

December 9, 2019

CFTC Advisory on Annual Compliance Reports

CFTC Staff Advisory on Chief Compliance Officer Annual Reports for Swap Dealers, Futures Commission Merchants and Major Swap Participants

SUMMARY

On December 4, the Division of Swap Dealer and Intermediary Oversight of the Commodity Futures Trading Commission issued an advisory to provide further guidance on certain requirements applicable to swap dealers, futures commission merchants, and major swap participants in connection with the preparation and submission of chief compliance officer annual compliance reports pursuant to CFTC Rule 3.3. Amongst other issues, the advisory provides guidance on the requirements to: (1) discuss areas for improvement; (2) discuss the financial, managerial, operational, and staffing resources devoted to compliance; (3) describe any material noncompliance issues; (4) furnish the annual report to a registrant's board or senior officer and, if it exists, audit committee; (5) include in the report an "accurate and complete" certification by either the chief compliance officer or the chief executive officer; and (6) include, if applicable, a discussion of the registrant's Volcker Rule compliance program.

BACKGROUND

CFTC regulations require that the chief compliance officer ("CCO") of each swap dealer, futures commission merchant, and major swap participant (collectively, "Registrants") prepare an annual report (a "CCO Annual Report") addressing the Registrant's compliance with the Commodity Exchange Act ("CEA" or the "Act") and the CFTC's regulations.¹ Each CCO Annual Report must contain a self-assessment of the Registrant's compliance program,² and the CCO must furnish each CCO Annual Report to the Registrant's board of directors or senior officer³ and, if the Registrant has established an audit committee, the Registrant's audit committee.⁴ Either the CCO or the registrant's chief executive officer ("CEO") must certify

that “to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and complete in all material respects.”⁵

The CFTC most recently modified its regulations related to CCO Annual Report requirements via an August 2018 rulemaking.⁶ Concurrent with the 2018 final rule, the CFTC published guidance that focused specifically on the required contents of the CCO Annual Reports.⁷ In an effort to further supplement the August 2018 rulemaking and guidance, the CFTC’s Division of Swap Dealer and Intermediary Oversight (“DSIO”) has issued the advisory⁸ in order to “provide additional guidance to Registrants” regarding the requirements for the CCO Annual Reports.

REVIEW OF DISO ADVISORY

I. AREAS FOR IMPROVEMENT

Each CCO Annual Report must contain a description of the “[a]reas for improvement, and recommended potential or prospective changes or improvements to [a Registrant’s] compliance program and resources devoted to compliance.”⁹ Regarding this requirement, DSIO advises that:

- This requirement consists of two distinct components. First, Registrants must identify and discuss the areas needing improvement. Second, the CCO Annual Report must discuss what changes the CCO is recommending to address such areas. DSIO recommends Registrants include discussions of potential or prospective changes or improvements in a stand-alone section in the CCO Annual Report.
- DSIO staff recommends that Registrants identify the underlying regulatory requirement associated with a cited area for improvement so that DSIO staff are better able to form a complete view as to the Registrant’s state of compliance. Note that this could represent a challenge for general areas of improvement that do not necessarily layer onto a specific underlying rule or set of rules.
- DSIO staff observed that Registrants often included the discussion of areas for improvement within the section describing the CCO’s assessment of effectiveness of the Registrant’s policies and procedures.¹⁰ Because these are distinct requirements, DSIO staff recommends that Registrants include in the section describing areas for improvement a full discussion of the various areas or initiatives the CCO has identified that are intended to help facilitate the Registrant’s compliance, and not limit the discussion to policies and procedures.
- DSIO Staff observed that some CCO Annual Reports contained additional sections not required under the regulations, 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 noncompliance sections¹¹ were discussed. DSIO staff recommends that Registrants report compliance issues not rising to the level of material noncompliance in the section on areas for improvement and include the required associated discussion.

II. RESOURCES DEVOTED TO COMPLIANCE

Each CCO Annual Report must contain a description of the “[t]he financial, managerial, operational, and staffing resources set aside for compliance with respect to the Act and Commission regulations relating to [the Registrant’s] business as a futures commission merchant, swap dealer or major swap participant, including any material deficiencies in such resources.”¹² Regarding this requirement, DSIO advises that:

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- Each Registrant's discussion of the resources devoted to compliance 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 is not sufficient.
- If a Registrant includes compliance costs beyond those related to the CEA and the CFTC's regulations in its CCO Annual Report, those additional compliance costs should be disaggregated from the compliance costs associated with complying with the CEA and the CFTC's regulations.
- If a Registrant is unable to provide precise numerical budget and staffing information related to compliance with the CEA and the CFTC's regulations, an effort should be made to reasonably estimate the portion of the aggregated numerical information dedicated to such compliance, and the Registrant should include an explanation of the basis for providing the estimate.
- The discussion of operational resources set aside for compliance should include general infrastructure information, including compliance-oriented software and technology infrastructure. DSIO staff recommends that Registrants include a description of compliance-oriented 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.

III. NONCOMPLIANCE ISSUES

Each CCO Annual Report must contain a description of the "material noncompliance issues identified and the corresponding action taken."¹³ Regarding this requirement, DSIO advises that:

- In DSIO's view, multiple or consecutive CCO Annual Reports that only discuss material noncompliance issues that were identified by external entities, such as a designated self-regulatory organization, may indicate an improper standard of materiality, insufficient self-evaluation, or lack of proper CCO engagement. Although it is appropriate for Registrants to include findings from reviews by external entities, CCO Annual Reports should also include any material findings from the Registrant's own self-evaluations.
- Although the CFTC has not defined "material" for the purposes of CFTC Rule 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 noncompliance section of the report. Registrants should include the standard of materiality used in the CCO Annual Report's discussion of material noncompliance issues.

IV. FURNISHING THE CCO ANNUAL REPORT

Under CFTC Rule 3.3(f)(1), the CCO must furnish each CCO Annual Report to the Registrant's board of directors or senior officer and, if the Registrant has established an audit committee (or equivalent body), to the Registrant's audit committee (or equivalent 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.

V. CERTIFICATION

Under CFTC Rule 3.3(f)(3), the CCO or the CEO must certify that "to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and complete in all material respects." DSIO advises that this certification should not be modified, amended, or otherwise altered by the certifying officer. It is DSIO staff's view that a certification statement that varies

from the exact language in CFTC Rule 3.3(f)(3) fails to satisfy the certification obligation, rendering the CCO Annual Report noncompliant with CFTC Rule 3.3(f)(3).

VI. OTHER GUIDANCE

DSIO also made the following additional recommendations related to the content of the CCO Annual Report:

- The Volcker Rule¹⁴ states 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 to be addressed as part of the [CCO] duties and requirements under CFTC regulation 3.3.”¹⁵ DSIO advises that, if applicable to a Registrant, a discussion of subpart D of part 75 of the CFTC’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.
- The CCO Annual Report covers the most recently completed fiscal year of the Registrant. DSIO Staff recommends that the Registrant include the specific dates of coverage in the CCO Annual Report.
- The CCO Annual Report must also include a description of “[a]ny material changes to compliance policies and procedures during the coverage period for the report.”¹⁶ DSIO advises that it is not sufficient for Registrants to provide updated policies and procedures or to list all changes to those policies and procedures. Instead, Registrants should 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.

DSIO stated that 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” and emphasized that Registrant’s should review whether their CCO Annual Reports “align with the requirements and recommendations set out [in the advisory] and in prior Commission rulemakings.”

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ENDNOTES

- 1 17 C.F.R. § 3.3(d)(6).
- 2 *Id.* § 3.3(e).
- 3 For the purposes of CFTC Rule 3.3, the “senior officer” is “the chief executive officer or other equivalent officer of a registrant.” *Id.* § 3.1(j).
- 4 *Id.* § 3.3(f)(1)(i) (board of directors or senior officer); *id.* § 3.3(f)(1)(ii) (audit committee).
- 5 *Id.* § 3.3(f)(3).
- 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 C.F.R. § 3.3). The CFTC’s 2018 rule changes sought to harmonize the CFTC’s CCO regulations with the corresponding CCO regulations of the Securities and Exchange Commission. The CFTC emphasized that the rule required more active engagement by the CCO in overseeing regulated activities than the traditional advisory role of a CCO.
- 7 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 C.F.R. pt. 3 app. C).
- 8 Annual Compliance Report Requirements, CFTC Staff Advisory No. 19-24 (December 4, 2019) available at <https://www.cftc.gov/csl/19-24/download>.
- 9 17 C.F.R. § 3.3(e)(3).
- 10 17 C.F.R. § 3.3(e)(2) requires that the CCO Annual Report contain a description of the Registrant’s “assessment of the effectiveness of its policies and procedures relating to its business as a futures commission merchant, swap dealer or major swap participant.”
- 11 Required by 17 C.F.R. § 3.3(5).
- 12 17 C.F.R. § 3.3(e)(4).
- 13 *Id.* § 3.3(e)(5).
- 14 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).
- 15 *Id.* at 6020 n. 2521.
- 16 17 C.F.R. § 3.3(e)(6).

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