THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 49 No. 4 February 24, 2016

SWAP DEALER CHIEF COMPLIANCE OFFICER REQUIREMENTS – RECENT DEVELOPMENTS

Recent developments discussed by the authors include CFTC and NFA feedback on CCO annual reports, NFA examinations of CCO programs, and CFTC's enforcement action against a non-U.S. swap dealer located in the EU. They also address CFTC's extension of CCO's duties to include Volcker rule compliance. The authors find that both CFTC and NFA have engaged in constructive dialogue with swap dealers on important matters, but that two significant issues remain: substituted compliance and CCO duties under the Volcker Rule.

By Dan M. Berkovitz and Gail C. Bernstein *

The swap dealer requirements under the Dodd-Frank Act[1] and the Commodity Futures Trading Commission's ("CFTC's" or "Commission's") implementing regulations have been in effect now for just over three years. Since December 2012, entities meeting the definition of "swap dealer" have been required to submit applications to the CFTC for registration as swap dealers and conduct their swap activities in accordance with the CFTC's regulatory regime for swaps and swap dealers. Among the requirements for swap dealers is that each swap dealer designate an individual to serve as its Chief Compliance Officer ("CCO"), whose responsibilities include ensuring that the swap dealer complies with the swap requirements of the Commodity Exchange Act ("CEA") and Commission regulations. The CCO also must establish and follow procedures for the remediation of any non-compliance issues.[2] In addition, the CCO must prepare and submit to the Commission an annual report that describes each policy and procedure of the swap dealer, and the compliance of the swap dealer with the CEA and Commission regulations.[3]

The CFTC and National Futures Association ("NFA"), to which the CFTC has delegated registration and certain oversight functions for swap dealers, have indicated that at this point — three years after swap dealers first became provisionally registered[4] — swap

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").

[2] 7 U.S.C. §6(k)(2)(E), (F).

[3] *Id.* §6(k)(3).

[4] Swap dealers become provisionally registered when the NFA receives a complete swap dealer registration submission ("Section 4s Submission"). A swap dealer will only become fully registered once the NFA, in consultation with the CFTC,

* *DAN M. BERKOVITZ is a partner and GAIL C. BERNSTEIN is a special counsel in WilmerHale's Broker/Dealer Compliance and Regulation and Futures and Derivatives practice groups. Their e-mail addresses are dan.berkovitz@wilmerhale.com and gail.bernstein@wilmerhale.com.*

IN THIS ISSUE

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. Copyright © 2016 by RSCR Publications LLC. ISSN: 0884-2426. All rights reserved. Reproduction in whole or in part prohibited except by permission. For permission, contact Copyright Clearance Center at www.copyright.com. *The Review of Securities & Commodities Regulation* does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions, or for the results obtained from the use of such information.

dealers should be moving into "business as usual" with respect to their swap dealer duties and swap activities. CFTC officials have indicated they believe that swap dealers have had sufficient time to implement the systems required to comply with the CFTC's swap regulations and the agency expects that swap dealers will be in full compliance with those regulations.[5] Accordingly, a failure to conduct activities in accordance with these regulations could subject a swap dealer to enforcement action, regardless of the recent vintage of the requirements.

The CFTC's 2012 rulemaking that specified the duties of the swap dealer CCO ("CCO Rule") left open certain issues regarding the CCO's responsibilities.[6] These issues related to the scope of the regulations over which the swap dealer CCO would have responsibilities, the extent to which the CFTC's regulations would apply to the activities of swap dealers located outside the United States ("non-U.S. swap dealers"), and the contents of the annual report, such as the standard of "materiality" for reporting non-compliance issues.[7]

Over the past three years, the CFTC and NFA have provided guidance on a number of issues involving the CCO requirements. As of late 2015, the NFA has reviewed and commented on swap dealer procedures submitted during the registration process and has conducted on-site examinations of swap dealer CCO programs. The CFTC has reviewed and provided feedback and guidance on two rounds of annual reports, each covering a full year's worth of swap activities. The CFTC and NFA also have provided informal guidance on various issues relating to the CCO requirements, such as the contents of the annual reports, the meaning of "materiality," and the level of detail expected in swap dealer procedures. However, a number of issues remain. These include the applicability of the CFTC's "substituted compliance" determinations, which permit non-U.S. swap dealers to comply with comparable requirements of their home jurisdiction in lieu of the corresponding CFTC requirements, in the context of enforcement actions for violations of CFTC requirements, and the scope of requirements for which the CCO is responsible. The latter issue has been of increased significance recently, as many swap dealers also have compliance requirements stemming from the statutory provisions known as the "Volcker Rule"[8] and the final rules implementing those statutory provisions ("Volcker Rule Regulations").[9] In particular, a footnote in the CFTC's rulemaking promulgating the Volcker

footnote continued from previous page…

determines that the swap dealer is in compliance with all of the implementing regulations under Section 4s of the CEA ("Section 4s Implementing Regulations"), and neither the swap dealer nor any of its principals is statutorily disqualified from registration under Section 8a(2) or (3) of the CEA. *See* NFA, Compliance Information for Swap Dealers and Major Swap Participants, *at* http://www.nfa.futures.org/nfa-compliance/NFA-swap-dealers-major-swap-participants/index.html.

[5] *See, e.g.*, CFTC Staff Advisory No. 15-66, Reporting Obligations under Regulations 23.204 and 23.205, Dec. 17, 2015 (to "remind swap dealers . . . of their obligations with respect to the data reporting requirements in Regulations 23.204 and 23.205").

[6] 17 C.F.R. §3.3.

[7] *See* Dan M. Berkovitz and Gail Bernstein, *Swap Dealer Chief Compliance Officer Requirements—First Year in Review*, 47 Review of Securities & Commodities Regulation, No. 16, at p. 195 (Sept. 3, 2014).

[8] The statutory Volcker Rule was enacted as part of the Dodd-Frank Act and codified in new Section 13 of the Bank Holding Company Act of 1956, as amended ("BHCA"), 12 U.S.C. § 1851 [hereinafter "BHCA Section 13"].

[9] The five federal financial regulators charged with adopting implementing regulations under BHCA Section 13 issued final rules in December 2013. The federal banking regulators and the Securities and Exchange Commission ("SEC") issued a common final rule and published a joint adopting release (Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 30, 2014). The CFTC, however, issued its own rule (with the same rule text as the common rule) and published a separate adopting release with the same title as the release for the common rule, 79 Fed. Reg. 5807 (Jan. 30, 2014) [hereinafter "CFTC Volcker Release"]. Unless otherwise specified herein, references to the "Volcker Rule" include both BHCA Section 13 and the Volcker Rule Regulations.

Rule Regulations ("CFTC Volcker Release") raises questions about the degree to which the Volcker Rule's compliance requirements are to be included as part of the CCO's duties under the CCO Rule. In 2016, swap dealer CCOs will face, for the first time, the issue of whether and how to address the Volcker Rule requirements in the CCO's swap dealer annual report.

This article examines the recent developments regarding the swap dealer CCO requirement. It reviews the CFTC and NFA feedback to swap dealers on their Section 4s Submissions, the results of NFA's on-site examinations of CCO programs, the CFTC's guidance on the CCO annual report, a recent enforcement action that raises questions concerning the scope of substituted compliance, and the CFTC's footnote in the Volcker Rule that seemingly makes the Volcker Rule's compliance requirements part of the CCO responsibilities.

THE SWAP DEALER CCO REQUIREMENT

Statutory requirements. Section 731 of the Dodd-Frank Act amended the CEA to include new Section 4s to require the registration of swap dealers.[10] Section 4s requires that registered swap dealers meet requirements relating to capital and margin; reporting, documentation, and recordkeeping; and the business conduct of swap dealers with counterparties.[11] The statute directs the CFTC to adopt regulations to specify the regulatory standards that swap dealers must meet.[12] As of the writing of this article, the CFTC has promulgated all of the Section 4s Implementing Regulations except for the standards relating to capital requirements.[13]

CEA Section 4s(k) requires each swap dealer to designate an individual to serve as the CCO and specifies the duties and responsibilities of the CCO. Under Section 4s(k) the CCO must: report directly to the board of directors or senior officer of the swap dealer; review the compliance of the swap dealer with respect to the Section 4s Implementing Regulations; in consultation with the board of directors or similar body, resolve any conflicts of interest that may arise; administer the swap dealer policies and procedures required to be established by the CFTC; "ensure compliance" with the CEA — "including regulations" — relating to swaps; and establish procedures for the remediation of non-compliance issues identified by the CCO or otherwise arising.[14] The CCO also must annually prepare and sign a report that describes "the compliance of the swap dealer . . . with respect to this Act (including regulations) . . . and . . . each policy and procedure of the swap dealer . . . (including the code of ethics and conflict of interest policies)."[15]

CFTC Rule. In 2012, the Commission promulgated Regulation 3.3 to define further the duties and responsibilities of the swap dealer CCO.[16] The CCO Rule tracks the statutory provisions and specifies several additional requirements. For example, to ensure a direct line of communication between the CCO and the board of directors or senior officer, the CCO must report directly to, his or her compensation must be approved by, and he or she may only be removed by, the board or

[10] CEA §4s(a).

[11] *Id.* §4s.

[12] *Id.* §4s(b)(4) (general rules applicable to swap dealers); §4s(d)(1) (rules for swap dealers); §4s(e)(2)(B) (capital and margin requirements for entities for which the CFTC is the prudential regulator); §4s(f)(2) (reporting and recordkeeping); §4s(g)(5) (daily trading records); §4s(h)(6) (business conduct standards); §4s(i)(2) (documentation standards); §4s(j)(7) (duties relating to monitoring of trading, risk management, conflict of interests, and antitrust considerations).

[13] Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 (Jan. 19, 2012); Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties,77 Fed. Reg. 9734 (Feb. 17, 2012); Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance

footnote continued from previous column…

Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20128 (Apr. 3, 2012) [hereinafter "CCO Rule Adopting Release"]; Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21278 (Apr. 9, 2012); In addition, on December 16, 2015, the Commission adopted a final rule and interim final rule requiring margin for uncleared swaps, which will become effective on April 1, 2016, with phased-in compliance dates beginning September 1, 2016. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

[14] CEA §4s(k).

[15] *Id.* §4s(k)(3)(A).

[16] 17 CFR § 3.3; CCO Rule Adopting Release, *supra* note 13. *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).

senior officer.[17] The CCO must meet with the board or senior officer at least annually, or more often at the CCO's election. The CCO Rule also incorporates the concept of reasonableness, such that the CCO is responsible for "[t]aking *reasonable* steps to ensure compliance with the Act and Commission regulations relating to the swap dealer's . . . swaps activities."[18] Under the CCO Rule, the CCO also is responsible for administering the swap dealer's "policies and procedures *reasonably* designed to ensure compliance with the Act and Commission regulations."[19]

The CCO Rule lays out specific requirements for the annual report. The annual report must describe the swap dealer's policies and procedures, including the code of ethics and conflicts-of-interest policies. It must review each applicable requirement of the CEA and Commission Regulations, and with respect to each: (1) identify the policies and procedures that are reasonably designed to ensure compliance with the CEA and Commission regulations; (2) provide an assessment as to the overall effectiveness of these policies and procedures; and (3) discuss any areas for improvements to the compliance program or resources devoted to compliance.[20] Any material changes to these policies and procedures over the relevant fiscal year must be identified.[21] The annual report must 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.[22] Finally, the report must also describe any material non-compliance issues by the swap dealer relating to a violation of the CEA or Commission Regulations and the corresponding action taken.[23]

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.[24] These records must be made available to the staff of the Commission or prudential regulators promptly upon request.[25]

Substituted Compliance. The Commission's Cross-Border Interpretive Guidance provides that non-U.S. swap dealers are fully subject to the CEA and the Commission's swap dealer regulations, but that the Commission may permit a swap dealer in another jurisdiction instead to comply with requirements in its home jurisdiction that the Commission determines are "comparable to and as comprehensive as" the corresponding CFTC requirements.[26] In December 2013, the Commission issued "comparability determinations" that permitted substituted compliance for certain of the Commission's "entity-level" requirements in six jurisdictions: Australia, Hong Kong, Japan, Switzerland, Canada, and the European Union ("EU").[27] With respect to the EU, for example, the Commission's substituted compliance determinations permit non-U.S. swap dealers to comply with the EU requirements regarding the CCO, swap data recordkeeping, risk management programs, monitoring of position limits, diligent supervision of swap activities, business continuity, clearing member risk management,

[17] 17 CFR §3.3(a).

[18] *Id.* §3.3(d)(3) (italics added).

[19] *Id.* §3.3(d)(1) (italics added).

[20] *Id.* § 3.3(e)(2).

[21] *Id.* § 3.3(e)(3).

[22] *Id.* § 3.3(e)(4).

[23] *Id.* § 3.3(e)(5).

[24] Commission Regulation 1.31 generally provides 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. *Id.* §1.31.

[25] *Id.* §3.3(g)(2).

[26] Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292, 45340 (July 26, 2013) [hereinafter "Cross-Border Interpretive Guidance"].

[27] The Commission's comparability determinations are available on its website, *at* http://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm. In the Cross-Border Interpretive Guidance, the Commission classified its various regulatory requirements as "entity-level," meaning that the requirement applied to the firm as a whole, with respect to all of its activities, and "transaction-level," meaning that the requirement would apply on a transaction-by-transaction basis. Substituted compliance is generally available for various entity-level requirements. *Id*. at 45331. The swap dealer CCO requirement is classified as an entity-level requirement. *Id.* at 45332.

and various conflicts of interest policies and procedures.[28]

The Commission did not provide substituted compliance in any jurisdiction for the requirements in CFTC Regulation 3.3(f) that the CCO or CEO of a swap dealer certify that the annual report is accurate and complete, and that the CCO submit the report to the Commission. Thus, regardless of whether there is substituted compliance for other CCO duties, all swap dealers, in any jurisdiction, must submit an annual report to the CFTC, with the requisite certification as to accuracy by the CCO or CEO.

RECENT DEVELOPMENTS

Guidance and Feedback on Annual Reports. In December 2014, the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") issued guidance to swap dealer CCOs regarding the preparation of annual reports.[29] DSIO's guidance emphasized that the annual report should be a "meaningful tool to communicate with the [board of directors] or senior officer and CFTC staff regarding the performance of the compliance program over the past year, the status of the program at the time the report is delivered, and the issues facing the compliance function of the registrant."[30] DSIO provided more detailed guidance as to each of the specific regulatory requirements for the annual report. Generally, DSIO's guidance indicated that the reports should provide more specific information as to the activities and procedures addressed in the report. For example, DSIO stated that the annual report should provide an assessment of the effectiveness of each of the written policies and procedures ("WPPs") that are reasonably designed to ensure compliance with each regulatory requirement, as opposed to "only a general indication of effectiveness of all WPPs," as DSIO stated had been provided previously in some of the annual reports. DSIO also recommended that the report provide "a detailed discussion of why the CCO believes [a] particular area needs improvement," as well as a discussion of the improvements to be implemented, the time frame for implementation, and a cross-reference to the regulatory requirement that the improvement addresses. DSIO advised that, to the extent possible, the report should provide information regarding specific budget and staff allocations for compliance and compliance-related activities. At the same time, however, DSIO indicated that information need not always be presented through lengthy narrative passages; rather a chart format could be acceptable in certain circumstances, such as where information is provided on a procedure-by-procedure basis.

In their reviews of the annual reports submitted by swap dealers in early 2015, CFTC staff observed considerable improvements from the first set of annual reports that had been submitted in the previous year, but found only seven of the 52 reports it reviewed to be adequate.[31] The CFTC identified three main types of deficiencies in its feedback letters on the remaining 45 reports: (1) the report was incomplete, i.e., the report did not provide sufficient information to meet the regulatory requirements; (2) the report needed improvement with respect to the amount of information provided to meet the regulatory requirements; and (3) additional detail was needed. Areas in which the CFTC found that more detail or information was required included the resources devoted to compliance, the improvements needed where deficiencies or non-compliance issues were identified, and the timelines for the resolution of compliance issues.

As this was only the second year of annual reporting and DSIO's guidance had been issued only about 90 days prior to the due date for these reports, the CFTC did not require any swap dealers to revise or resubmit reports that the CFTC considered deficient. CFTC staff has recently stated, however, that it expects the guidance to be fully incorporated into the next round of annual reports and, in the future, the CFTC may issue notices of violation and/or require that deficient reports be amended.

The CFTC did not review the contents of the annual reports submitted by non-U.S. swap dealers in jurisdictions where the CFTC had granted substituted compliance for the requirements concerning the contents of the annual report. Because the requirements relating to annual reporting in these jurisdictions do not exactly align with the CFTC requirements, non-U.S. swap dealers have taken several approaches to the annual

[28] Comparability Determination for the European Union: Certain Entity-Level Requirements, 78 Fed. Reg. 78923 (Dec. 27, 2013) ("EU Comparability Determination").

[29] CFTC Staff Advisory No. 14-153, Chief Compliance Officer Annual Reports, Dec. 22, 2014.

[30] *Id.* at p. 3.

[31] The CFTC staff presented the following information regarding the review of the annual reports at the *ISDA Symposium,– Dodd-Frank, the Compliance Perspective*, September 22, 2015 (remarks of Erik Remmler, Deputy Director, Registration and Compliance, Division of Swap Dealer and Intermediary Oversight) [hereinafter *ISDA Symposium*].

reports they have submitted to the CFTC under Regulation 3.3(e). For example, many of the annual reports prepared by non-U.S. swap dealers to meet home jurisdiction requirements are designed to address a broad range of home jurisdiction requirements, rather than focus on swaps activities. Some non-U.S. swap dealers redacted the information about non-swaps activities from the reports that were submitted to their home jurisdiction regulators and then submitted the redacted reports to the CFTC. Other non-U.S. swap dealers submitted to the CFTC annual reports that reflected a hybrid approach — in addition to redacting the material from the home jurisdiction annual reports pertaining to non-swap activities, these non-U.S. swap dealers also drafted and submitted to the CFTC new material specifically designed to address the CFTC's requirements. CFTC staff has indicated that the hybrid approach was most useful to the agency, but also has acknowledged that such an approach is not required under the substituted compliance regime.

Materiality standard. Under Regulation 3.3(e), the annual report must "[d]escribe any material non-compliance issues identified and the corresponding action taken."[32] The annual report must list material changes to the compliance policies over the report period, as well as identify any material deficiencies in resources set aside for compliance.[33] CFTC staff also has made clear its expectations that swap dealers notify the staff of any material non-compliance issues prior to the filing of the annual report.[34] The CFTC's rulemaking, however, did not define or provide any guidance as to the meaning of the term "material."

In its December 2014 guidance for the swap dealer annual report, DSIO staff recommended that "CCOs include a description of the standard of materiality used. This will provide a meaningful context for any reported changes to the WPPs." The guidance also stated that the report should "include an explanation of the standard the registrant used to determine a non-compliance event's materiality." Many swap dealers have been concerned that absent clearer guidance from the regulators, their determinations on materiality are subject to "second-guessing" by the agency, particularly in the context of an enforcement action, if the agency subsequently takes issue with the standard of materiality used by the swap dealer in determining that a particular event need not be reported.

In response to these concerns, DSIO staff has provided informal guidance as to what the CFTC would consider to be "material."[35] The staff has stated that in its view materiality should be determined in consideration of the particular facts and circumstances of the business. The staff suggests that an issue should be considered material if the swap dealer board or management would want to know about the issue, it had a significant effect on the swap dealer's clients, was systemic or recurring rather than isolated, or required a change in policy or procedures.

Timing of Annual Report. CFTC Regulation 3.3(f)(2) requires that a swap dealer file the CCO's annual report not more than 60 days after the end of the fiscal year, simultaneously with the submission of its financial condition reports.[36] In March 2015, the Commission staff issued No-Action Letter No. 15-15, providing no-action relief from the 60-day requirement, permitting swap dealers to file their annual reports within 90 days after the end of the fiscal year. The staff stated that "an additional 30 days will allow CCOs to devote sufficient time and resources to the creation of a report that facilitates an in-depth, substantial discussion on the state of the compliance program with the registrant's senior management or board of directors."[37]

NFA Examinations of CCO Programs. In addition to reviewing the Section 4s Submissions submitted by swap dealers as part of the registration process,[38] the

[32] 17 C.F.R. §3.3(e)(5).

[33] *Id.* §3.3(e)(3), (4).

[34] The NFA also expects to be notified of material non-compliance issues when they arise. NFA stresses that "timeliness [rather than being able to provide detailed information] is often the most important factor for firms to consider when self-reporting." NFA Audio Conference, March 4, 2015 [hereinafter "March 2015 Audio Conference"]. Swap data recordkeeping and reporting have been among the most commonly reported non-compliance issues. The NFA typically requests a written summary as well as an appropriate remediation plan following receipt of a self-report. The NFA and CFTC generally coordinate their follow-up efforts, including joint conference calls, with the swap dealer.

[35] *ISDA Symposium*, *supra* note 31.

[36] 17 C.F.R. §3.3(f)(2).

[37] CFTC Letter No. 15-15, Mar. 27, 2015.

[38] As part of the registration process, the NFA reviews each firm's Section 4s Submission on a topic-by-topic basis and then sends feedback letters to each firm detailing those parts of the Section 4s Submission that the NFA believes may not adequately demonstrate the swap dealer's ability to comply with the relevant Section 4s Implementing Regulations. Until very recently, swap dealers have been required to submit to the NFA

NFA has commenced a program of on-site examinations of the implementation of the swap dealer requirements and procedures.[39] The first round of on-site examinations covered the U.S. swap dealer CCO programs and was conducted between the summer of 2014 through early 2015.[40] Although the NFA does not publicly disclose the results of its examination of each swap dealer, it has provided general information about the results of these examinations. The NFA publicly identified three main areas of concern: (1) training; (2) compliance monitoring; and (3) tracking of non-compliance issues.

The NFA expects that swap dealers will have trained their personnel on applicable regulations and implemented a training monitoring program. The NFA found that some firms had not yet provided training or had not yet established a training program. Some firms had trained only senior, front-office personnel, and then expected those personnel to train their staff. More commonly, firms did not maintain adequate records of who had received training.

The NFA found a number of instances of inadequate monitoring of compliance by the CCO, either because a CCO was too removed from or not sufficiently knowledgeable about the firm's compliance monitoring, or because the CCO was too dependent upon the discretion of other individuals as to whether issues should be escalated to the CCO. The NFA examinations also revealed instances where the CCO was not sufficiently engaged in risk management compliance issues. Although the NFA has noted that the CCO is not a risk officer, it emphasized "the CCO is responsible indeed to monitor the firm's compliance with risk management requirements."[41] The NFA has indicated that appropriate CCO engagement would include being on certain committees and at key meetings, and that the CCO receive reports that highlight risk management compliance concerns. The NFA recommends that the CCO "get comfortable with the testing of the risk management program . . . and . . . review the results of those tests"[42]

The NFA also identified gaps in the CCOs' tracking of non-compliance issues and monitoring for remediation of these issues. The NFA considers that the CCO has responsibilities regarding "all non-compliance issues." The NFA found, however, instances where certain non-compliance issues identified by operations staff or internal audits were not tracked by the CCO. In other cases, remediation plans for non-compliance issues

footnote continued from previous page…

additional documentation or revisions in response to the feedback letters. Effective January 6, 2016, however, swap dealers will no longer need to submit additional documentation or revisions to the NFA. Instead, they will need to revise their WPPs to respond to the feedback and then submit an attestation by a principal of the firm within the time specified in each feedback letter "attesting that the firm has revised its policies and procedures to address comments in the [f]eedback [l]etter." NFA Notice I-16-01 (Jan. 6, 2016). Once the attestation is filed, the NFA will issue an acknowledgement letter informing the swap dealer that the NFA does not have any further inquiry regarding the particular Section 4s topic area(s) at that time. *Id.* If a swap dealer does not complete the items in the feedback letter within the time specified in the letter, it must notify the NFA in writing and provide reasons for not timely completing the revisions. The NFA intends to notify CFTC staff of any failure to file a timely attestation. For those Section 4s topic areas for which feedback letters are outstanding, the NFA intends to reissue the letters, identifying where an attestation (instead of revised documentation) is required. These letters will include an attestation template. *Id.* This modification to the Section 4s review process will shift the burden of determining the sufficiency of a swap dealer's WPPs from the NFA to the swap dealer, potentially exposing the swap dealer to examination findings or even an enforcement action if it attests to WPPs that the NFA or CFTC later find to be insufficiently responsive to a feedback letter.

[39] The NFA commences an on-site examination with a "first-day letter," which provides the swap dealer with a 30-day advance notification of the on-site examination. The letter also informs the swap dealer of the expected time and durations of the on-site visit, including the first day examiners will arrive on site, and includes any requests for documents to be provided. The NFA also sends a questionnaire to the swap dealer. For the CCO examinations these questionnaires requested information as to whether there had been any changes in the CCO or the CCO's reporting lines. The on-site examinations consist of meetings with key personnel to understand the procedures and infrastructure in place to ensure compliance with regulatory requirements, the review of exception and management reports, and real-time observations. National Futures Association Audio Conference, NFA's Examination Approach for Swap Dealers and Major Swap Participants, June 5, 2014.

[40] The NFA is focusing its second examination cycle on risk management and market practices. As with the examinations in the first cycle, the second cycle also does not include non-U.S.

footnote continued from previous column…

swap dealers that are relying on substituted compliance. March 2015 Audio Conference, *supra* note 34.

[41] *Id.*

[42] *Id.*

were found to be incomplete due to missing target dates or owners, or were not updated in a timely manner.

Overall, the NFA observed that firms with dedicated swap dealer compliance resources generally were able to meet the CCO requirements effectively. Dedicated swap dealer compliance resources also supported a firm's ability to prepare adequate CCO annual reports. The NFA has commented that firms that do not have dedicated resources to support the CCO have "struggled" to meet the CCO requirements.[43]

Continuous Monitoring Program. In the spring of 2015, the NFA introduced its "Continuous Monitoring Program" ("CMP") to enable it to keep abreast of industry developments. The NFA has begun meeting with swap dealer CCOs to introduce them to the CMP, and intends to have introductory meetings with all swap dealer CCOs, including CCOs of swap dealers that have elected substituted compliance, by the spring of 2016. The CMP will include periodic meetings with swap dealer CCOs and other key personnel, which may occur quarterly or semi-annually, depending on the information obtained from the monitoring. It also will include reviews of swap dealer reports, including the NFA's annual questionnaire,[44] and assessment of events or trends that could have an impact on swap dealers more generally. For the first few years, the CMP will focus on developing an understanding of firms' swap dealer business and infrastructure, following up on remediation of issues identified in an NFA examination, and learning more about regulatory implementation initiatives and challenges.

Substituted compliance. Although the CFTC has granted substituted compliance with respect to the specific duties of the CCO, other than those related to certifying the accuracy of the annual report and filing it with the CFTC, the agency has provided substituted compliance only for a limited number of the regulatory requirements for which the CCO has compliance-related responsibilities. Substituted compliance has not been provided for most of the transaction-level requirements, including clearing, trade execution, real-time public reporting, reporting to the swap data repository, and certain record-keeping requirements. Thus, a CCO operating under substituted compliance for the CCO requirements nonetheless is responsible for developing or administering procedures for complying with a number of CFTC requirements for which substituted compliance was not granted, albeit under the requirements for a CCO under the laws of the home jurisdiction. These non-U.S. swap dealer CCOs also would be responsible, in accordance with the CCO-related requirements in their home jurisdiction, for taking steps to ensure compliance with these procedures and to remediate any issues regarding non-compliance.[45] Thus, even though a CCO may be operating under substituted compliance with respect to its duties as a CCO, the CCO's compliance-related duties with respect to many CFTC regulatory requirements will be very similar, if not identical, to the duties of a CCO operating under Regulation 3.3.

Recent CFTC action has muddied these waters. In September 2015 the Commission instituted and settled an enforcement action against a non-U.S. swap dealer located in the EU for violations of various swap data reporting requirements.[46] Significantly, the CFTC also cited the non-U.S. swap dealer for violation of CFTC Regulation 23.602, which imposes on registered swap dealers a duty to diligently supervise all of their activities relating to their business, even though the CFTC had granted swap dealers in the EU substituted compliance for this regulation.[47]

---

[43] *Id.*

[44] All NFA members, including swap dealer members, must complete an annual questionnaire as part of the NFA membership renewal process. The questionnaire provides NFA with information about the swap dealer and allows NFA to better understand the composition of its membership. Member firms are encouraged to update their questionnaire data on a regular basis, but must, at a minimum, complete the annual questionnaire on the anniversary of their NFA Membership date. *See* NFA website *at* https://www.nfa.futures.org/NFA-electronic-filings/annual-questionnaire.html (*last visited* Dec. 21, 2015).

[45] *See*, e.g., EU Comparability Determination, *supra* note 28, at 78928; Comparability Determination for Australia: Certain Entity-Level Requirements, 78 Fed. Reg. 78864, 78868-9 (Dec. 27, 2013).

[46] *In the Matter of Deutsche Bank AG*, CFTC Docket No. 15-40 (Sept. 30, 2015).

[47] Regulation 23.602 provides:

(a) *Supervision.* Each swap dealer and major swap participant shall establish and maintain a system to supervise, and shall diligently supervise, all activities relating to its business performed by its partners, members, officers, employees, and agents (or persons occupying a similar status or performing a similar function). Such system shall be reasonably designed to achieve compliance with the requirements of the Commodity Exchange Act and Commission regulations.

(b) *Supervisory System.* Such supervisory system shall provide, at a minimum, for the following:

In its 2013 EU Comparability Determination, the Commission provided substituted compliance for a variety of specific regulatory requirements pertaining to the swap dealer's risk management program. The duty to diligently supervise under Regulation 23.602 was specifically included within the suite of risk management program requirements for which substituted compliance was granted. The Commission found "the Markets in Financial Instruments Directive ("MiFID") standards specified above [regarding supervisory duties] are generally identical in intent to [Regulation] 23.602 because such standards seek to ensure that SDs and MSPs strictly comply with applicable law, which would include the CEA and the Commission's regulations."[48]

A straightforward interpretation of the substituted compliance determinations for the EU is that although a non-U.S. swap dealer must comply with the CFTC regulations when substituted compliance has not been granted, the responsibility for supervising the swap dealer's compliance with all regulatory requirements — including the CEA and the CFTC regulations — rests with the home jurisdiction regulator. This interpretation is supported by the classification of the risk management program requirements, including the duty to diligently supervise, as entity-level requirements, meaning that they apply across all transactions or activities conducted by the swap dealer, rather than in particular circumstances. The EU Comparability Determination appears to be unambiguous that a non-U.S. swap dealer located in the EU would be subject to its home jurisdiction's requirements as to the duty to supervise — even with respect to the supervision of compliance with CFTC regulations for which substituted compliance was not granted. This is clearly stated in the Commission's EU Comparability Determination:

> Through the MiFID standards specified above, EU laws and regulations seek to ensure that each SD and MSP not only establishes the necessary policies and procedures that would lead to compliance with applicable law, which would include the CEA and Commission regulations, but also establishes an effective system of internal oversight and enforcement of such policies and procedures to ensure that such policies and procedures are diligently followed.[49]

The CFTC's recent enforcement action against Deutsche Bank, however, follows a different paradigm. In this case, the CFTC did not recognize substituted compliance for the duty to supervise when the underlying substantive requirement did not receive substituted compliance. The CFTC could have chosen in its EU Comparability Determination to provide substituted compliance for the duty to supervise only when it also provided substituted compliance for the underlying activity being supervised. However, the CFTC chose not to do so. In the EU Comparability Determination, the Commission unambiguously provided substituted compliance for the duty to supervise all swap dealer activities, including the supervision of activities that must comply with CFTC regulations.

As the Commission noted in the EU Comparability Determination, the requirements under EU law regarding the supervision of swap policies and procedures are "comparable to and as comprehensive" as under CFTC Regulation 23.602. Thus, as a practical matter, the manner in which a swap dealer supervises its policies and procedures will be substantially the same whether or not substituted compliance applies. However, as the Commission's recent enforcement order illustrates, the extent to which substituted compliance applies has significant implications for a swap dealer in the event of non-compliance with an underlying CFTC requirement. It remains to be seen whether the recent CFTC enforcement case will establish a precedent that the Commission will follow in future cases involving supervisory duties.[50]

---

footnote continued from previous page…

> (1) The designation, where applicable, of at least one person with authority to carry out the supervisory responsibilities of the swap dealer or major swap participant for all activities relating to its business as a swap dealer or major swap participant.
>
> (2) The use of reasonable efforts to determine that all supervisors are qualified and meet such standards of training, experience, competence, and such other qualification standards as the Commission finds necessary or appropriate.

[48] EU Comparability Determination, *supra* note 28, at 78931.

[49] *Id.*

[50] In the EU Comparability Determination, the Commission stated that its comparability determinations were "subject to the Commission's retention of its examination authority and its enforcement authority." EU Comparability Determination, *supra* note 28, at 78924, *citing* Cross-Border Interpretive Guidance, *supra* note 26, *at* 45342–44. The recent action indicates that the Commission may be less reticent to exercise its retained enforcement authority than its inspection authority in areas where substituted compliance has been granted.

INTERPLAY OF THE SWAP DEALER CCO WITH VOLCKER RULE COMPLIANCE

Another area where the waters are murky is the interplay of the swap dealer CCO with compliance requirements under the Volcker Rule.

Preliminarily, the CCO Rule proposed by the CFTC would have required registrants to include in the annual report a certification of compliance with sections 619 and 716 of the Dodd-Frank Act (the Volcker Rule and Derivatives Push-Out), and any rules adopted pursuant to these sections. However, in response to comments from FIA and SIFMA objecting to the provision, the Commission determined not to adopt that provision in the final CCO Rule.[51] Nevertheless, the CFTC Volcker Release states in footnote 2521:

> For Commission registrants that are swap dealers and to which [the Volcker Rule] applies, it is noted that the compliance requirements of subpart D are included in the Commission's regulations that are to be addressed as part of the chief compliance officer duties and requirements under CFTC regulation 3.3.[52]

This statement purports to incorporate the Volcker Rule compliance program into the CCO's duties generally. Compliance with the Volcker Rule began on July 21, 2015. Thus, swap dealers that are also banking entities under the Volcker Rule have begun to grapple with the reach of footnote 2521 and whether Regulation 3.3 covers the Volcker Rule compliance program. These swap dealers are also considering whether and how to include Volcker Rule compliance issues in their CCO annual reports.

Thus, in footnote 2521 in the CFTC Volcker Release, the Commission has sought to impose a requirement it explicitly withdrew from its Regulation 3.3 rulemaking, but it has done so without considering the costs and benefits of the requirement, and also without providing interested persons adequate notice of and opportunity to comment on the requirement as required by the APA for informal rulemakings. After declining to extend the swap dealer CCO requirements to incorporate the Volcker Rule in its Section 3.3 rulemaking, the Commission also did not propose to extend the CCO Rule to Volcker Rule compliance in its proposed Volcker Regulations.[53] Rather than repropose a new requirement that would specify the CCO's duties regarding the Volcker rule, in proposing the Volcker rule the Commission presented a set of questions (Question No. 346) on the subject of the annual compliance report.[54]

In our view, the presence of these questions, without more, likely would not be deemed to satisfy a notice and comment requirement. First, the annual compliance report the questions address is not the same type of report required under the CCO Rule. Second, one set of questions of approximately 400 is unlikely to suffice as notice that the Commission intended to extend Regulation 3.3 to the Volcker Rule. Even if these questions could reasonably be viewed as providing adequate notice and opportunity to comment, the final CFTC Volcker Regulations do not in fact incorporate the possible requirements implicated by these questions. Question 346 in the proposed rule asks about the review and approval of a compliance program and a potential annual compliance report. Footnote 2521 would impose much broader requirements, as it purports to extend all of the CCO's duties under Regulation 3.3 to the Volcker Rule requirements. Any such modification of Regulation 3.3, in our view, would need to be done under a separate CEA rulemaking, which would require a separate notice and comment process, and cost benefit analysis. Nonetheless, the CFTC staff recently issued an advisory to "remind" the CCOs of swap dealers and futures commission merchants that are banking entities that the Volcker Rule requirements are within the scope of their duties under Regulation 3.3, and that their annual reports must address the compliance requirements of the Volcker Rule.[55]

CONCLUSION

The CFTC and NFA have made clear their expectations that at this point in time — more than three

[51] CCO Rule Adopting Release, *supra* note 13, at 20164.

[52] CFTC Volcker Release, *supra* note 9, at n.2521. Subpart D of the Volcker Rule Regulations requires a banking entity engaged in activities covered by the Volcker Rule to develop and implement a compliance program reasonably designed to ensure and monitor compliance with the Volcker Rule prohibitions and restrictions. The compliance program must include written policies and procedures, internal controls, a management framework, independent testing of the program, training, and recordkeeping. 12 CFR part 208, subpart D.

[53] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (Feb. 14, 2012).

[54] *Id.*, at 8408.

[55] CFTC Staff Advisory, Volcker Rule Compliance, January 19, 2016.

years after swap dealers first became provisionally registered — swap dealers should be complying with the CFTC swap dealer requirements. The next round of annual reports is due in March 2016. The CFTC's comments on these reports, and whether the CFTC requires revisions to the reports that are submitted, will provide an indication of the agency's views as to whether swap dealer CCOs are meeting these expectations.

Both the CFTC and NFA have engaged in a constructive dialogue with swap dealers on several important regulatory issues, providing guidance through a combination of no-action letters, written guidelines, and an iterative registration and Section 4s Submission process. The CFTC and NFA have also given swap dealers time to adjust to the new swap dealer regulatory regime. However, two significant issues remain for which additional engagement and guidance would be helpful. First, non-U.S. swap dealers continue to grapple with the scope and application of substituted compliance generally, and especially after the *Deutsche Bank* matter,[56] with substituted compliance for supervisory duties in particular. In addition, now that Volcker Rule compliance has begun and swap dealers that are also banking entities are examining their compliance programs and responsibilities in advance of the next CCO annual report, it is important that the meaning and impact of Footnote 2521, and the interplay of the CCO Rule and the Volcker Rule Requirements, be clear and on a firm foundation. The Commission has established a position on both of these important swap dealer issues without providing swap dealers and other market participants the same level of meaningful opportunity to participate in the decision-making process as it has on other issues. In our view, both the regulators and swap dealers would benefit greatly from additional and timely engagement, and further consideration by the CFTC and NFA on these two important issues. ■

[56] *See supra* note 46.

The Review of Securities & Commodities Regulation

General Editor
Michael O. Finkelstein

Associate Editor
Sarah Strauss Himmelfarb

Board Members

Jay Baris
Morrison & Foerster LLP
New York, NY

James N. Benedict
Milbank, Tweed, Hadley & McCloy LLP
New York, NY

John C. Coffee, Jr.
Columbia Law School
New York, NY

Roberta S. Karmel
Brooklyn Law School
Brooklyn, NY

Amy Jane Longo
O'Melveny & Myers LLP
Los Angeles, CA

Rita M. Molesworth
Willkie Farr & Gallagher LLP
New York, NY

Richard M. Phillips
K&L Gates LLP
San Francisco, CA

A. Robert Pietrzak
Sidley Austin LLP
New York, NY

Irving M. Pollack
Pollack & Storch LLP
Washington, DC

Norman S. Poser
Brooklyn Law School
Brooklyn, NY

Edmund R. Schroeder
Scarsdale, NY

Heath P. Tarbert
Allen & Overy LLP
Washington, D.C.