including the substance of its risk tolerance limits and the frequency of related internal reviews and approvals) with the policies, procedures, systems and controls applicable to the Swap Entity on a consolidated basis. In so doing, the approach would bring similar benefits as deference to the Prudential Regulators and the SEC, as described above. In particular, the approach would be consistent with the Commission's objective, as reflected in the 2016 Capital Proposal, to "allow an SD that consolidates into a bank holding company to maintain books and records, and perform capital computations, in a manner that is consistent with its holding company parent entity."¹⁹ Given the integral relationship between capital adequacy and risk management described above, it would be counterproductive to align SD capital requirements with holding company capital requirements without also aligning risk management requirements accordingly.²⁰

2. Risk Exposure Reporting Requirements

As described in Part B.5. above, Rule 23.600(c)(2) and new NFA monthly risk metric reporting requirements lead both U.S. and non-U.S. Swap Entities to incur additional, unnecessary costs to compile duplicative risk exposure information and provide that information to the Swap Entity's governing body, senior management, the Commission and NFA. This information is not necessary to address internal risk governance objectives or facilitate supervision by the Commission or NFA.

In light of these considerations, the Commission should permit non-U.S. Swap Entities eligible for substituted compliance with other elements of Rule 23.600 to be eligible for substituted compliance with Rule 23.600(c)(2). U.S. Swap Entities eligible for substituted compliance under the

¹⁸ The Commission should also permit substituted compliance for a non-U.S. Swap Entity subject to such consolidated supervision and regulation, if the non-U.S. Swap Entity is not otherwise eligible for substituted compliance with home country, entity-level supervision and regulation. For example, if a U.S. bank holding company had an SD subsidiary in a foreign jurisdiction that was not covered by a comparability determination by the Commission, such foreign SD subsidiary should still be eligible for substituted compliance with consolidated supervision and regulation by the Federal Reserve.

¹⁹ 2016 Capital Proposal, 81 Fed. Reg. at 91255.

²⁰ Certain other aspects of the 2016 Capital Proposal would, however, undermine achievement of this objective by, for example, imposing a minimum capital requirement calculated with reference to hypothetical margin for derivatives activities (without regard to the aggregate, net portfolio-wide risk exposures of an SD), imposing standalone liquidity requirements that do not account for parent company liquidity resources and support, and requiring separate and duplicative risk model approvals. We discuss these issues in greater detail in our comment letter on the 2016 Capital Proposal, which is available at: <https://www.sifma.org/resources/submissions/sifma-submits-comments-to-the-cftc-on-capital-requirements-for-swap-dealers-and-major-swap-participants/>.

expanded framework described in Part C.1. above should likewise be eligible for substitute compliance with Rule 23.600(c)(2). In each case, to the extent the Commission or NFA consider it desirable to receive firm-specific risk exposure information from these Swap Entities, it would be more efficient and less disruptive to obtain that information from the Swap Entities' prudential supervisors.

In addition, for Swap Entities that have a Prudential Regulator or that substitute compliance with home country capital requirements for compliance with Commission capital requirements, NFA's monthly risk metric reporting requirements duplicate existing information provided to those other regulators, while still requiring those Swap Entities to incur the costs of performing the risk metric calculations and formatting the resulting data in a manner designed to meet NFA's precise specifications. Since the Commission and NFA are not responsible for supervising those Swap Entities' capital adequacy, there is little corresponding supervisory benefit to requiring risk metrics relating to registrant-specific safety and soundness. Accordingly, as part of a holistic review of the risk management rule and associated reporting metrics, the CFTC should work with NFA to tailor NFA's monthly risk metric reporting requirements for these Swap Entities so as to focus on the subset of risk metrics most relevant to market-wide financial surveillance (*e.g.*, metrics relating to such a Swap Entity's top 15 largest counterparty current exposures).²¹

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Please feel free to reach out to the undersigned should you have any questions.

Sincerely,



Kyle Brandon
Managing Director, Head of Derivatives
SIFMA

²¹ For non-U.S. Swap Entities, these metrics should exclude non-U.S. counterparties whose uncleared swaps with the Swap Entity are not covered by U.S. margin requirements.

APPENDIX

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| <p><u>Risk Governance: Governing Body</u></p> <ul style="list-style-type: none"> The “governing body” of a Swap Entity must be the Swap Entity’s CEO, board of directors or similar body, a committee of such a board or body, or such a board, body, committee or officer of a division of the Swap Entity if the swaps activities for which registration with the Commission is required are wholly contained in a separately identifiable division. <i>See</i> Rule 23.600(a)(4). The governing body must satisfy certain specified obligations under Rule 23.600 which include approving, in writing, the RMP and written risk management policies and procedures. <i>See</i> Rule 23.600(b)(3). | <ul style="list-style-type: none"> Requiring swap-related policies, procedures and risk tolerance limits to be approved by a Swap Entity’s “governing body” results in duplicative obligations for governing body members to oversee matters that have already been considered by other governance committees or forums within a Swap Entity’s broader organization.²² This duplication cultivates a “check-the-box” approach to risk management with unclear lines of accountability and authority. It also reduces the bandwidth available for governing body members to oversee a Swap Entity’s overall business risk and strategy. Subjecting all risk management policies and procedures to governing body approval—instead of only those procedures that materially affect the risk profile of a Swap Entity—unnecessarily impedes the development and update of policies and procedures and requires undue senior-level attention to immaterial matters. Furthermore, while policies are typically subject to approval by committees under prudential guidance, it is not common practice to require procedures to be so approved. Procedures are typically updated on a more frequent basis than policies; for example, procedures may be updated when processes are improved or due to technology, personnel or other changes. Requiring procedures to be approved every time a change in process is made, for example, to replace a reference to a retired system, creates an unnecessary burden that discourages up-to-date procedures. <p><i>See, also</i> the below comments on “Risk Governance: Senior Management”, “Risk Management Program: Policies and Procedures”, “Risk Management Program: New Products”, “Risk Management Program: Risk Tolerance Limits” and “Business Trading Unit”.</p> |

²² Prudential regulations with respect to governance require policies to be approved by the applicable committees. These committees are ultimately delegated their authority by the Board of Directors. As a result, Rule 23.600(b)(3)’s requirement that the governing body also approve swap specific policies and procedures creates a duplicative burden.

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| <p><u>Risk Governance: Senior Management</u></p> <p>The governing body must appoint officers to act as “senior management” of the Swap Entity. <i>See</i> Rule 23.600(a)(6).</p> | <p>Swap Entities subject to prudential supervision typically have one or more risk committees which are designated by the appropriate governance forum and ultimately trace their authority to the board of directors. Rule 23.600 disrupts this structure by requiring that firms overlay a separately designated Swap Entity “governing body” and “senior management”. These groups must then review and approve limits and policies and procedures that are already addressed by other committees, creating the opportunity for conflict and control failures as discussed in Part B.1. above.</p> <p>In response to NFA feedback, the “senior management” of many Swap Entities is composed of representatives from both business and multiple control functions. However, control function personnel are not well-positioned to review risk exposures and approve risk tolerance limits outside their area of expertise. For instance, a market risk senior manager is not well-positioned to approve credit risk limits. As such, the Commission should clarify that the requirements of “senior management” may be fulfilled by different personnel (individually instead of collectively) depending on the requirement and the expertise or role of the individual.</p> |
| <p><u>Risk Management Program: Policies and Procedures</u></p> <ul style="list-style-type: none"> • Swap Entities must maintain written policies and procedures that describe their Risk Management Program. <i>See</i> Rule 23.600(b)(2). • The RMP must include procedures for the timely distribution of its written risk management policies and procedures to relevant supervisory personnel. Swap Entities must maintain records of the persons to whom the risk management policies and procedures were distributed and when they were distributed. <i>See</i> Rule 23.600(f). | <ul style="list-style-type: none"> • NFA feedback has led Swap Entities to create separate “Risk Management Program” documents specifically designed for the purpose of making it easier to identify which of a Swap Entity’s existing, enterprise-wide risk management policies and procedures correspond to specific elements of Rule 23.600. The process for continually updating these non-substantive documents when the underlying policies and procedures change creates inefficient redundancies and the potential for inadvertent confusion. • Swap Entities already have robust programs in place to distribute policies and procedures to relevant personnel. Imposing a regulatory requirement to distribute risk management policies and procedures in particular, along with a requirement to maintain records of the persons to whom such policies and procedures were distributed and when they were distributed, inappropriately incentivizes a scattershot approach to compliance at the cost of more thoughtful and targeted distribution. |

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| <p><u>Risk Management Program: New Products</u></p> <ul style="list-style-type: none"> • The RMP must include a new product policy that is designed to identify and take into account the risks of any new product prior to engaging in transactions involving the new product. <i>See</i> Rule 23.600(c)(3). • The new product policy must include, <i>inter alia</i>, an assessment, signed by a “risk management unit” supervisor, as to whether the new product would materially alter the Swap Entity’s overall entity-wide risk profile. If the new product would materially alter the overall risk profile of the swap dealer or major swap participant, the new product must be pre-approved by the governing body before any transactions are effectuated. <i>See</i> Rule 23.600(c)(3)(iii). • The new product policy may allow limited preliminary approvals if the level of risk is immaterial and such approval is only to allow the Swap Entity to develop appropriate operational and risk management processes for a product. <i>See</i> Rule 23.600(c)(3)(v). | <ul style="list-style-type: none"> • Rule 23.600(c)(3), as currently drafted, is unclear as to whether the specific requirements with respect to new products also apply to products the Commission does not regulate or that are used by a Swap Entity to hedge products the Commission does not regulate.²³ As such, the rule conflicts with supervision of a Swap Entity’s non-swap dealing business lines. The Commission should revise Rule 23.600(c)(3) to only apply to new products that will be sold to non-Swap Entities in connection with the swaps activities of the Swap Entity or, at a minimum, clarify this provision to limit the scope of new products to only those products that would constitute swaps activities. • New products are generally subject to a robust review process by an internal committee dedicated to reviewing new products. The committee is composed of individuals from many different risk areas, each of whom independently assess the materiality of risks for their particular area. Requiring a single person to certify the assessment adds no value for Swap Entities that already have robust internal review processes, and so the Commission should eliminate this requirement. Similarly, Commission should replace the requirement for a pre-approval by the governing body with a notification to the governing body, so as to eliminate undue burdens on the bandwidth of governing bodies. • The Commission should not limit the potential purposes for granting a preliminary approval of a new product whose risks are immaterial, because doing so impedes commercial activities that, by definition, pose no material risk. |

²³ This requirement is also duplicative of the new product policy requirement under the Volcker Rule. *See* Appendix B to CFTC Regulations, Part 75.

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| <p><u>Risk Management Program: Central Counterparties</u></p> <p>Swap Entities must establish policies and procedures relating to their use of central counterparties. Such policies and procedures must:</p> <ul style="list-style-type: none"> i. Require the use of central counterparties where clearing is required, unless the counterparty has properly invoked a clearing exemption; ii. Set forth the conditions for the voluntary use of central counterparties for clearing when available as a means of mitigating counterparty credit risk; and iii. Require diligent investigation into the adequacy of the financial resources and risk management procedures of any central counterparty through which the swap dealer or major swap participant clears. <p><i>See</i> Rule 23.600(c)(5).</p> | <ul style="list-style-type: none"> i. Several other Commission rules address compliance with mandatory clearing requirements. Separately requiring policies and procedures regarding mandatory clearing as part of a Swap Entity’s RMP is unnecessary and presents confusion as to which functions within a Swap Entity should be responsible for ensuring compliance with those requirements. ii. The purpose of Rule 23.600(c)(5)(ii) is unclear. If the rule’s purpose is to provide for voluntary use of central counterparties (“CCPs”) when necessary to manage bilateral credit exposures, that objective is already addressed implicitly by the generally applicable credit risk policies and procedures otherwise required by Rule 23.600. If the rule’s purpose is to encourage voluntary use of CCPs in other circumstances, then the rule would seem to conflict with efforts by other regulators to mitigate CCP risk (including through the sort of due diligence required by Rule 23.600(c)(5)(iii)). iii. Many Swap Entities are not clearing members of the central counterparties through which they clear and therefore do not interact with them directly. These Swap Entities are poorly equipped to determine the adequacy of the central counterparty’s financial resources and risk management procedures. Additionally, central counterparties are registered with the Commission as derivatives clearing organizations, with their financial resources and risk management procedures required to satisfy Part 39 of the Commission’s regulations. |
| <p><u>Risk Management Program: Margin and Capital</u></p> <p>Swap Entities must satisfy all capital and margin requirements established by the Commission or prudential regulator, as applicable. <i>See</i> Rule 23.600(c)(6).</p> | <p>Several other Commission rules address compliance with margin and capital requirements. Separately requiring policies and procedures regarding margin and capital as part of a Swap Entity’s RMP is unnecessary and presents confusion as to which functions within a Swap Entity should be responsible for ensuring compliance with those requirements. In addition, for a Swap Entity with a Prudential Regulator, it would be more appropriate for the Commission to defer to the Prudential Regulator’s risk management supervision and regulation than to require the Swap Entity to integrate compliance with the Prudential Regulator’s capital and margin requirements into an RMP designed to satisfy all the prescriptive requirements of Rule 23.600.</p> |

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| <p><u>Risk Management Program: Periodic Risk Exposure Reports</u></p> <p>Swap Entities’ “risk management unit” must provide to the Commission, “senior management”, and the “governing body” quarterly written “risk exposure reports” setting forth applicable risk exposures and discussing recommended or completed changes to the RMP. For purposes of this regulation, such reports shall be referred to as “Risk Exposure Reports.”</p> <p>The Risk Exposure Reports also shall be provided to the senior management and the governing body immediately upon detection of any material change in the risk exposure of the swap dealer or major swap participant.</p> <p><i>See</i> Rule 23.600(c)(2).</p> | <p><i>See</i> Parts B.5. and C.2. above.</p> |
| <p><u>Risk Management Program: Risk Tolerance Limits</u></p> <p>The risk tolerance limits shall be reviewed and approved quarterly by senior management and annually by the governing body. Exceptions to risk tolerance limits shall be subject to written policies and procedures. <i>See</i> Rule 23.600(c)(1).</p> | <p>The frequency of risk tolerance limit approvals required by Rule 23.600(c)(1) does not correspond with practices developed to satisfy applicable prudential rules and guidance. In particular, most firms’ risk committees set and approve risk tolerance limits on an annual basis, with interim adjustments made by an independent risk function when needed. Requiring limits that remain unchanged to be approved quarterly by senior management is unnecessary and inefficient.</p> <p>In addition, the governing body should not be required to approve risk tolerance limits and should only be notified of the limits. Consistent with our comments on Risk Governance above, individual risk tolerance limits are too granular for the “governing body” to approve, and such limits are already approved by those who are well-positioned to do so.</p> |

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| <p><u>Types of Risk: Identification of Risks</u></p> <p>The RMP should take into account the following types of risks:</p> <ul style="list-style-type: none"> • Market Risk • Credit Risk • Liquidity Risk • Foreign Currency Risk • Legal Risk • Operational Risk • Settlement Risk • Affiliate Risk • Any other applicable risk <p><i>See</i> Rule 23.600(c)(1).</p> | <p>The risks enumerated in Rule 23.600(c)(1) do not necessarily correspond to the material risks faced by a Swap Entity. For example, a Swap Entity primarily trading cleared swaps does not typically face credit and settlement risks to the same extent as a Swap Entity trading uncleared swaps. Similarly, a Swap Entity primarily trading swaps denominated in its own local currency does not face material foreign currency risks. The prescriptive approach reflected in the rule, however, requires the governing body and senior management to focus on all the risks enumerated in the rule, regardless of materiality. Swap Entities should only be required to focus on material risks.</p> <p>In addition, Rule 23.600(c)(4)(i)-(vii) specifies considerations that each form of risk must take into account. For example, “Market risk policies and procedures shall take into account, among other things:… [p]eriodic reconciliation of profits and losses resulting from valuations with the general ledger.” The Commission should provide more certainty as to the extent of these risk areas by deleting the phrase “among other things” from each of the subsections (i) through (vii).</p> |
| <p><u>Types of Risk: Affiliate Risk</u></p> <p>The RMP must take into account risks posed by affiliates, and the RMP shall be integrated into risk management at the consolidated entity level. <i>See</i> Rule 23.600(c)(1)(ii).</p> | <p>Prudentially regulated banks already managed risk associated with their swaps activities in a manner that was integrated at the consolidated entity level. Rule 23.600 has forced prudentially regulated banks to de-integrate the risks associated with their swaps activities from the consolidated entity level by requiring a standalone RMP and quarterly risk exposure reports. Meanwhile, these prudentially regulated banks continue to conduct their integrated activities using their pre-existing forums and processes. The Commission should promote broader deference to centralized, consolidated RMPs.</p> |

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| <p><u>Types of Risk: Market Risk</u></p> <p>Market risk policies and procedures must take into account, among other things, the daily measurement of market exposure, including exposure due to unique product characteristics, volatility of prices, basis and correlation risks, leverage, sensitivity of option positions, and position concentration, to comply with market risk tolerance limits. <i>See</i> Rule 23.600(c)(4)(i)(A).</p> | <p>Rule 23.600(c)(4)(i)(A) implies that unique product characteristics, volatility of prices, basis and correlation risks, leverage, sensitivity of option positions, and position concentration exposures are relevant in all cases. However, for some Swap Entities, business lines or desks, some of these exposures might not be relevant. In these cases, requiring daily measurement of these exposures results in unnecessary costs.</p> |
| <p><u>Types of Risk: Liquidity Risk</u></p> <p>The RMP must include liquidity risk policies and procedures which take into account, among other things, (A) the daily measurement of liquidity needs, (B) the assessment of procedures to liquidate all non-cash collateral, and (C) the application of appropriate collateral haircuts. <i>See</i> Rule 23.600(c)(4)(iii).</p> | <p>This requirement is duplicative of specific prudential regulatory requirements, <i>e.g.</i>, Basel’s liquidity coverage ratio.</p> |
| <p><u>Types of Risk: Legal Risk</u></p> <p>The RMP must include legal risk policies and procedures which take into account, among other things, (A) determinations of the sound legal basis for transactions and netting arrangement, and (B) establishing documentation tracking procedures. <i>See</i> Rule 23.600(c)(4)(v).</p> | <p>The legal departments at most firms historically do not have “policies and procedures”, as the practice of law is by necessity based on the careful analysis of laws and regulations and the application those laws and regulations to specific contexts. The purpose of procedures is to provide step-by-step guides for particular processes—the practice of law does not lend itself well to such documentation.</p> |

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| <p><u>Types of Risk: Operational Risk</u></p> <p>The RMP must include operational risk policies and procedures shall take into account, among other things:</p> <p>A. Secure and reliable operating and information systems with adequate, scalable capacity, and independence from the business trading unit...</p> <p>C. Reconciliation of all data and information in operating and information systems.</p> <p><i>See Rule 23.600(c)(4)(vi).</i></p> | <p>A. The duplicative requirement to maintain information systems under Rule 23.600(c)(4)(vi) poses a burden to Swap Entities who are also prudentially regulated. As an example, a member reports that it will undergo simultaneous on-site cybersecurity examinations by both the NFA and the member’s Prudential Regulator. Not only does such duplication create a burden on those employees charged with actively managing such risk, it clearly limits the ability of such employees to conduct business-as-usual risk management and wastes regulatory resources that could be better focused elsewhere.</p> <p>C. It is unclear what “reconciliation” means in this context. We recommend that the Commission consider eliminating this example.</p> |
| <p><u>Business Trading Unit</u></p> <p>Swap Entities must establish policies and procedures that, at a minimum:</p> <p>1) Require all trading policies be approved by the “governing body”;...</p> <p>4) Monitor each trader throughout the trading day to prevent the trader from exceeding any limit to which the trader is subject, or from otherwise incurring unauthorized risk;...</p> <p>8) Ensure that broker statements and payments to brokers are periodically audited by persons independent of the business trading unit;...</p> | <p>1) So long as a Swap Entity’s trading policies are consistent with the overall RMP and risk tolerance limits notified to the Swap Entity’s governing body and approved by relevant risk committees, requiring separate governing body approval of trading policies is duplicative and blurs the appropriate line between responsibilities of the governing body and management of the business trading unit.</p> <p>4) At smaller swap dealers who execute a modest number of transactions each trading day, the benefits of this requirement have been negligible and daily limit calculations historically have proved sufficient.</p> <p>8) Broker statements are typically reconciled by the risk management unit, not the business trading unit. Broker statements may also not be formally audited nor is there any need to periodically audit them.</p> |

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| <p>10) Require the separation of personnel in the business trading unit from personnel in the risk management unit.</p> <p><i>See</i> Rule 23.600(d).</p> | <p>10) Existing prudential supervisory guidance already requires most Swap Entities to ensure adequate separation among the “three lines of defenses” (<i>i.e.</i>, business units, control units (including but not limited to relevant risk management functions), and internal audit). Rule 23.600(d)(10) has accordingly resulted in a need for these Swap Entities to adopt additional, duplicative procedures addressing separation of personnel in the business trading unit from personnel in the risk management unit.</p> |
| <p><u>Review and testing:</u></p> <ul style="list-style-type: none"> • The RMP must be reviewed and tested on at least an annual basis, or upon any material change in the business that is reasonably likely to alter the Swap Entity’s risk profile. • The annual testing must be performed by qualified internal audit staff that are independent of the business trading unit being audited or by a qualified third party audit service reporting to staff that are independent of the business trading unit. • Annual reviews must include an analysis of the risk management policies and procedures and any recommendations for modifications to the RMP. <p><i>See</i> Rule 23.600(e).</p> | <ul style="list-style-type: none"> • A review triggered “upon any material change” must allow a sufficient lapse time for the change to become operational, in order for internal audit to have sufficient sample for effectiveness testing. • Firms’ internal audit resources are necessarily limited. Rule 23.600(e)(1) artificially requires internal audit staff to prioritize the Swap Entity RMP over other topics that might be more material to the firm as a whole, which ultimately can expose firms to greater risk. In addition, Rule 23.600(e)(1) overlaps with the second-line of defense reviews and testing conducted by firms’ Compliance departments in connection with the annual compliance report required by Commission Regulations § 3.3. • For an internal audit function to audit all Swap Entity “risk management policies and procedures” on an annual basis disregards the important role of independent internal auditors in conducting risk-based assessments which informs the annual audit calendar. Swap Entities instead should have the flexibility to determine a risk-based approach to its annual review, subject to its approved internal audit policies and methodologies. For example, mature areas with little control infrastructure change may require testing less frequently than annually. • In addition, it is unclear whether the scope of RMP subject to the annual review is limited to Rule 23.600(c) [Elements of the Risk Management Program] or also includes the other components of Rule 23.600 such as Rule 23.600(d) [Business Trading Unit], Rule 23.600(f) [Distribution of Risk Management Policies and Procedures] and Rule 23.600(g) [Recordkeeping]. |