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## SWAP DEALER CHIEF COMPLIANCE OFFICER REQUIREMENTS – FIRST YEAR IN REVIEW

*The CFTC by regulation requires each registered swap dealer to designate a chief compliance officer to carry out certain duties relating to swaps activities and to furnish an annual report describing the swap dealer's compliance procedures and assessing its performance. The authors review the rule and the CFTC's "comparability determinations" for foreign swap dealers, and discuss CCO-related developments and interpretive issues that have arisen in the first full year of the rule.*

By Dan M. Berkovitz and Gail Bernstein \*

Section 732 of the Dodd-Frank Act<sup>1</sup> amended the Commodities Exchange Act ("CEA") by adding Section 4s(k),<sup>2</sup> which requires every registered swap dealer to designate an individual to serve as its chief compliance officer ("CCO") to perform a number of specified duties.<sup>3</sup> In February 2012, the Commodity Futures Trading Commission ("CFTC" or "Commission")

adopted Regulation 3.3 to implement the CCO duties as set forth in Section 4s(k) ("CCO Rule").<sup>4</sup> The CCO Rule largely tracks the statute and requires each swap dealer to designate and provide authority and resources to a qualified CCO to carry out the specified duties in connection with the swap dealer's compliance with the

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> 7 U.S.C. § 6s(k).

<sup>3</sup> The Dodd-Frank Act also requires designation of a CCO for major swap participants, futures commission merchants ("FCMs"), derivative clearing organizations, and swap execution facilities. 7 U.S.C. §§ 6d(d), 6s(k), 7a-1(i), 7b-3(f)(15). The discussion in this article is limited to CCO requirements for swap dealers.

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<sup>4</sup> 17 CFR § 3.3. *See* Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20128 (Apr. 3, 2012) [hereinafter "Adopting Release"]. *See also* Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant, 75 Fed. Reg. 70881 (Nov. 19, 2010) [hereinafter "Proposed Rule"].

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provisions of the CEA and Commission regulations thereunder relating to the entity's swaps activities. Section 4s(k) and the CCO Rule also require that the CCO prepare and furnish to the CFTC an annual report containing a description of the swap dealer's compliance procedures and an assessment of the swap dealer's compliance activities. The annual report must be signed by the CCO, and either the CCO or the chief executive officer ("CEO") must certify, to the best of his or her knowledge and reasonable belief, that the information in the report is accurate and complete.<sup>5</sup>

Application of the CCO Rule to swap dealers was triggered with the first wave of provisional swap dealer registrations on December 31, 2012. As of May 31, 2014, 105 entities were provisionally registered as swap dealers.<sup>6</sup> Just over half of these swap dealers — 53 in total — are located in the United States; the rest are located in other jurisdictions, including Australia, Canada, the European Union (EU), Hong Kong, Japan, Mexico, Singapore, and Switzerland.<sup>7</sup> The first round of CCO annual reports was due at the end of March 2014. On December 21, 2013, the CFTC issued several "comparability determinations" in accordance with the policies and procedures set forth in the CFTC's Interpretive Guidance and Policy Statement regarding the cross-border application of the swap provisions of the Dodd-Frank Act and the Commission's regulations.<sup>8</sup> The comparability determinations permit non-U.S. swap dealers to comply with most of the CCO requirements of their home jurisdictions — including the annual reporting requirements of their home jurisdictions —

rather than the requirements under the CCO Rule (*i.e.*, "substituted compliance"). This article reviews the CCO Rule and the applicable comparability determinations, and discusses CCO-related developments and implementation and interpretive issues that have emerged during the first full year of the application of the CCO Rule.

In summary, the CFTC and the National Futures Association ("NFA"), the self-regulatory association charged with implementing swap dealer registration requirements and overseeing swap dealer compliance with Commission regulations implementing Section 4s of the CEA,<sup>9</sup> have made clear their expectation that CCOs be actively engaged in all aspects of swap dealer compliance, be provided with both the authority and resources to facilitate effective compliance, and have direct and meaningful access to the swap dealer's governing body. To date, the NFA and CFTC reviews of swap dealer submissions of policies and procedures pursuant to Section 4s ("Section 4s submissions") have resulted in requests from the regulators for more detail, especially surrounding the procedures swap dealers are or will be using to implement their policies. In conducting their reviews, the CFTC and NFA have also recognized the complexities involved in the new swap dealer regulatory regime and have indicated a willingness to work with swap dealers to refine and improve their Section 4s submissions. NFA on-site examinations of U.S. swap dealers were scheduled to begin in the summer of 2014.

Although the regulators have not yet begun to review Section 4s submissions of non-U.S. swap dealers and have indicated that they have not yet determined how they will conduct oversight activities with respect to regulatory requirements for which substituted compliance has been provided, non-U.S. swap dealers also were required to submit annual reports at the end of March. Following the review of the initial annual reports submitted by non-U.S. swap dealers, CFTC staff have stated that over the course of the next year they intend to work with foreign regulators to refine and

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<sup>5</sup> 17 CFR § 3.3(f)(3).

<sup>6</sup> National Futures Association SD/MSP Registry, *available at* <https://www.nfa.futures.org/NFA-swaps-information/regulatory-info-sd-and-msp/SD-MSP-registry.HTML>.

<sup>7</sup> *Id.*

<sup>8</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013) [hereinafter "Cross-border Interpretive Guidance"]. All of the Commission's comparability determinations are available on its website, *at* <http://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm>.

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<sup>9</sup> Section 4s of the CEA covers "registration and regulation of swap dealers and major swap participants." 7 U.S.C. § 6s.

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improve the format and content of the annual report to be prepared by non-U.S. swap dealers.

A number of important interpretive and implementation issues remain. In response to questions from swap dealers regarding the interpretation of specific provisions of the CCO Rule, the CFTC and NFA have stated generally that the initial interpretation of these provisions is the responsibility of the swap dealer. The interpretation and implementation of a number of these provisions can require a significant amount of judgment. For example, the annual report must identify material noncompliance issues, a term the CFTC has declined to define. Thus, the CCO must use his or her judgment to determine when a noncompliance issue is material and must be reported. It remains to be seen how much flexibility the CFTC will allow in making the determination of materiality. Similarly, the CCO is responsible, in consultation with the board of directors or senior officer, for “resolving any conflicts of interest that may arise” and for taking reasonable steps to ensure compliance with the CEA and the Commission regulations.<sup>10</sup> The CCO’s authority in these areas is not precisely defined. The Commission has explicitly declined to adopt the “existing precedent for compliance models in the financial services industry,” but has not provided specific guidance on alternative models.<sup>11</sup> It also may be challenging for a CCO with a dual role (*e.g.*, an individual who is both CCO and general counsel), which is permitted by the CCO Rule, to manage all aspects of both roles, some of which may potentially be in conflict, as discussed below. As the CFTC and NFA review Section 4s submissions and CCO annual reports over the next two years, the regulators may provide additional guidance on some of the less clear interpretive and/or implementation issues.

## DISCUSSION

### *The CCO Rule*

*Designation of the CCO.* Under the CCO Rule, each swap dealer’s board or senior officer must appoint one individual with the appropriate background and skills to serve as its CCO.<sup>12</sup> The CCO must be provided with the responsibility and authority to administer the swap dealer’s policies and procedures that are reasonably designed to ensure compliance with the CEA and Commission regulations thereunder relating to the swap

dealer’s swaps activities.<sup>13</sup> To ensure a direct line of communication between the CCO and the board or senior officer, the CCO must report directly to, and his or her compensation must be approved, and he or she may only be removed by, the board or senior officer.<sup>14</sup> In addition, the CCO must meet with the board or senior officer at least annually and more often at the CCO’s election.<sup>15</sup>

The CCO may be an existing officer within the swap dealer and/or have other responsibilities. If the CCO does have multiple responsibilities, such as also acting as the general counsel, the CCO and non-CCO functions must be clearly delineated. Further, the same individual may be appointed as CCO for multiple legal entities, such as where an organization is registered as both a swap dealer and FCM, but then the CCO must report to the board or senior officer of each regulated entity and not the board or senior officer of a consolidated parent company.<sup>16</sup> Alternatively, an organization with multiple registrations may appoint separate persons as CCO for each registration category. However, each registered entity may have only one CCO; the role may not be split between more than one individual.<sup>17</sup>

*Duties of the CCO.* The CCO Rule specifies, without limitation, six separate CCO responsibilities, which largely align with the statutory language in Section 4s(k). But the CCO Rule incorporates the concept of reasonableness and recognizes the somewhat more limited role for the CCO in the administration (rather than the enforcement) of a swap dealer’s policies and procedures. The Commission has made clear that the CCO Rule is intended to transform the CCO’s role beyond that of a traditional compliance officer who acts in a strictly advisory capacity, and that the Commission fully expects the CCO to be engaged in a more active compliance monitoring function.<sup>18</sup>

Under the CCO Rule, the CCO is responsible for administering the swap dealer’s policies and procedures reasonably designed to ensure compliance with the CEA and Commission regulations in connection with the swap dealer’s swaps activities. The CCO must establish procedures, in consultation with the board or senior

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<sup>10</sup> 17 CFR § 3.3(d)(2).

<sup>11</sup> Adopting Release, 77 Fed. Reg. at 20157.

<sup>12</sup> 17 CFR §§ 3.3(a) and (b).

<sup>13</sup> 17 CFR § 3.3(a).

<sup>14</sup> *Id.* See also 7 U.S.C. § 6s(k)(2)(A).

<sup>15</sup> 17 CFR § 3.3(a).

<sup>16</sup> Adopting Release, 77 Fed. Reg. at 20158.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 20162.

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officer, for the remediation of noncompliance issues identified by the CCO, and for the handling, management response, remediation, retesting, and closing of noncompliance issues.<sup>19</sup>

The CCO is further tasked with a duty to resolve, in consultation with the board or senior officer, any conflicts of interest that may arise. The Adopting Release notes that the term “resolve” means both elimination and mitigation of the conflict of interest. The CCO’s involvement in that process may include actions other than making the final decision in resolving the conflict of interest.<sup>20</sup> Finally, as discussed below, the CCO is responsible for preparing, signing, and certifying the annual report. Alternatively, the swap dealer’s CEO may complete the certification.<sup>21</sup>

*Annual Report Requirement.* The CCO Rule requires that the CCO prepare and sign an annual report covering the most recently completed fiscal year of the swap dealer, to be filed electronically with the CFTC no more than 60 days after the end of the swap dealer’s fiscal year together with the swap dealer’s annual financial condition report.<sup>22</sup> Prior to filing, the annual report must be delivered to the board or senior officer for review.<sup>23</sup>

While the CCO must sign the annual report, either the CCO or the CEO must sign the required certification that provides that to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and complete.<sup>24</sup> The certifying officer must apply his or her independent knowledge and determine whether he or she is aware of any facts that are likely to make the annual report certification not true. However, the “to the best of his or her knowledge and reasonable belief” qualifier permits the CCO to rely on other experts for statements made in the annual report. The Adopting Release notes that the certification is intended to assure that a process reasonably designed to ensure the accuracy of the annual report was followed. It is not intended to be a guarantee that all information contained therein is accurate.<sup>25</sup>

The CCO Rule specifies minimum requirements for the annual report. It must contain a description of the swap dealer’s policies and procedures, including the code of ethics and conflicts of interest policies. It must then review each applicable requirement of the CEA and Commission regulations, identify the policies and procedures that are reasonably designed to ensure compliance with these requirements, and provide an assessment as to the overall effectiveness of these policies and procedures in ensuring such compliance. Any material changes to these policies and procedures over the relevant fiscal year must be identified. Further, areas for improvement must be discussed and the CCO must include recommendations for potential or prospective changes, or improvements to the swap dealer’s compliance program and related resources.<sup>26</sup>

The annual report must also describe the financial, managerial, operational, and staffing resources set aside for compliance with respect to the CEA and Commission regulations, including any material deficiencies in such resources. Finally, the report must also describe any material noncompliance issues by the swap dealer relating to a violation of the CEA or Commission regulations and the corresponding action taken.<sup>27</sup>

*Recordkeeping.* The CCO Rule requires that the CCO maintain records in the ordinary course as required by Commission Regulation 1.31, including a copy of the swap dealer’s policies and procedures, copies of materials provided to the board or senior officer in connection with the review of the annual report, and any records relevant to the preparation of the annual report.<sup>28</sup> These records must be made available promptly upon Commission request.<sup>29</sup>

### ***Significant Changes from the Rule Proposal***

While Regulation 3.3 was adopted largely as proposed, the final rule reflects several key changes that together make the CCO requirements significantly less onerous than as originally proposed. First, the CCO Rule includes reasonableness and materiality qualifiers,

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<sup>19</sup> 17 CFR § 3.3(d).

<sup>20</sup> Adopting Release, 77 Fed. Reg. at 20161.

<sup>21</sup> 17 CFR § 3.3(f)(3).

<sup>22</sup> *Id.* § 3.3(f)(2).

<sup>23</sup> *Id.* § 3.3(f)(1).

<sup>24</sup> *Id.* § 3.3(f)(3).

<sup>25</sup> Adopting Release, 77 Fed. Reg. at 20163.

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<sup>26</sup> 17 CFR § 3.3(e).

<sup>27</sup> *Id.*

<sup>28</sup> Commission Regulation 1.31 generally requires that all books and records that are required to be kept shall be kept in their original form (for paper records) or native file format (for electronic records) for five years. The regulation specifies various technical requirements for the storage media for electronic records. 17 CFR § 1.31.

<sup>29</sup> 17 CFR § 3.3(g)(2).

which had been absent from the Proposed Rule. Second, the CCO Rule eliminates the proposed requirement that the annual report include a description of the swap dealer's compliance with the CEA and Commission regulations in favor of a description of policies and procedures that are reasonably designed to ensure compliance. The Adopting Release notes concerns that the proposed requirement would have "impose[d] unnecessary burdens on the CCO with little offsetting benefits."<sup>30</sup> Finally, the CCO Rule includes qualifying language that limits the certifier's potential liability to what he or she knew or reasonably believed.<sup>31</sup>

Specifically, with respect to the CCO duties and in response to commenters' concerns that the Proposed Rule would have imposed on the CCO *full* responsibility to develop *and enforce* compliance policies, thereby turning the CCO into a control person and line supervisor, the Commission revised the Proposed Rule to: (i) remove the requirement that a CCO be provided with "full" responsibility and authority; (ii) remove the requirement that a CCO "enforce" policies and procedures; (iii) require that the CCO "administer" policies and procedures rather than "establish" them; (iv) clarify that a CCO need only develop policies and procedures to fulfill the duties set forth in, and take reasonable steps to ensure compliance with, the CEA and Commission regulations; and (v) limit the responsibilities of the CCO to the "swaps activities" of swap dealers.<sup>32</sup>

With respect to the annual report, the Commission modified the Proposed Rule to require: (i) a description of the swap dealer's policies and procedures, rather than of the swap dealer's compliance; (ii) identification of the swap dealer's policies and procedures that "are reasonably designed" to ensure compliance, rather than those that ensure compliance; and (iii) identification of "material noncompliance issues," rather than "noncompliance issues." The CCO Rule also includes a materiality standard with respect to the description of any deficiency in compliance resources.<sup>33</sup> The Commission agreed with commenters that certain information need be reported only if it is materially significant and that the requirement to "ensure

compliance" can be interpreted to mean "safeguard" rather than "guarantee."<sup>34</sup>

Finally, either the CCO or the CEO can execute the certification as to the accuracy and completeness of the final report. Unlike the Proposed Rule, the CCO Rule permits the certifying officer to rely reasonably on the expertise of others for statements made in the annual report by including the qualifier "to the best of his or her knowledge and reasonable belief."<sup>35</sup>

### ***Substituted Compliance: The Commission's Comparability Determinations***

*Background.* Under the Commission's Cross-border Interpretive Guidance, swap dealers located outside the United States are fully subject to the Commission's swap dealer regulations, but the Commission may permit a swap dealer located in another jurisdiction to comply with certain specified regulations of the dealer's home jurisdiction if the Commission determines that the relevant regulations in the home jurisdiction are "comparable [to] and [as] comprehensive [as] the applicable requirements under the CEA and the Commission's regulations."<sup>36</sup> If the Commission makes such a "comparability determination" with respect to a particular regulatory requirement, then compliance with the requirement of the foreign jurisdiction will serve as a "reasonable substitute" for compliance with the attendant CEA and Commission requirements.<sup>37</sup>

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<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 20163.

<sup>36</sup> Cross-border Interpretive Guidance, 78 Fed. Reg. at 45342-44. The Cross-border Interpretive Guidance provided interpretive guidance as to CEA Section 2(i), as added by Section 722(d) of the Dodd-Frank Act. Section 2(i) provides that the swaps provisions of the CEA (and the Commission's implementing regulations) shall not apply to activities outside the United States unless those activities either: (i) "have a direct and significant connection with activities in, or effect on, commerce of the United States"; or (ii) contravene such rules and regulations that the Commission may promulgate to prevent the evasion of any provisions of the CEA as enacted by the Dodd-Frank Act. 7 U.S.C. § 2(i).

<sup>37</sup> Cross-border Interpretive Guidance, 78 Fed. Reg. at 45342-44. In the Cross-border Interpretive Guidance, the Commission classified its various regulatory requirements as "entity-level," meaning that the requirement applies to the firm as a whole, with respect to all of its activities, and "transaction-level," meaning that the requirement applies on a transaction-by-transaction basis. Substituted compliance is generally available

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<sup>30</sup> Adopting Release, 77 Fed. Reg. at 20163.

<sup>31</sup> *Id.* Section 4(s)(k)(3)B(ii) of the CEA is silent on who must execute the annual report certification.

<sup>32</sup> *Id.* at 20159.

<sup>33</sup> *Id.* at 20164.

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On December 21, 2013, the Commission issued comparability determinations for Australia, Hong Kong, Japan, Switzerland, Canada, and the EU, in which it determined, among other things, that based on the representations of the relevant regulatory bodies in each of these jurisdictions, the laws and regulations in each of these jurisdictions are “generally identical in intent” and comparable to and as comprehensive as Section 4s(k) and Regulation 3.3, with some exceptions.<sup>38</sup> Accordingly, the Commission permitted non-U.S. swap dealers to follow substituted compliance in these other jurisdictions with respect to most, but not all, of the CCO requirements, as follows:

For Australia, the local requirements were determined to be comparable to the CFTC’s CCO regulations, except with respect to Regulation 3.3(e) (production of an annual report) and Regulation 3.3(f) (CEO/CCO certification and annual report submission to CFTC). The Commission stated that it would deem an entity to be in compliance with Regulations 3.3(e) and (f) if it complied with the comparable requirements of Australian law regarding the compliance officer and program, and prepared and signed the annual report in accordance with Regulation 3.3(e) and certified the report and furnished it to the Commission in accordance with Regulation 3.3(f).

For Canada, the EU, Hong Kong, Japan, and Switzerland, the local requirements were determined to be comparable to the CFTC’s CCO regulations, except for Regulation 3.3(f) (CEO/CCO certification and annual report submission to CFTC). The Commission stated that compliance with Regulation 3.3(f) may be

satisfied by certification of and submission to the CFTC of the comparable annual report required under local law.

None of the comparability determinations permits substituted compliance for the requirements that the annual report be certified by the CCO or CEO and filed with the Commission. Accordingly, where a non-U.S. swap dealer follows substituted compliance and complies with the CCO and annual report requirements of its home jurisdiction, it must nevertheless submit a certified annual report to the Commission (in Australia it must also prepare the annual report in accordance with Regulation 3.3(e)).

*Substituted Compliance Challenges.* Notwithstanding the CFTC’s comparability determinations, rules governing CCOs and their reporting responsibilities differ across jurisdictions and, while the intent behind the requirements may be comparable to, and as comprehensive as, that underlying Regulation 3.3, the requirements themselves, and thus the practices of non-U.S. swap dealers, vary.

The Commission’s comparability determinations provide: (i) that a covered swap dealer may follow only its home jurisdiction rules with respect to preparation and form of the annual report and (ii) that this report be certified by the swap dealer’s CCO or CEO and submitted timely to the Commission. However, the different requirements and practices outside the United States have raised a number of issues for non-U.S. swap dealers regarding how to comply with the substituted compliance determinations. Concerns have ranged from issues of scope to issues of format and timing. For example, there has been significant uncertainty as to the degree to which non-U.S. swap dealers should read the Commission’s comparability determinations literally and rely fully on substituted compliance, *i.e.*, whether they should provide to the Commission precisely in form and substance that which they are required to produce in their home jurisdiction.

The EU requirements in this regard are illustrative. In the EU, investment firms (which would include swap dealers) are generally required to establish adequate policies and procedures to ensure compliance with applicable requirements.<sup>39</sup> Swap dealers must ensure

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*footnote continued from previous page...*

for entity-level requirements. *Id.* at 45331. The swap dealer CCO requirement is classified as an entity-level requirement. *Id.* at 45332. An application for a substituted compliance determination may be made by any entity that is eligible for substituted compliance, including a foreign entity, a U.S. bank that is a swap dealer with foreign branches, or an association of foreign entities, including trade associations. Foreign regulators also may apply. *Id.* at 45344. Once a substituted compliance determination is made, it applies to all entities or transactions in that jurisdiction to the extent provided in the determination. *Id.*

<sup>38</sup> Substituted compliance also was granted with respect to several other entity-level requirements in these jurisdictions, including risk management requirements, certain swap data recordkeeping requirements, business continuity requirements, position limit monitoring, and various conflicts of interest provisions. *See supra* note 8.

<sup>39</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC, and Directive 2000/12/EC of the European Parliament and of the Council, and repealing Council Directive 93/22/EEC, O.J. (L 145), as amended, Articles 13(2), 13(3) and 18.

that their senior management receives, on a regular basis (and at least annually), written reports on compliance, risk management, and internal audit (“MiFID Reporting Requirement”). These reports should also indicate whether appropriate remedial action has taken place in the event of any deficiencies.<sup>40</sup>

The MiFID Reporting Requirement, together with supporting guidelines issued by the European Securities and Markets Authority, require that reports to senior management contain a description of the implementation and effectiveness of the overall control environment for investment services and activities, and a summary of the risks that have been identified, as well as remedies undertaken or to be undertaken. Significant compliance findings should be reported promptly to senior management. The MiFID Reporting Requirement does not mandate a particular form of or timing for the reports to senior management, nor does it require an investment firm to provide these reports to the relevant competent authority (*i.e.*, the relevant regulator in each EU Member State). Rather, the reports are designed solely to inform senior management.

The MiFID Reporting Requirement does not differentiate among the various regulated entities within an investment firm. For example, an investment firm may have one or more swap dealers, broker-dealers, FCMs, or banks within the corporate family, and the reports to senior management would generally not be limited to any one of the registered entities, *i.e.*, one quarterly report to senior management could cover the activities of a swap dealer, a bank, and/or a broker-dealer. In addition, the reports may contain information as to the investment firm’s global activities and not simply its activities in its home jurisdiction or in the United States.

Implementation issues resulting from the Commission’s comparability determinations include how to deal with information reported to senior management or non-U.S. regulatory authorities, including sensitive proprietary information that is not relevant to the entity’s swap dealer business. Such information may be subject to privacy or blocking laws of non-U.S. jurisdictions or other home country permission issues, and/or may be beyond the scope of

the Commission’s jurisdiction. There has been similar uncertainty as to how best to formalize periodic compliance reports to senior management that may have been presented in myriad formats and at intervals that may overlap but not track a swap dealer’s fiscal year, as well as questions about efficiencies for entities that have both U.S. and non-U.S. swap dealers.

To address all these concerns, non-U.S. swap dealers have considered a range of approaches, including: (i) submitting one or more unabridged global reports; (ii) excerpting such report(s) to include only information relating to an entity’s swap dealer business; (iii) drafting a new report covering only the swap dealer business but in a form and scope that would satisfy the home jurisdiction’s requirements (rather than the CFTC’s requirements); and (iv) drafting a new report consistent with the standards outlined in Regulation 3.3(e).

Given the short time period between the comparability determinations (December 21, 2013) and the due date of many of the non-U.S. swap dealer initial annual reports (March 31, 2014), many non-U.S. swap dealers submitted to the CFTC those relevant portions of the periodic compliance reports that were provided to their boards or senior officers during 2013. Recently, CFTC staff have clarified that they do not expect the annual report to contain information that does not relate to the entity’s swap dealer business, and that they are working with their foreign counterparts and non-U.S. swap dealers to ensure that annual reports for subsequent years will more closely match Commission standards regarding the contents of the report.<sup>41</sup>

Another practical consideration for compliance officers of non-U.S. swap dealers operating under a regime of substituted compliance is that the CFTC has granted substituted compliance only with respect to certain specified regulatory requirements. Substituted compliance has not yet been provided for a number of key regulatory requirements, such as the clearing requirement, the trade execution requirement, real-time public reporting, and certain record-keeping requirements. A compliance officer operating under a substituted compliance determination therefore may be responsible for developing or administering procedures for complying with the CFTC requirements for which substituted compliance was not granted. Additionally, compliance officers for non-U.S. swap dealers operating under substituted compliance generally will also be

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<sup>40</sup> Commission Directive 2006/73/EC of 10 August 2006 Implementing Directive 2004/39/EC of the European Parliament and of the Council as Regards Organisational Requirements and Operating Conditions for Investment Firms and Defined Terms for the Purposes of that Directive, O.J. (L 421), Article 9(2).

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<sup>41</sup> Futures Industry Association, 2014 FIA Law and Compliance Conference, *Chief Compliance Officer – First “Big” Year* (May 8, 2014).



responsible for taking steps to ensure compliance with those procedures and to remediate any issues regarding noncompliance.<sup>42</sup> In other words, a compliance officer for a non-U.S. swap dealer operating under substituted compliance nonetheless may be required to perform many duties in accordance with its home jurisdiction requirements for the compliance officer that are very similar, if not identical, to those of a CCO of a U.S. swap dealer under Regulation 3.3.<sup>43</sup>

### ***Other Developments, and Interpretive and Implementation Issues***

*CCO Requirements Generally, Developments.* Each swap dealer registered with the Commission must also be a member of the NFA, which has been charged with overseeing swap dealer registration and compliance with the Commission regulations implementing Section 4s of the CEA. NFA Compliance Rule 2-49, adopted in December 2013, provides that any violation by a swap dealer of Regulation 3.3 will be deemed to be a violation of an NFA requirement as well. The same compliance rule also requires swap dealers promptly to furnish to NFA upon its request any reports, documents, or notices required under Regulation 3.3. As part of its oversight of the Section 4s requirements, the NFA has been conducting reviews of swap dealers' Section 4s submissions, *i.e.*, submissions of policies and procedures relating to each of the Section 4s requirements, including the Regulation 3.3 CCO requirements.

As of May 2014, the NFA had completed a review of policies and procedures submitted by U.S. swap dealers relating to CCOs, business continuity and disaster recovery, conflicts of interest, risk management, and external business conduct. Results of these reviews have been reported to the CFTC and written feedback provided to the swap dealers. Following these reviews, the NFA will review policies and procedures relating to documentation, general and miscellaneous duties, swap data repository reporting, daily trading records, and recordkeeping.

CFTC and NFA staff have both made clear that they expect to see a high level of engagement by the CCO in

the compliance function related to the swap dealer's activities. They expect that the CCO will have broad access to the board or senior officers, and that the swap dealer will be structured in such a way as to provide the CCO with the authority, support, and resources he or she needs to be able to perform the CCO function properly.

The CFTC's expectations regarding the ultimate authority and responsibility of the CCO in ensuring compliance have been another source of uncertainty for swap dealers. In its responses to comments on the proposed rule, the CFTC rejected recommendations that the duties of a CCO of a swap dealer be "harmonized with existing precedent for compliance models in financial services."<sup>44</sup> With respect to comments that CCOs "customarily do not have the ability to enforce compliance by directing staff, or making hiring and firing decisions," the Commission replied that "the role of the CCO required under the CEA, as amended by the Dodd-Frank Act, goes beyond what has been represented by commenters as the customary and traditional role of the compliance officer."<sup>45</sup> Although the Commission clarified that Regulation 3.3 does not require that the CCO be granted "ultimate supervisory authority by a registrant," the Commission also stated that the CCO should be afforded supervisory authority "over all staff acting at the direction of the CCO." The Commission additionally emphasized "the importance of the active compliance monitoring duties."<sup>46</sup> The NFA's reviews of the CCO policies and procedures submitted by U.S. swap dealers and the on-site examinations should provide further clarity as to regulatory expectations of the appropriate level of involvement of the CCO in overseeing activities and ensuring compliance.

The regulators are reviewing each swap dealer's Section 4s submission with a view to determining whether the swap dealer followed a process for ensuring the CCO is appropriately qualified. In addition, they are reviewing each swap dealer's policies and procedures to ensure that the policies are not mere recitations of the applicable rule but contain a sufficient level of detail to show how the rule's requirements will be implemented in the context of that swap dealer's business. Most U.S. swap dealers have received written feedback on at least parts of their Section 4s submissions, with requests for additional detail on procedures a consistent theme.

The NFA on-site examinations of U.S. swap dealers were scheduled to begin in July 2014. The initial round

<sup>42</sup> See, e.g., Comparability Determination for the European Union: Certain Entity-Level Requirements, 78 Fed. Reg. 78923, 78928 (Dec. 27, 2013); Comparability Determination for Australia: Certain Entity-Level Requirements, 78 Fed. Reg. 78864, 78868-9 (Dec. 27, 2013).

<sup>43</sup> Neither the CFTC nor the NFA has provided guidance as to when or how it may review activities of non-U.S. swap dealers in areas where substituted compliance has been provided.

<sup>44</sup> Adopting Release, 77 Fed. Reg. at 20157.

<sup>45</sup> *Id.* at 20162.

<sup>46</sup> *Id.*



of examinations are focusing on the implementation of the CCO requirements, and the infrastructures and processes the swap dealers have established to support the firm's regulatory compliance obligations.<sup>47</sup> The NFA may also conduct investigations "due to events occurring at a swap dealer or major swap participant, or due to developments in the industry that warrant scrutiny."<sup>48</sup> The NFA plans to issue a self-examination questionnaire within the next year, similar to what it has issued for FCMs, to assist swap dealers and their CCOs in their compliance and preparation for a regulatory exam.

With respect to the annual report, CFTC staff has indicated that it expects the report to provide a meaningful degree of transparency, in particular in connection with the discussion of the swap dealer's risk profile and its risk management processes. In addition, the staff has made clear that the swap dealer's annual report should not be the first time that it learns of a material issue.

*Issues Relating to Designation of CCO.* As discussed above, each swap dealer may only designate one individual to be its CCO. However, an individual may be the CCO for more than one regulated entity and may serve different functions within the same entity. This construct is more likely to be used by smaller swap dealers, whose resources may be more limited, particularly since the CCO needs to be able to function at a high level within each regulated entity of which he or she is the CCO. Thus, for example, a swap dealer's general or other in-house counsel may also be its CCO. In that case, the different responsibilities must be clearly described and segregated. While such an arrangement may be more efficient for certain swap dealers, the dual role may at the same time raise potential conflicts and other concerns. For example, an in-house lawyer may assert and must protect attorney-client privilege. But a CCO, on the other hand, is required to make certain disclosures. A dual-hatted CCO, therefore, must always be aware of the capacity in which he or she is acting and potential conflicts arising from his or her dual roles.

Having one CCO across more than one affiliated entity also may raise concerns, particularly with respect to reporting lines and ensuring that the CCO has unfettered access to the board or senior officer of each

entity for which it is the CCO and not just to the most senior governing body of the consolidated entity. If an individual is the CCO for multiple entities, his or her reporting lines and responsibilities should be carefully spelled out.

*Annual Report: Timing.* Due to the short time period between the initial submission of applications for swap dealer registration and the end of the fiscal year that would be covered by the first annual report required to be filed, the CFTC staff provided no-action relief that, in essence, waived the requirement for the initial annual report for swap dealers. In December 2012, CFTC staff issued time-limited no-action relief to swap dealers regulated by a U.S. prudential regulator or registrants of the SEC that were required to register by December 31, 2012, and that had a fiscal year ending on December 31, 2012, from the requirement under Commission Regulation 3.3 to prepare and file an annual report no later than March 31, 2013.<sup>49</sup> In June 2013, CFTC staff issued time-limited no-action relief to swap dealers not regulated by a U.S. prudential regulator or registrants of the SEC, and that ended their fiscal year on March 31, 2013.<sup>50</sup> These swap dealers would have been required to submit their first annual report by July 1, 2013. The staff's relief retained the July filing date, but limited both the scope of the annual report and the period to be covered by the CCO/CEO certification to the last two days of the swap dealers' fiscal year. In March 2014, the staff provided this same relief for the year 2014 to a swap dealer with a March 31 fiscal year-end date that had not been required to register until December 2013.<sup>51</sup>

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<sup>49</sup> Div'n of Clearing and Intermediary Oversight, CFTC Letter No. 12-52, Request for Time-Limited No-Action Relief for Certain Swap Dealers from Compliance with Requirements of Commission Regulation 3.3 Relating to Annual Reports by Chief Compliance Officers (Dec. 14, 2012). The CFTC staff letter noted that the time period that would be addressed by the Annual Report that would otherwise be required to be submitted would total "at most a single day (December 31, 2012)."

<sup>50</sup> Div'n of Clearing and Intermediary Oversight, CFTC Letter No. 13-32, Request for Time-Limited No-Action Relief for Certain Swap Dealers from Compliance with Requirements of Commission Regulation 3.3 Relating to Annual Reports by Chief Compliance Officers (Jun. 26, 2013).

<sup>51</sup> Div'n of Swap Dealer and Intermediary Oversight, CFTC Letter No. 14-32, No-Action Relief from Compliance with Certain Requirements of Commission Regulation 3.3 Relating to the Chief Compliance Officer Annual Report (Mar. 21, 2014).

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<sup>47</sup> NFA's Examination Approach for Swap Dealers and Major Swap Participants, National Futures Association Audio Conference, June 5, 2014, Tr. at pp. 3-4, available at <http://www.nfa.futures.org/NFA-compliance/NFA-education-training/NFA-podcasts/index.HTML>.

<sup>48</sup> *Id.* at 5.

The CCO Rule initially required submission of the annual report within 90 days of the end of the swap dealer's fiscal year and simultaneously with the swap dealer's financial condition report.<sup>52</sup> In November 2013, the Commission amended Regulation 3.3(f)(2) to impose a 60-day filing requirement.<sup>53</sup> Subsequent no-action relief permitted swap dealers to file an annual report due in 2014 within 90 days of the end of the fiscal year and without requiring that it be filed together with the financial condition report.<sup>54</sup> The no-action relief is limited to fiscal year 2014 and, at least as of May 2014, swap dealers will be required to submit the 2015 report together with the financial condition report within 60 days of the end of their fiscal year.

*Annual Report: Meaning of Material.* The annual report must "[l]ist any material changes to compliance policies and procedures during the coverage period for the report," describe any "material deficiencies" in financial, managerial, operational, and staffing resources set aside for compliance, and "[d]escribe any material noncompliance issues identified and the corresponding action taken."<sup>55</sup>

The revision of the Proposed Rule to include a materiality qualifier indicates that the Commission intended for the qualifier to act as a limitation on the

scope of the annual report. However, the Commission has not defined the term "material," leaving swap dealers to define it for themselves. A determination by a swap dealer of materiality will involve subjective judgment in light of the relevant facts and circumstances.

Changes to policies and procedures, deficiencies in resources, and noncompliance issues all may raise questions of materiality. Within each of these "topics," the threshold for what is material and the reasonableness of a determination is likely to differ in different circumstances. It is also likely to differ depending on the size and scope of a swap dealer's business.

Depending on the circumstances, materiality could be measured both quantitatively and qualitatively, and in absolute as well as relative terms. For example, in the context of noncompliance issues, relevant factors could be the number and frequency of similar instances of noncompliance, the number of people involved, the number of violations by a particular person, the importance of the system affected, and the monetary impact measured in both absolute and relative terms. Similarly, relevant factors could include an assessment of the importance of the law, rule, or policy/procedure involved, the effect of the noncompliance on customer protection, counterparty relationships, or issues of market integrity, the seniority or background of the person(s) involved, the potential for reputational risk, whether the noncompliance was intentional, and remediation measures.

A related implementation issue facing swap dealers is whether the annual report should contain a definition of materiality, describe the various factors that are considered in making a materiality determination, or not provide any such definition or description.

CFTC staff has made clear that it expects to be made aware of material noncompliance issues before filing of the annual report. Accordingly, swap dealers may consider it advisable to report such noncompliance issues that, in their view, rise to the level of materiality to the CFTC before submitting an annual report, possibly in their periodic risk-exposure reports, which are due to the Commission shortly after they are provided to the swap dealer's board and senior management.<sup>56</sup> How the Commission will view a swap dealer's determinations on materiality in connection with the annual report requirements remains to be seen.

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<sup>52</sup> See Adopting Release, 77 Fed. Reg. at 20201.

<sup>53</sup> Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68506, 68577 (Nov. 14, 2013).

<sup>54</sup> Div'n of Swap Dealer and Intermediary Oversight, CFTC Letter No. 13-84, Time-Limited No-Action Relief for Futures Commission Merchants, Swap Dealers, and Major Swap Participants from Compliance with the Timing Requirements of Commission Regulation 3.3(f)(2) Relating to Annual Reports by Chief Compliance Officers (Dec. 30, 2013). In Letter No. 13-84 the CFTC staff noted that the effective date of the amendment to Regulation 3.3(f)(2) was Jan. 13, 2014, meaning that the 60-day requirement would not apply to CCO annual reports covering the fiscal year ending on Dec. 31, 2014. CFTC staff stated that the 90-day requirement still applied to firms with a fiscal year-end of Dec. 31, 2013. See also Div'n of Swap Dealer and Intermediary Oversight, CFTC Letter No. 13-85, Time-Limited No-Action Relief for Certain Swap Dealers from Compliance with the Requirements of Commission Regulation 3.3 Relating to Annual Reports by Chief Compliance Officers (Dec. 30, 2013) (providing relief to swap dealers that were not required to register until Dec. 31, 2013 from having to file a report for fiscal year 2013).

<sup>55</sup> 17 CFR §§ 3.3(e)(3), (4), and (5).

<sup>56</sup> 17 CFR § 23.600(c)(2).

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*Annual Report: CCO/CEO Certification.* The CCO (or CEO) must certify that “to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and complete.”<sup>57</sup> While the CCO Rule incorporates a reasonable belief limitation on the certification, it does not include a materiality threshold. It thus requires that the certification apply to everything in the annual report. The CCO (or CEO) may face administrative, civil, and/or even criminal penalties for knowingly certifying an inaccurate or incomplete annual report.

Over the past year, CCOs have had to determine the appropriate persons within the organization on whom they should be able to rely in good faith in making their certification. Issues swap dealers have had to consider in this regard, for example, include how many sub-certifications are appropriate and from whom, and how to craft sub-certifications to ensure that certifiers are not asked to attest to matters beyond the scope of their knowledge or expertise.

*Annual Report: Applicable Requirements.* Regulation 3.3(e)(2) requires that the annual report shall “review each applicable requirement” under the CEA and CFTC regulations, and with respect to each: (i) identify the policies and procedures to ensure compliance with the requirement; (ii) assess the effectiveness of the policies and procedures; (iii) discuss areas for improvement; and (iv) list any material changes to the policies and procedures.<sup>58</sup> Under Regulation 3.3(a), the policies and procedures that the swap dealer must develop are those “relating to the swap dealer’s . . . swaps activities.”<sup>59</sup>

To help develop a common understanding of the CFTC rules and regulations for which a swap dealer must develop policies and procedures, and which it must then review and address as specified in the annual report, the Futures Industry Association, working with swap dealers, developed a list of “In-Scope Rules.” The In-Scope Rules are those that impose a requirement upon a swap dealer such that the swap dealer would be obligated to develop and implement policies and procedures reasonably designed to ensure compliance with that requirement.<sup>60</sup> In the absence of any contrary

guidance, it is likely that swap dealers will continue to use this list of In-Scope Rules to determine the applicable requirements that must be reviewed and addressed as specified in Regulation 3.3(e) with respect to the Annual Report.

## CONCLUSION

This past year has been a busy one for swap dealers and their CCOs, which have grappled not only with the extensive structural requirements imposed by Section 4s and the Commission’s implementing regulations, but also with the heightened expectations of active engagement of the compliance function that now attach to CCOs under Section 4s(k) and Regulation 3.3. The CFTC and NFA have both responded to swap dealers’ Section 4s submissions by asking for more detail, particularly as to process. We would expect, at least for the coming year, to see an iterative process between the regulators and swap dealers as they work through the appropriate level of detail and the various interpretive and implementation issues, many of which will likely only be identified after a complete review of the Section 4s submissions and the CCO annual reports and on-site examinations by NFA.

We also would expect to see a similar process in the area of substituted compliance. While the Commission generally appears to be comfortable with permitting swap dealers to comply with comparable non-U.S. regulatory requirements in some areas, such as the annual report requirement, the CFTC is likely to press, whether formally or informally, for greater convergence as to form and substance over the coming year. This is likely to result in a more consistent understanding of CCO responsibilities and more uniform annual reports from non-U.S. swap dealers. ■

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*footnote continued from previous column...*

23.201- 23.203, 23.501- 23.505, 45.2, and 46.2; Registration: 2.3, 3.10, 3.30, 3.31, 23.21, and 23.22; Reporting: 20.4- 20.7, 23.204, 23.205, 43.3, 43.5, 45.3-45.8, 45.10, 45.11, 45.13, 45.14, 46.3-46.5, 46.8, 46.10, and 46.11; Business Conduct: 1.6, 1.67, 23.402, 23.410, 23.430, 23.433, 23.434, 23.440, 23.450, 23.451, 23.600-23.603, 23.605-23.610, 32.2-32.4, 37.9, 43.6, 166.3, 180.1, and 180.2; Clearing: 23.506, 39.8, 50.2, 50.4, 50.10, and 50.50-50.52; Position Limits: 150.2-150.5; Customer Information and Affiliate Marketing: 160.4-160.9, 160.13-160.15, 160.30, 162.3-162.9, 162.21, and 162.30; Disclosure Limits: 23.431, 23.432, and 160.10-160.12.

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<sup>57</sup> 17 CFR § 3.3(f)(3).

<sup>58</sup> 17 CFR § 3.3(e)(2).

<sup>59</sup> 17 CFR § 3.3(a).

<sup>60</sup> The In-Scope Rules are defined as the following CFTC regulations: Recordkeeping and Documentation: 1.31, 1.39,