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Katten Attorneys Sit Down With the Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight Director and National Futures Association's New OTC Derivatives Head

CFTC Guidance Regarding CCO Annual Compliance Reports

Background: A CCO's Obligation to File Annual Compliance Reports

All futures commission merchants (FCMs) and swap dealers (SDs) must appoint a chief compliance officer (CCO).¹ Among the required duties of a CCO is to prepare and sign an annual compliance report. These reports must be filed with the Commodity Futures Trading Commission (CFTC) by no later than 90 days after each FCM's and SD's fiscal year-end and contain a certification by the firm's CCO or chief executive officer that, to the best of his or her knowledge and reasonable belief, all information contained in the annual report is materially accurate and complete.² Other CFTC-regulated entities also have obligations to submit CCO annual reports to the CFTC (e.g., derivatives clearing organizations³ and swap execution facilities⁴). However, the CFTC's revised guidance is expressly applicable solely to FCMs and SDs (although the guidance is helpful to CCOs of all registered entities that must file an annual compliance report with the CFTC).

The CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) issued initial guidance regarding CCO annual reports in 2014.⁵ The CFTC refreshed this guidance in 2018 when it amended its rules related to CCOs and their annual compliance reports.⁶

¹ 17 C.F.R. § 39.10; 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; Final Rule, 77 FR 20127 (Apr. 3, 2012).

² Annual Compliance Report Requirements, CFTC Staff Advisory No. 19-24 (Dec. 4, 2019).

³ 17 C.F.R. § 39.10(c)(3) and (4).

⁴ 17C.F.R. § 37.1501(e) and (f).

⁵ Chief Compliance Officer Annual Reports, CFTC Staff Advisory No. 14-153 (Dec. 22, 2014).

⁶ Chief Compliance Officer Duties and Annual Report Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants, 83 FR 43510 (Aug. 27, 2018) (codified at 17 CFR § 3.3); Chief Compliance Officer Annual Report Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants; Amendments to Filing Dates, 81 FR 80563 (Nov. 16, 2016).

CFTC's December 2019 Guidance

In December 2019, DSIO issued updated guidance on certain required elements of the CCO annual compliance reports.⁷ DSIO generally framed its guidance in terms of deficiencies it believed should be corrected based on its review of 2018 CCO annual compliance reports.

The CFTC staff also included a list of common deficiencies and recommendations regarding the CCO's annual report's certification requirement and other matters.⁸

The common deficiencies identified by staff in recent reports are:

Areas for Improvement

- Failure to include a discussion of why the area needs improvement
- Failure to include the current status of the area for improvement
- Failure to cite to the Commission regulation associated with the area for improvement
- Failure to provide sufficient context or explanatory information regarding an area for improvement

Prospective Changes or Improvements to Compliance Program

- Failure to address this element at all
- Failure to provide an adequate discussion of the CCO's recommended improvements or changes

Financial, Managerial, Operational and Staffing Resources

- Providing budget and staffing information at a parent or consolidated level, rather than a Registrant level
- Aggregating compliance costs not related to complying with the CEA and Commission regulations with the compliance costs of complying with the CEA and Commission regulations

Material Non-Compliance Issues

- Multiple or consecutive CCO Annual Reports that only discuss material non-compliance issues that were identified by external entities — potentially indicating an improper standard of materiality, insufficient self-evaluation, or lack of proper CCO engagement

CCO Certification Requirement

- Modification of the certification language contained in 3.3(f)(3)

⁷ Annual Compliance Report Requirements, CFTC Staff Advisory No. 19-24 (Dec. 4, 2019).

⁸ 17 C.F.R. § 3.3(e) and (f).

Areas for Improvement

- Identifying the underlying regulatory requirement associated with a cited area for improvement
- Including a full discussion of the various areas or initiatives the CCO has identified that are intended to help facilitate the Registrant's compliance in the areas for improvement discussion and not limiting the discussion to policies and procedures
- Using the areas for improvement discussion to raise issues that do not rise to the level of material non-compliance issues

Prospective Changes or Improvements to Compliance Program

- Including discussions of potential or prospective changes or improvements in a stand-alone section in the CCO Annual Report
- Including a discussion of any recommendation or change to the compliance program that necessitates a change in resource allocation

Financial, Managerial, Operational and Staffing Resources

- Providing sufficient information for DSIO staff to assess the adequacy of the resources dedicated to compliance with the CEA and related Commission regulations
- Reasonably estimating the portion of the aggregated numerical information dedicated to such compliance when unable to provide precise numerical budget and staffing information related to compliance with the CEA and the Commission's regulations
- Including a description of software, including the name of the specific software used for compliance purposes, how the software is used by personnel and how the software fits into the entity's overall regulatory compliance

Material Non-Compliance Issues

- Including a discussion of the Registrant's independent evaluation of its own compliance program
- Including the standard of materiality in the CCO Annual Report's discussion of material non-compliance issues under § 3.3(e)(5)

Material Changes to Compliance Policies and Procedures

- Identifying those changes to the policies and procedures that are material, as that term is defined and discussed by the Registrant in its CCO Annual Report

Furnishing the Annual Report and Related Matters

- When applicable, including a statement that the audit committee (or equivalent body) requirement in 3.3(f)(1) is not applicable to a Registrant in its CCO Annual Report

⁹ Annual Compliance Report Requirements, CFTC Staff Advisory No. 19-24 (Dec. 4, 2019).

Coverage Period of the Report

- Including the specific dates of coverage in the CCO Annual Report

January 2020 Public Statement

In January 2020, DSIO issued a public statement advising FCMs and SDs that the guidance it issued on December 4, 2019 was more aspirational than mandatory for such registrants' 2019 reports to be filed this year.¹⁰ Acknowledging the late issuance of its guidance, DSIO said that while it expected CCOs to “take reasonable measures” to institute the guidance’s recommendations this year, it expects CCOs “to consider those recommendations more completely when preparing their 2020 annual reports” to be filed in 2021.

Katten’s Recommendations Regarding CCO Annual Compliance Reports for Fiscal Year 2019

Given the status of the December 2019 Guidance, how should a practitioner proceed? SD members of the NFA (Members) should make sure they have considered each of elements of the guidance, and, to the extent one or more specific proposals are not feasible because of insufficient time, document the CCO’s analysis and retain that documentation.

NFA Exams

Background

The National Futures Association (NFA) is the self-regulatory organization for the US derivatives industry. The NFA and CFTC cooperate to supervise derivatives activities in the United States.

In order to supervise Members’ activities, the NFA periodically examines both US and non-US SDs in either pre-scheduled or *ad hoc* exams regarding the SDs compliance with NFA and CFTC rules and regulations. The priorities for the examination of a given firm are tailored pursuant to a risk-based analysis of the firm’s:

- Previous exam findings
- Swap valuation dispute notices
- Risk data filings
- Self-reported non-compliance issues
- Other filings including CCO Annual Reports and Risk Exposure Reports

¹⁰ <https://www.cftc.gov/PressRoom/SpeechesTestimony/dsio120419advstatement010220>

Additionally, the NFA monitors firms on an ongoing basis in order to keep abreast of changes and significant developments at SD Member firms by conducting periodic meetings and phone interviews with SD Member firms, reviewing reports submitted by the SDs and assessing market events.¹¹

Structure of an NFA Examination¹²

Announcement

The NFA will contact the Member firm and announce an upcoming examination. Following the initial contact, a formal announcement, known as a “First Day Letter,” also will be sent. Additionally, the NFA will notify the CTFC and local regulators of the planned examination. Then, the NFA will contact the Member firm to announce the upcoming examination. The NFA will also send a First Day Letter to the firm containing:

- Examination scope
- Preliminary document and meeting requests
- Proposed meeting schedules and agendas for on-site fieldwork
- Management Representation Letter to be signed by a principal of the firm prior to issuance of the examination report
- Data Transfer Agreement (non-US firms only) to be signed by a principal of the firm prior to the start of the examination

Fieldwork

The on-site portion generally lasts between two and four weeks. During this phase, Members can expect NFA to:

- Interview key personnel
- Review policies, procedures, reports and documentation
- Assess the Member’s compliance with NFA rules and CFTC regulations
- Request documents
- Conduct an exit interview

Reporting

Following fieldwork, the NFA will hold an Examination Closing Meeting to discuss findings; and issue a written examination report.

¹¹ <https://www.nfa.futures.org/members/sd/sd-exams.html>

¹² <https://www.nfa.futures.org/members/sd/sd-exams.html>

Remediation

To the extent corrective action(s) must be taken, the Firm is required to provide a written response within 35 days after the issuance of the examination report which should include:

- Remediation plan
- Name of individual responsible for remediation
- Target date for completion

Exam Priorities for 2019

In February 2019, DSIO (among other CFTC divisions) published its examination priorities in a press release.¹³ DSIO's stated priorities were as follows:

- Withdrawal of residual interest from customer accounts
- Accepted forms of non-cash margin
- Compliance with segregation requirements
- FCM use of customer depositories
- FCM customer account documentation

¹³ <https://www.cftc.gov/PressRoom/PressReleases/7869-19>

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| Appendices



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Division of Swap Dealer and
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Joshua B. Sterling
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December 4, 2019

Audience: Registered Swap Dealers, Futures Commission Merchants, and Major Swap Participants

Topic: Annual Compliance Report Requirements

I. Introduction and Background

The Division of Swap Dealer and Intermediary Oversight (“DSIO”) of the Commodity Futures Trading Commission (“Commission” or “CFTC”) is issuing this advisory to provide further guidance on certain requirements applicable to swap dealers, futures commission merchants, and major swap participants¹ (collectively, “Registrants”) in connection with the preparation and submission of chief compliance officer (“CCO”) annual compliance reports (“CCO Annual Reports”) pursuant to § 3.3.²

The Commission issued a final rule governing the preparation and submission of CCO Annual Reports in April 2012 (“2012 Final Rule”).³ In December 2014, DSIO issued a staff advisory providing Registrants guidance and recommendations for best practices regarding future CCO Annual Reports (“2014 Advisory”).⁴ Most recently, in August 2018, the Commission modified its regulations related to CCO Annual Report requirements (“2018 Final Rule”).⁵ Concurrent

¹ Currently there are no registered major swap participants.

² 17 CFR § 3.3 (2019). This advisory is intended to assist Registrants by setting forth the staff’s interpretations and recommendations relating to CCO Annual Reports. This advisory is not binding on the Commission and should not be interpreted as establishing any new regulatory requirements.

³ 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; Final Rule, 77 FR 20127 (Apr. 3, 2012).

⁴ Chief Compliance Officer Annual Reports, CFTC Staff Advisory No. 14-153 (Dec. 22, 2014).

⁵ Chief Compliance Officer Duties and Annual Report Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants, 83 FR 43510 (Aug. 27, 2018) (codified at 17 CFR § 3.3). In addition, unrelated to the content requirements discussed in this advisory, in November 2016 the Commission issued a final rule amending the timing for furnishing CCO Annual Reports to the Commission. Chief Compliance Officer

with the 2018 Final Rule, the Commission published guidance in the form of an appendix to part 3 that focused specifically on the requirements of § 3.3(e) (“2018 Guidance”).⁶

DSIO staff has reviewed each of the CCO Annual Reports submitted for the 2018 fiscal year, most of which were submitted after the effective date of the 2018 Final Rule and publication of the 2018 Guidance. In light of this review, DSIO staff believes it is helpful to provide additional guidance to Registrants regarding the requirements of §§ 3.3(e) and (f).

In this advisory, DSIO staff will address the following areas of the CCO Annual Report: (1) areas for improvement; (2) financial, managerial, operational, and staffing resources; (3) material non-compliance issues; (4) furnishing the annual report and related matters; (5) the certification requirement; and (6) other miscellaneous items. A Registrant that files a CCO Annual Report that DSIO staff determines is not in compliance with §§ 3.3(e) and (f) may be required to file a corrected CCO Annual Report as required by § 3.3(f)(4).

II. Guidance

A. Commission regulation 3.3(e)(3): Areas for improvement

Commission regulation 3.3(e)(3) requires that each CCO Annual Report contain a description of “[a]reas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance.”⁷ This requirement consists of two distinct components.⁸ First, Registrants must identify and discuss the area(s) needing improvement, including the basis for each recommended area(s) for improvement. Second, the CCO Annual Report must discuss what changes the CCO is recommending to address such area(s), including the proposed improvements and the time frame for their implementation. In addition, the discussion should include cross-references to the regulations that the area(s) for improvement and recommended changes would address.⁹

The following sections address certain deficiencies with respect to the required discussion under § 3.3(e)(3) that DSIO staff observed in many of the CCO Annual Reports submitted for the 2018 fiscal year.

Annual Report Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants; Amendments to Filing Dates, 81 FR 80563 (Nov. 16, 2016).

⁶ 83 FR at 43523 (codified as Appendix C to Part 3 – Guidance on the Application of § 3.3(e), Chief Compliance Officer Annual Report Form and Content, 17 CFR pt. 3 app. C).

⁷ 17 CFR § 3.3(e)(3).

⁸ 17 CFR pt. 3 app. C, at C.1.; *see also* 2014 Advisory at 6-7.

⁹ 17 CFR pt. 3 app. C, at C.1.

i. Areas for improvement discussion

Many of the 2018 CCO Annual Reports were deficient in their discussion of the areas for improvement. In general, DSIO staff often concluded that additional context around the identified areas for improvement was necessary to fully satisfy the requirements of § 3.3(e)(3). For example, some CCO Annual Reports failed to include a discussion of why the area needs improvement. In addition, some CCO Annual Reports failed to include the current status of the area for improvement, for example whether a compliance failure was ongoing and/or any remediation plan. Without these key pieces of information, DSIO staff may be unable to fully assess the nature or status of the area for improvement. Further, CCO Annual Reports did not always cite to the Commission regulation associated with the area for improvement. Where an identified area for improvement has an underlying regulatory requirement, the regulation should be cited in the CCO Annual Report. Notably, in the 2012 Final Rule, the Commission stated that the CCO Annual Report serves two purposes – to focus the registrant’s board and senior officer on areas requiring additional compliance resources or changes to business practices, and to provide the Commission with a detailed overview of the state of compliance of the industry as a whole.¹⁰ Whereas a Registrant’s board of directors (“BOD”) or senior officer is likely familiar with the firm’s swaps business or related strategic initiatives, Commission staff may have less familiarity with the structure of a specific Registrant or its particular areas of challenge. As a result, without this information, DSIO staff may be unable to form a complete view as to the Registrant’s state of compliance for the CCO Annual Report’s scope period, and therefore, may consider the CCO Annual Report to not be in compliance with § 3.3(e).

Areas for Improvement and Assessments of Effectiveness. Another commonly identified issue was CCO Annual Reports including the discussion of the areas for improvement within the section addressing the CCO’s assessment of effectiveness of the Registrant’s policies and procedures under § 3.3(e)(2). CCO Annual Reports that did not include the areas for improvement discussion in a stand-alone section, but rather included it in the discussion of the CCO’s assessment, often did not include the explanatory information discussed above regarding the areas for improvement. The discussion of areas for improvement is not limited to identifying policies and procedures that are not effective, which is one of the core roles of the assessment of effectiveness requirement under § 3.3(e)(2). Although an ineffective policy or procedure could be an area for improvement, the areas for improvement discussion requirement in § 3.3(e)(3) is not limited to policies and procedures, and should include a full discussion of the various areas or initiatives the CCO has identified that are intended to help facilitate the Registrant’s compliance, including providing the additional context around the area for improvement discussed above.

“The areas for improvement discussion requirement in § 3.3(e)(3) is not limited to policies and procedures.”

ii. Potential or prospective changes or improvements to compliance program and resources devoted to compliance

¹⁰ 2012 Final Rule, 77 FR at 20190.

In addition to identifying areas for improvement, § 3.3(e)(3) requires the CCO Annual Report to discuss what changes are being recommended to address each area needing improvement.¹¹ Registrants have addressed this requirement in two different ways. Some CCO Annual Reports contained a discussion of potential or prospective changes or improvements to the compliance program and resources devoted to compliance in the areas for improvement section of the CCO Annual Report. Other CCO Annual Reports contained a stand-alone section dedicated to a discussion of the potential or prospective changes or improvements. **DSIO staff recommends including discussions of potential or prospective changes or improvements in a stand-alone section in the CCO Annual Report.**

DSIO staff found that when a CCO Annual Report did not contain a stand-alone section addressing the CCO's recommended improvements or changes to the compliance program or compliance resources, it was more likely that the CCO Annual Report either did not address this element at all, or did not provide an adequate discussion of the CCO's recommended improvements or changes. This was particularly true with respect to the discussion of potential or prospective changes or improvements to the resources devoted to compliance. If a CCO makes a recommendation or change to the compliance program that necessitates a change in resource allocation, DSIO staff would generally expect a corresponding discussion of such change in this section of the report.

iii. CCO Annual Report sections other than “Areas for Improvement” and “Material Non-Compliance Issues”

Commission regulations 3.3(e)(3) and 3.3(e)(5) require a discussion of areas for improvement and material non-compliance issues, respectively. However, some CCO Annual Reports contained additional sections, such as “areas for continued focus and diligence” or “other compliance challenges,” where compliance issues, other than those discussed in the areas for improvement and material non-compliance sections, were discussed. As discussed above, the areas for improvement discussion required by § 3.3(e)(3) already provides a mechanism for identifying areas of concern or possible compliance issues that do not rise to the level of material non-compliance to the Registrant's BOD or senior officer and the Commission. The discussion of areas for improvement is required to contain certain elements that are designed to inform the Commission and DSIO staff of potential compliance issues. DSIO staff is concerned that Registrants may fall short of the information requirements associated with the areas for improvement and material non-compliance sections if potential compliance issues are reported in alternative sections. DSIO staff recommends that, as a best practice, **Registrants that are reporting compliance issues not rising to the level of material non-compliance should report those issues as areas for improvement, and include the required associated discussion**, as set out above.

B. Commission regulation 3.3(e)(4): Financial, managerial, operational, and staffing resources

¹¹ 17 CFR pt. 3 app. C, at C.

Commission regulation 3.3(e)(4) requires the CCO Annual Report to contain a discussion of the financial, managerial, operational, and staffing resources set aside for compliance with the Commodity Exchange Act (“CEA”) and the Commission’s regulations. The most common deficiency that DSIO staff identified in its review of CCO Annual Reports was in connection with this requirement. DSIO staff understands that a discussion of specific compliance budget allocations can be challenging to accurately convey, particularly when factoring in the size and complexity of a Registrant’s compliance program and the extent to which shared compliance resources may be used for non-CFTC activities. The following discussion should facilitate an understanding of the type of information DSIO staff generally expects CCO Annual Reports to contain in order to adequately address this element of the report.

The financial, managerial, operational, and staffing resources discussion should include information specific to the Registrant submitting the CCO Annual Report. Budget and staffing information that is provided at a parent or consolidated level, rather than the Registrant level, is not sufficient to satisfy the reporting requirements of § 3.3(e)(4). For example, a firm that has multiple registered swap dealers and futures commission merchants must make an effort to provide budget and staffing information for each of those Registrants in their respective CCO Annual Reports. Aggregate budget and staffing information for the parent entity rather than the specific Registrant does not, itself, provide an adequate understanding of the resources the

“Budget and staffing information that is provided at a parent or consolidated level, rather than the Registrant level, is not sufficient to satisfy the reporting requirements of § 3.3(e)(4).”

Registrant has dedicated to compliance with the CEA and Commission regulations. In addition to providing aggregate budget and staffing information for the parent entity, Registrants should also include budget and staffing information specific to the Registrant.

Non-CEA Compliance Obligations. Similarly, DSIO staff understands that Registrants may have compliance obligations beyond those related to the CEA and Commission regulations. Those additional compliance obligations may require significant financial and staffing resources. If these additional compliance costs are included in the CCO Annual Report, they should be disaggregated from the compliance costs associated with complying with the CEA and Commission regulations. For example, a swap dealer that is also a bank may provide budget and staffing numbers at the swap dealer entity level for all compliance. However, the allocation of compliance costs associated with complying with the CEA and Commission regulations must also be included. For example, if the swap dealer/bank spends 90% of its budget on compliance with prudential regulatory requirements, this additional information is critical for the Commission to understand the adequacy of funding and staffing for compliance with the CEA and Commission regulations.

Estimated Compliance Costs. As stated in the 2018 Guidance, the Commission acknowledges that providing budget and staffing information to satisfy the requirements of § 3.3(e)(4) may not be straightforward.¹² This may be particularly true, as discussed above, when a Registrant is part

¹² *Id.*

of an affiliated group of entities operating with a single compliance budget, or when a compliance budget is also used for non-CFTC compliance matters. Therefore, the 2018 Guidance contemplates the use of estimated figures when providing the required information to the Commission. However, the 2018 Guidance also states that the “Commission expects that the CCO Annual Report will still address shared resources in as much detail as is necessary to convey the information needed to assess the overall compliance activities of the Registrant.”¹³ DSIO staff reaffirms that expectation here. **If a Registrant is unable to provide precise numerical budget and staffing information related to compliance with the CEA and the Commission’s regulations, an effort should be made to reasonably estimate the portion of the aggregated numerical information dedicated to such compliance.**

Based on its review of fiscal year 2018 CCO Annual Reports, DSIO staff recommends including an explanation of the basis for the provided estimate as a best practice going forward. Registrants may use different methods to estimate the percentage of the shared budget and staffing allocated to CEA and Commission regulation compliance, as appropriate depending on the circumstances of the Registrant. The key point, however, is that each Registrant should provide sufficient information for DSIO staff to assess the adequacy of the resources dedicated to compliance with the CEA and related Commission regulations.

Operational Resources. In addition to a discussion of financial and staff resources, § 3.3(e)(4) requires the CCO Annual Report to include a discussion of the Registrant’s operational resources. As discussed in the 2018 Guidance, this element should discuss general infrastructure information, including compliance-oriented software and technology infrastructure.¹⁴ **With respect to compliance-oriented software, the most useful discussions would include a description of the software, including the name of the specific software used for compliance purposes, how the software is used by personnel, and how the software fits into the entity’s overall regulatory compliance program.**

C. Commission regulation 3.3(e)(5): Material non-compliance issues

Commission regulation 3.3(e)(5) requires the CCO Annual Report to contain a description of any identified material non-compliance issues.¹⁵ This requirement is consistent with the Commission’s intent that CCO Annual Reports promote compliance behavior through periodic self-evaluation.¹⁶ The 2018 Guidance stated that this discussion should include a description of each material non-compliance issue, whether identified through an internal self-assessment or through a review by an external entity such as a designated self-regulatory organization.¹⁷

¹³ *Id.*

¹⁴ *Id.*

¹⁵ 17 CFR § 3.3(e)(5).

¹⁶ See Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant, 75 FR 70881, 70883 (proposed Nov. 19, 2010).

¹⁷ 17 CFR pt. 3 app. C, at E.

Based on its review of the most recently filed CCO Annual Reports, DSIO staff believes it is necessary to clarify its view that reliance on a designated SRO as the sole evaluator for a Registrant's compliance program is inconsistent with the self-evaluation intent and purpose of § 3.3.

DSIO staff recognizes that § 3.3(d)(1), which addresses the CCO's duty to administer the Registrant's written policies and procedures ("WPPs"), and § 3.3(d)(3), which addresses the CCO's duty to take

"Reliance on a designated SRO as the sole evaluator for a Registrant's compliance program is inconsistent with the self-evaluation intent and purpose of § 3.3."

reasonable steps to ensure the Registrant's compliance with the CEA and Commission regulations, both address how the CCO should be actively engaged in the daily compliance activities of the Registrant. Further, § 3.3(e)(2) requires the CCO Annual Report to include a description of the Registrant's assessment of effectiveness of their WPPs. In addition, it is DSIO staff's view that the requirement in § 3.3(e)(5) to describe any identified material non-compliance issue is another important self-evaluation mechanism that should be used to inform the Registrant's BOD or senior officer, as well as the Commission, about the cumulative results of the CCO's administration of the WPPs and the reasonable steps taken to ensure compliance. DSIO staff recognizes that even with the most robust compliance and monitoring program in place, a Registrant may simply not identify any non-compliance issues that it deems to be material. However, in DSIO staff's view, multiple or consecutive CCO Annual Reports that only discuss material non-compliance issues that were identified by external entities may indicate an improper standard of materiality, insufficient self-evaluation, or lack of proper CCO engagement. Therefore, although it is appropriate for Registrants to include findings of reviews by external entities, CCO Annual Reports should also include any material findings from the Registrant's own self-evaluations.¹⁸

Standard of Materiality. In addition, in connection with the discussion of material non-compliance issues, DSIO staff considers it critical that the CCO Annual Report include a discussion of the standard that the Registrant used to determine whether a non-compliance issue was deemed to be material as specified in the 2018 Guidance.¹⁹ Although the Commission has not defined "material" for the purposes of § 3.3(e)(5), including the Registrant's standard of materiality in the CCO Annual Report allows DSIO staff to understand the process through which issues were selected for inclusion in the material non-compliance section of the report. Without a discussion of the materiality standard, DSIO staff lacks context to evaluate the identified material non-compliance issues. DSIO staff reiterates the 2018 Guidance and emphasizes that **the standard of materiality should be included in the CCO Annual Report's discussion of material non-compliance issues under § 3.3(e)(5).**²⁰

¹⁸ Although this clarification is discussed here in connection with the material non-compliance section of the CCO Annual Report, the same clarification applies to the areas for improvement section of the CCO Annual Report. Neither section should be entirely reliant on the reviews of external entities.

¹⁹ 17 CFR pt. 3 app. C, at E.

²⁰ *Id.*

D. Commission regulation 3.3(f)(1): Furnishing the annual report and related matters

Commission regulation 3.3(f)(1), as modified by the 2018 Final Rule, contains two furnishment requirements. First, the CCO must provide the CCO Annual Report to the BOD or senior officer of the Registrant.²¹ Second, the CCO must furnish the CCO Annual Report to the audit committee (or an equivalent body) if the Registrant has such a body.²² In both cases, a written record of the transmittal of the report must be maintained.²³

Most of the CCO Annual Reports reviewed by DSIO staff addressed the first furnishment requirement and stated when and to whom the CCO Annual Report was provided. Some also discussed the second furnishment requirement either by stating when the CCO Annual Report was, or would be, furnished to the audit committee (or equivalent body), or by stating that the Registrant does not have such a body. **If the audit committee (or equivalent body) requirement is not applicable to a Registrant, DSIO staff recommends that the Registrant include a statement to that effect in its CCO Annual Report.** Including such a statement makes clear that the requirements of § 3.3(f)(1) have been met and reduces the need for additional follow-up inquiries to the Registrant.

E. Commission regulation 3.3(f)(3): Certification requirement

Commission regulation 3.3(f)(3) requires the CCO Annual Report to include a certification by the CCO or the chief executive officer 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 in all material respects.”²⁴ This certification should not be modified, amended, or otherwise altered by the certifying officer. **DSIO staff’s view is that a certification statement that varies from the exact language in § 3.3(f)(3) fails to satisfy the certification obligation rendering the CCO Annual Report noncompliant with § 3.3(f)(3).**

F. Volcker Rule

In 2014, the Commission adopted a final rule setting out certain prohibitions and restrictions on the ability of a banking entity and a non-bank financial company supervised by the Board of Governors of the Federal Reserve System to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund (“2014 Volcker Rule”).²⁵ The 2014 Volcker Rule release stated that for registered swap dealers to which the rule applies, “the compliance requirements of subpart D are included in the Commission’s regulations that are

²¹ 17 CFR § 3.3(f)(1)(i).

²² 17 CFR § 3.3(f)(1)(ii).

²³ 17 CFR § 3.3(f)(1)(iii).

²⁴ 17 CFR § 3.3(f)(3).

²⁵ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 FR 5808 (Jan. 31, 2014).

to be addressed as part of the [CCO] duties and requirements under CFTC regulation 3.3.”²⁶ In response to the Commission’s notice of proposed rulemaking related to CCO Annual Reports issued in 2017, the Commission received two comments related to this Volcker Rule footnote. The Commission noted these comments in its 2018 Final Rule.²⁷ Although it declined to address the comments at the time, the Commission stated that it may address the issue in future guidance or rulemakings.

To provide clarity to Registrants, DSIO staff is taking the opportunity to address the subpart D compliance requirements here. If applicable to a Registrant, DSIO staff expects the compliance requirements of subpart D of part 75 of Commission regulations to continue to be included as part of the CCO duties and requirements under § 3.3. DSIO staff notes that this means that **a discussion of subpart D of part 75 of the Commission’s regulations and applicable subpart D requirements, as well as any applicable final rule amendments, should be included among the suite of compliance obligations addressed in the CCO Annual Report.**

G. Other Items

DSIO staff is also making the following recommendations related to the content of the CCO Annual Report.

Coverage period of the report. The CCO Annual Report covers the most recently completed fiscal year of the Registrant.²⁸ Staff recommends that the **Registrant include the specific dates of coverage in the CCO Annual Report.** For example, if a Registrant is on a calendar year fiscal year, the report would contain a statement that the CCO Annual Report covers the time period from January 1st to December 31st of the relevant year.

Material changes to compliance policies and procedures. Commission regulation 3.3(e)(6) requires the CCO Annual Report to include a description of any material changes to compliance policies and procedures.²⁹ In the 2018 Guidance, the Commission stated that when describing such material changes, a description of the standard of materiality should be provided.³⁰ As discussed above in section II.C. regarding material non-compliance issues, the description of the standard of materiality is critical to the context of the required discussion and necessary for DSIO staff’s understanding of the CCO Annual Report. It is not sufficient to provide updated policies and procedures or to list all changes to those policies and procedures. **An effort should**

²⁶ *Id.* at 6020 n. 2521.

²⁷ 2018 Final Rule, 83 FR at 43519 (stating: “FIA/ SIFMA requested that the Commission revisit the footnote in the part 75 adopting release that includes the compliance requirements under subpart D of part 75 among the regulations covered by § 3.3(d) and (e). Similarly, ISDA requested that the Commission remove the requirement for an applicable [futures commission merchant] or [swap dealer] to address Volcker compliance program requirements in its CCO Annual Report.” (internal citation omitted)).

²⁸ 17 CFR § 3.3(e).

²⁹ 17 CFR § 3.3(e)(6).

³⁰ 17 CFR pt. 3 app. C, at F.

be made to identify those changes to the policies and procedures that are material, as that term is defined and discussed by the Registrant in its CCO Annual Report.

III. Conclusion

The goal of this advisory is to foster better compliance with the Commission's regulations by Registrants when creating and furnishing their CCO Annual Reports. This advisory does not address all aspects of the CCO Annual Report but seeks to address those areas that present common and consistent challenges to a large proportion of Registrants. A summary list of some common deficiencies and staff recommendations is included here as attachment A. DSIO staff and the Commission have provided many of the clarifications and recommendations contained in the foregoing discussion in prior publications. Emphasis of those recommendations in this advisory should indicate to Registrants that these areas still cause concern with respect to many CCO Annual Reports and that CCOs should review whether their Registrants' CCO Annual Reports align with the requirements and recommendations set out here and in prior Commission rulemakings. Doing so will facilitate a more efficient, and less disruptive, review process for both DSIO staff and Registrants' compliance departments, and will help to ensure that the Registrant is in compliance with the Commission's regulations.

Issued in Washington, D.C. on December 4, 2019, by the Division of Swap Dealer and Intermediary Oversight.

Joshua Sterling

DIRECTOR

Attachment A

Common Deficiencies in CCO Annual Reports

Areas for Improvement

- Failure to include a discussion of why the area needs improvement.
- Failure to include the current status of the area for improvement
- Failure to cite to the Commission regulation associated with the area for improvement.
- Failure to provide sufficient context or explanatory information regarding an area for improvement.

Prospective Changes or Improvements to Compliance Program

- Failure to address this element at all.
- Failure to provide an adequate discussion of the CCO's recommended improvements or changes.

Financial, Managerial, Operational, and Staffing Resources

- Providing budget and staffing information at a parent or consolidated level, rather than a Registrant level.
- Compliance costs not related to complying with the CEA and Commission regulations aggregated with the compliance costs of complying with the CEA and Commission regulations.

Material Non-Compliance Issues

- Multiple or consecutive CCO Annual Reports that only discuss material non-compliance issues that were identified by external entities – potentially indicating an improper standard of materiality, insufficient self-evaluation, or lack of proper CCO engagement.

Certification Requirement

- Modification of the certification language contained in 3.3(f)(3).

Attachment A (continued)

Staff Recommendations for CCO Annual Reports

Areas for Improvement

- Identifying the underlying regulatory requirement associated with a cited area for improvement.
- Including a full discussion of the various areas or initiatives the CCO has identified that are intended to help facilitate the Registrant's compliance in the areas for improvement discussion and not limiting the discussion to policies and procedures.
- Using the areas for improvement discussion to raise issues that do not rise to the level of material non-compliance issues.

Prospective Changes or Improvements to Compliance Program

- Including discussions of potential or prospective changes or improvements in a stand-alone section in the CCO Annual Report.
- Including a discussion of any recommendation or change to the compliance program that necessitates a change in resource allocation.

Financial, Managerial, Operational, and Staffing Resources

- Providing sufficient information for DSIO staff to assess the adequacy of the resources dedicated to compliance with the CEA and related Commission regulations.
- If unable to provide precise numerical budget and staffing information related to compliance with the CEA and the Commission's regulations, reasonably estimating the portion of the aggregated numerical information dedicated to such compliance.
- Including a description of software, including the name of the specific software used for compliance purposes, how the software is used by personnel, and how the software fits into the entity's overall regulatory compliance.

Material Non-Compliance Issues

- Including a discussion of the Registrant's independent evaluation of its own compliance program.
- Including the standard of materiality in the CCO Annual Report's discussion of material non-compliance issues under § 3.3(e)(5).

Material Changes to Compliance Policies and Procedures

- Identifying those changes to the policies and procedures that are material, as that term is defined and discussed by the Registrant in its CCO Annual Report.

Attachment A (continued)

Staff Recommendations for CCO Annual Reports (continued)

Furnishing the Annual Report and Related Matters

- When applicable, including a statement that the audit committee (or equivalent body) requirement in 3.3(f)(1) is not applicable to a Registrant in its CCO Annual Report.

Coverage Period of the Report

- Including the specific dates of coverage in the CCO Annual Report.

SPEECHES & TESTIMONY

January 3, 2020

Statement of Division of Swap Dealer and Intermediary Oversight on Annual Compliance Report Requirements

Washington, DC — On December 4, 2019, the Division of Swap Dealer and Intermediary Oversight (DSIO) issued an advisory regarding annual compliance report requirements for swap dealers, futures commission merchants, and major swap participants (Advisory).^[1] The Advisory clarifies annual compliance reporting requirements for those categories of registered firms and provides additional recommendations to those firms regarding the manner in which they prepare their reports. DSIO intends the Advisory to help registrants improve the quality and usefulness of their reports in accordance with their existing obligations under CFTC Regulation 3.3.^[2]

DSIO considers the Advisory to be targeted in scope and to reflect certain iterations in its thinking about how annual compliance reports can be more effective, based on its years of experience in reviewing reports submitted by registered firms. At the same time, DSIO is aware that having issued the Advisory in December may present challenges for chief compliance officers (CCOs) of registered firms to adapt their existing reporting procedures in time to produce reports in 2020 that take the Advisory into full consideration.

The Advisory is merely guidance and does not impose any new requirements. As such, DSIO expects that CCOs will take reasonable measures to implement the Advisory's recommendations when preparing their annual compliance reports for 2019. DSIO recognizes that CCOs may not be able to implement those recommendations fully for their 2019 reports given the potential timing constraints identified above. DSIO does expect, however, that CCOs will be able to consider those recommendations more completely when preparing their 2020 annual reports, which will be due in 2021.

Any questions regarding this statement should be directed to the following DSIO Staff members: Amanda Olear, Acting Deputy Director (202.418.5283, aolear@cftc.gov); Pamela Geraghty, Special Counsel (202.418.5634, pgeraghty@cftc.gov); and Owen Kopon, Special Counsel (202.418.5360, okopon@cftc.gov).

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Division of Swap Dealer and Intermediary Oversight

[1] <https://www.cftc.gov/csl/19-24/download>; see also <https://www.cftc.gov/PressRoom/PressReleases/8090-19>.

[2] 17 C.F.R. § 3.3.

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