

Client Alert

September 5, 2018

CFTC Amends Chief Compliance Officer Duties and Annual Report Requirements

By Julian E. Hammar

On August 27, 2018, the Commodity Futures Trading Commission (“CFTC”) published final rules in the Federal Register amending its regulations regarding duties of chief compliance officers (“CCOs”) of swap dealers (“SD”), major swap participants (“MSPs”) and futures commission merchants (“FCMs”) (collectively, “Registrants”) and requirements for preparing, certifying and furnishing to the CFTC the annual report containing an assessment of these Registrants’ compliance activities.¹ The overarching goals of the rule amendments are to make clarifications regarding the rules in light of the CFTC’s experience in administering them and harmonize the CFTC’s rules with similar rules of the Securities and Exchange Commission (“SEC”) applicable to security-based swap dealers. Specifically, the final rule amendments:

- Define the term “senior officer,” to whom CFTC rules require the CCO report directly in the alternative to reporting directly to the board of directors, as the Chief Executive Officer (“CEO”) or other equivalent officer, consistent with the SEC’s CCO rule;
- Clarify that the CCO’s duty to administer policies and procedures applies in relation to the Registrant’s business as an SD, MSP or FCM’s businesses that are required to be established pursuant to the Commodity Exchange Act (“CEA”) and CFTC regulations;
- Provide that CCOs have a duty, in consultation with the board of directors or senior officer, to “take reasonable steps” to resolve “material” conflicts of interest relating to the Registrant’s business as an FCM, SD or MSP (and not all conflicts as proposed); and
- Require that CCOs take “reasonable steps” to ensure the Registrant establishes, maintains and reviews applicable policies and procedures to remediate noncompliance issues identified by the CCO, no longer requiring that the CCO consult with the board or senior officer in connection with establishing procedures to remediate noncompliance.

In addition, with regard to the CCO’s annual report, the rule amendments:

- Eliminate the requirement that the annual report identify and assess the effectiveness of each written policy and procedure (“WPP”) for each regulatory requirement under the CEA and CFTC Regulations, although emphasizing that a CCO must still conduct an underlying assessment of the WPPs to meet the rule’s requirements;

¹ *Chief Compliance Officer Duties and Annual Report Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants*, 83 Fed. Reg. 43,510 (Aug. 27, 2018) (the “Release”).

Client Alert

- Require that the report, in lieu of the above assessment, contain, among other things, a description of the CCO's assessment of the effectiveness of the Registrant's WPPs relating to its business as an FCM, SD or MSP;
- Clarify that the discussion of compliance resources can be limited to resources relevant to the Registrant's business as an FCM, SD or MSP;
- Provide that the annual report must be furnished to the board or senior officer prior to submission to the Commission, as well as the audit committee (or equivalent body) if one exists not later than its next scheduled meeting after submission (but in no event later than 90 days after submission);
- Modify the certification requirement such that the CCO must certify that the report is accurate and complete "in all material respects;" and
- Permit dual-registrants and affiliated registrants under certain conditions to incorporate by reference in their reports.

The amendments become effective September 26, 2018, and are available [here](#).

I. BACKGROUND

Section 4d(d) and 4s(k) of the CEA² require that Registrants designate a CCO to fulfill certain duties and prepare and sign an annual report regarding the Registrants' compliance program. The CFTC promulgated regulations in 2012 that implemented these requirements,³ and subsequently issued a staff advisory in 2014 that provided guidance regarding annual reports.⁴ The advisory provided guidance on the annual report's form and content, including the requirement that the Registrant identify and assess each of its WPPs for each regulatory requirement under the CEA and CFTC regulations. In May 2017, the CFTC issued proposed rules to amend the regulations to streamline and clarify the CCO's duties and annual report requirements, as well as to harmonize the CFTC's rules with the SEC's comparable rules for security-based swap dealers.⁵ The final rule amendments stem from this proposal.

II. FINAL RULE AMENDMENTS

A. Definition of "Senior Officer"

The final rule amendments add a definition of the term "senior officer," which is defined as "the chief executive officer or other equivalent officer" of the Registrant.⁶ The definition is consistent with the SEC's definition of senior officer" in the comparable rule for security-based swap dealers.⁷ The CFTC declined to adopt industry

² 7 U.S.C. 6d(d)(FCMs) and 6s(k)(SDs and MSPs).

³ See *Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants*, 83 Fed. Reg. 43,510 (Apr. 3, 2012). The regulations are promulgated at 17 CFR 3.1 and 3.3.

⁴ See CFTC Staff Advisory 14-153 (Dec. 22, 2014).

⁵ For more background on the proposed rules, please see our client alert [here](#).

⁶ 17 CFR 3.1(j).

⁷ See 17 CFR 240.15Fk-1(e)(2).

Client Alert

commenter requests that would have included within the definition the most senior officer within a Registrant's group-wide compliance, risk, legal or other control function, emphasizing that the CCO must directly report to the highest executive level (or the board) at the Registrant.⁸

B. CCO's Duties

1. *Duty to Administer Compliance Policies and Procedures*

The final rule amendments limit the scope of the CCO's duty to administer each of the Registrant's policies and procedures to those policies and procedures "relating to its business as a futures commission merchant, swap dealer or major swap participant that are required to be established by the [CEA] and Commission regulations."⁹ This change, like that of the senior officer definition, is consistent with the SEC's CCO Rules.¹⁰ However, the CFTC declined in response to a commenter's request to amend the rule's language to replace "administer" with "reviewing, evaluating, and advising" the Registrant on its written policies and procedures. Instead, the CFTC emphasized that "the role of the CCO, under the Dodd-Frank Act, goes beyond the customary and traditional advisory role of a CCO and requires more active engagement."¹¹ The CFTC went on to note that the CCO could, in many circumstances, fulfill his or her duty under this provision through actively engaging in processes involving "reviewing, evaluating and advising" on policies and procedures and compliance matters, while others in the organization would remain responsible for daily implementation. However, the CCO remains responsible for elevating significant issues that are not being addressed in a reasonably satisfactory manner to the board or senior officer.

2. *Duty to Resolve Conflicts of Interest*

Consistent with the SEC CCO Rule,¹² the final rule amendments require the CCO, in consultation with the board of directors or senior officer, to take "reasonable steps" to resolve "material conflicts of interest" relating to the Registrant's business as an FCM, SD or MSP.¹³ Thus, the duty required under the rule is qualified by a reasonableness standard (i.e., to take "reasonable" steps) and a materiality standard (i.e., to resolve "material" conflicts of interest). The CFTC did not adopt a set definition of materiality in this context, stating rather that the determination of what is a "material" conflict for a particular Registrant should be assessed based on the relevant facts and circumstances.¹⁴

With regard to the requirement to take reasonable steps, the CFTC emphasized that the CCO must take an active role in the conflict resolution process, including:

⁸ See Release at 43,512.

⁹ 17 CFR 3.3(d)(1).

¹⁰ See 17 CFR 240.15Fk-1(b)(4).

¹¹ Release at 43,512.

¹² See 17 CFR 240.15Fk-1(b)(3).

¹³ 17 CFR 3.3(d)(2).

¹⁴ Release at 43,513-514.

Client Alert

- Direct involvement of the CCO in developing and implementing active processes for conflict identification, evaluation and resolution;
- Advising on the effectiveness of alternatives to mitigate or eliminate conflicts; and
- Escalating conflict issues if the conflicts are not otherwise resolved or mitigated, including through the CCO's direct reporting line to the board or senior officer if necessary or appropriate.¹⁵

The CFTC declined to adopt comments suggesting that CCOs should have a duty to “minimize,” rather than “resolve,” conflicts of interest, noting that it would be inconsistent with Section 4s(k)(2)(C) of the CEA, which explicitly requires conflict resolution.¹⁶ However, in addition to the elimination of conflicts where reasonably practicable, the CFTC stated that resolution can include mitigation of conflicts to the point where they are no longer material.¹⁷

3. *Duty to Ensure Compliance*

The CFTC declined, as had been proposed, to amend the CCO's duty to take reasonable steps to ensure compliance with the CEA and CFTC regulations to be consistent with the SEC's CCO Rule, which requires the CCO to take reasonable steps to ensure that the security-based swap dealer establishes, maintains and reviews written compliance policies and procedures reasonably designed to ensure compliance with the securities laws and regulations relating to its business.¹⁸ The CCO's duty for Registrants thus remains the same under the current rule, which requires that the CCO take reasonable steps to ensure compliance with the CEA and CFTC regulations relating to the Registrant's activities.¹⁹

In this regard, the CFTC believes that the statutory text requires more than taking reasonable steps to ensure that the Registrant establishes, maintains and reviews written policies and procedures. A CCO's duty includes active engagement in the day-to-day implementation of compliance policies and procedures, which the CFTC states likely would include a reasonable level of involvement in compliance monitoring, identifying non-compliance, advising on mitigation and correction of compliance activities and, where necessary, escalating significant matters that require senior management attention.²⁰

4. *Duty to Remediate Noncompliance Issues*

The final rule amendments would require that the CCO take “reasonable steps” to ensure that the Registrant:

- Establishes, maintains and reviews the applicable policies and procedures reasonably designed to remediate noncompliance issues identified by the CCO through any means and

¹⁵ Release at 43,513.

¹⁶ See 7 USC 6s(k)(2)(C)(requiring that the CCO in consultation with the Board or senior officer “resolve any conflicts that may arise”).

¹⁷ See Release at 43,513.

¹⁸ See 17 CFR 240.15Fk-1(b)(2).

¹⁹ See 17 CFR 3.3(d)(3).

²⁰ Release at 43,514.

Client Alert

- Establishes written procedures reasonably designed for the handling, management, response, remediation, retesting and resolution of noncompliance issues.²¹

The CCO would no longer be required under the rules as amended to consult with the board or senior officer in connection with establishing procedures to remediate noncompliance issues identified by the CCO, although particular issues with respect to such procedures may still require escalation.²² Noncompliance matters identified by the CCO “through any means” would include all complaints that could be validated, whether written or verbal, which contrasts with the SEC’s CCO rule, under which the SEC clarified that a validated complaint means a written complaint that can be supported upon a reasonable investigation.²³

C. Annual Report

1. *Description of the Registrant’s WPPs*

The final rule amendments continue to require a CCO to describe the Registrant’s WPPs, including its code of ethics and conflict of interest policies, but clarify that the description is limited to WPPs that relate to the Registrant’s business as an FCM, SD or MSP.²⁴

2. *Assessment of the Effectiveness of Policies and Procedures*

The final rule amendments eliminate the requirement for the CCO annual report to identify and assess the effectiveness of each WPP for each regulatory requirement under the CEA and CFTC regulations. Instead, the rule amendments require that the report contain a description of the CCO’s assessment of the effectiveness of the Registrant’s WPPs relating to its business as an FCM, SD, or MSP.²⁵ The CFTC emphasizes that the CCO must still conduct an underlying assessment of the WPPs to meet the requirements of the rule, but may rely upon the use of sub-certifications or any other methodologies previously employed to conduct the assessment.²⁶

3. *Resources Set Aside for Compliance*

The final rule amendments clarify that the annual report’s discussion of resources need only address those resources set aside for compliance activities that relate to the Registrant’s business as an FCM, SD or MSP,²⁷ consistent with the SEC’s CCO Rule.²⁸ The CFTC declined to provide a clarification sought by some commenters that the discussion not be required to include quantitative assessments or numerical estimates. The CFTC noted that some of the categories of resources CCOs are required to describe are, by their nature, quantitative, such as

²¹ See 17 CFR 3.3(d)(4) and (d)(5).

²² See Release at 43,515.

²³ See 17 CFR 15Fk-1(e)(3).

²⁴ See 17 CFR 3.3(e)(1) and Release at 43,516.

²⁵ See 17 CFR 3.3(e)(2).

²⁶ See Release at 43,516.

²⁷ See 17 CFR 3.3(e)(4).

²⁸ See 17 CFR 240.15Fk-1(c)(2)(i)(E).

Client Alert

the number of compliance personnel and budgetary information, which may be necessary in order to adequately assess the Registrant's compliance program.²⁹

4. *Furnishing the Annual Report*

The final rule amendments require that the annual report be furnished to the board of directors or the senior officer prior to filing the report with the Commission. In addition, the annual report is required to be furnished to the audit committee (or equivalent body), if one exists. The report must be furnished to that committee (if one exists) not later than its next scheduled meeting after the date on which the annual report is furnished to the Commission, but in no event more than 90 days after the Registrant's annual report is furnished to the Commission. The CFTC affirms in response to comments that there is no obligation for a Registrant to form an audit committee to satisfy this requirement.³⁰

The CFTC's rule contrasts with that of the SEC, which requires delivery of the annual report to the board *and* the senior officer, as well as the audit committee.³¹ While acknowledging the divergence from the SEC's rule, the CFTC stated that divergence in this area is necessary, citing greater diversity in corporate forms and organization structures among CFTC Registrants than with SEC-regulated entities.³²

5. *Certification*

The final rule amendments retain the requirement for the CCO, under penalty of law, to sign and certify that the CCO Annual Report is accurate and complete.³³ However, in response to comments, the CFTC added a materiality qualifier that the CCO certify that the report is accurate and complete "in all material respects," which harmonizes the CFTC's rule with the SEC's rule.³⁴ The CFTC did not define materiality in this context, but noted that it is consistent with the related duty provided for in the rules to promptly amend and recertify the CCO annual report if "material errors or omissions" in the report are identified.³⁵

²⁹ See Release at 43,516-517. In addition to these requirements, the final rule amendments retain the requirements in the current rule that the annual report contain a description of (i) areas for improvement, and recommended potential or prospective changes or improvements to the Registrant's compliance program and resources devoted to compliance; (ii) any "material noncompliance issues" identified and the corresponding action taken; and (iii) any material changes to compliance policies and procedures during the coverage period for the report. The CFTC declined to define "material noncompliance issue" in this context as requested by some commenters, citing differences in the size and nature of Registrants' businesses. Registrants should continue to make their own internal assessments of what constitute material noncompliance issues, which the CFTC staff believes has been adequate. See Release at 43,512.

³⁰ See Release at 43,517.

³¹ See 17 CFR 240.15Fk-1(c)(2)(ii)(B).

³² See Release at 43,517.

³³ See 17 CFR 3.3(f)(3).

³⁴ See Release at 43,517-518.

³⁵ See Release at 43,518 n.70.

Client Alert

D. Other Matters

1. *Dual Registrants and Affiliated Registrants*

The final rule amendments provide that Registrants registered in more than one capacity (e.g., an FCM also registered as an SD) (“Dual Registrants”) may cross-reference sections in CCO annual reports submitted on behalf of either of its registrations within the current or immediately preceding reporting period. In addition, Dual Registrants under the final rule amendments may submit a single annual report covering the reporting requirements relevant to each registration category, subject to the following conditions:

- The regulatory requirements for annual reports must be clearly addressed and identifiable as they apply to the Dual Registrant in each of its registration capacities;
- To the extent a section of the annual report addresses shared compliance programs, resources or other elements related to compliance, there must be a clear description of the commonality and delineation of any differences; and
- The Registrant must comply with the requirements to certify and furnish the annual report for each of its registrations.³⁶

With respect to this last requirement, the CFTC expects the Dual Registrant to separately certify the annual report with respect to each registration category, even if the same CCO or CEO serves as the certifying officer for each registration.

The final rule amendments also clarify that Registrants that control, are controlled by or are under common control with other Registrants (“Affiliated Registrants”) are permitted to use incorporation by reference in their annual reports to address matters shared across related registered legal entities. The final rule amendments do not prescribe a requirement regarding the extent that reports may incorporate by reference. If Affiliated Registrants submit joint reports, however, the CCO or CEO for each Registrant must certify the applicable contents of the annual report in accordance with the final rules.³⁷

2. *Appendix C to Part 3*

The final rule amendments add an Appendix C, “Guidance on the Application of Rule 3.3(e), Chief Compliance Officer Annual Report Form and Content,” to Part 3 of the Commission’s regulations. Appendix C largely tracks the guidance included in Staff Advisory 14-153, other than the requirement to identify and assess a WPP for each applicable regulatory requirement under the CEA and CFTC regulations, which the final rule amendments eliminate. The CFTC states that Staff Advisory 14-153 is superseded by Appendix C and the final rule amendments. Appendix C emphasizes that, although the requirement-by-requirement assessment has been eliminated by the final rule amendments, the annual report should address all of the general areas of regulation applicable to the Registrant.³⁸

³⁶ See Release at 43,518.

³⁷ See Release at 43,518-519.

³⁸ See 17 CFR Part 3, Appendix C.

Client Alert

3. *Volcker Rule*

Although commenters raised a significant issue regarding the interplay between the Volcker Rule's compliance program requirements and the requirements for the CCO's annual report, the CFTC declined to address it in the final rule amendments because the issue was not addressed in the proposed rules. However, the CFTC states that the issue may be addressed in a subsequent rulemaking or guidance.³⁹

4. *Substituted Compliance*

The CFTC confirmed that any existing substituted compliance determinations with respect to CFTC Reg. 3.3 are not affected by the final rule amendments.⁴⁰

Contacts:

Susan I. Gault-Brown
(202) 887-1597
sgaultbrown@mofo.com

David H. Kaufman
(212) 468-8237
dkaufman@mofo.com

Vladimir Maly
44 (207) 9204031
vmaly@mofo.com

Barbara R. Mendelson
(212) 468-8118
bmendelson@mofo.com

Chrys A. Carey
(202) 887-8770
ccarey@mofo.com

Julian E. Hammar
(202) 887-1679
jhammar@mofo.com

James Schwartz
(212) 336-4327
jschwartz@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.

³⁹ See Release at 43,519.

⁴⁰ *Id.*