

# CFTC Amends Chief Compliance Officer Duties and Annual Report Requirements

August 29, 2018

On August 21, 2018, the Commodity Futures Trading Commission (the “**CFTC**”) unanimously approved final amendments (the “**Amendments**”)<sup>1</sup> to its regulations governing chief compliance officer (“**CCO**”) duties and annual compliance report requirements for swap dealers (“**SDs**”), major swap participants (“**MSPs**”) and futures commission merchants (“**FCMs**,” and together with SDs and MSPs, “**Registrants**”) (the “**CCO Rule**”).

The Amendments seek to streamline and clarify the CCO Rule, as well as align the CCO Rule with the corresponding Securities and Exchange Commission (“**SEC**”) regulations governing CCOs of security-based swap dealers and major security-based swap participants (the “**SEC CCO Rule**”).<sup>2</sup> In particular, the Amendments significantly streamline and help harmonize the content of the annual compliance report (the “**CCO Annual Report**”). However, the CFTC declined to fully harmonize the CCO’s duties with parallel provisions of the SEC CCO Rule. Specifically, the CFTC emphasized that the CCO Rule requires CCOs to take a more active role in oversight of regulated activities, rather than the advisory role more traditionally associated with CCOs in the securities industry. The CFTC justified the departures from the SEC CCO Rule in respect of these duties by referring to the differences between the Registrants and the SEC-regulated entities. The CFTC did not, however, take these differences into account by adopting more flexible reporting lines, as commenters had requested. If anything, the Amendments reinforce the CFTC’s expectations regarding escalation of issues by the CCO to the highest levels of management of a Registrant.

This Memorandum provides an overview of the Amendments. Included as Appendix A to this Memorandum is a comparison showing changes that will be implemented by the Amendments to the text of the current CCO Rule. The effective date of the Amendments is September 26, 2018. While not expressly addressed by the CFTC, we expect the Amendments to apply to any CCO Annual Reports submitted following the effective date, including for reports that include reporting periods prior to the effective date.

<sup>1</sup> Chief Compliance Officer Duties and Annual Report Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants, 83 Fed. Reg. 43510 (Aug. 27, 2018).

<sup>2</sup> 17 C.F.R. § 240.15Fk-1.

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**Background**

- In 2010, the Dodd-Frank Act amended sections 4d(d) and 4s(k) of the Commodity Exchange Act (“CEA”) to require Registrants to designate a CCO to fulfill certain requirements and duties.<sup>3</sup> These duties include preparing and signing the CCO Annual Report.
- In 2012, the CFTC implemented these requirements when it finalized the CCO Rule, which became effective on June 4, 2012.
- In December 2014, in response to industry requests for guidance and clarification, the CFTC issued a staff advisory (“**Advisory 14-153**”),<sup>4</sup> which provided guidance to Registrants on the form and content requirements of CCO Annual Reports, including the requirement that the Registrant identify and assess each of its written policies and procedures (“**WPPs**”) for each regulatory requirement under the CEA and CFTC regulations. The Amendments replace and supersede Advisory 14-153 with a new appendix to CFTC Rule 3.3.
- In May 2017, the CFTC published a Notice of Proposed Rulemaking to amend the CCO Rule,<sup>5</sup> pursuant to which it requested and received public comment on streamlining and clarifying the CCO’s duties and CCO Annual Report requirements, including comments suggesting that the CFTC increase flexibility to account for Registrants’ various internal governance structures.

**The CFTC Amendments***Definition of “Senior Officer”*

<sup>3</sup> CEA §§ 4d(d), 4s(k); 7 U.S.C. §§ 6d(d), 6s(k).

<sup>4</sup> CFTC Staff Advisory No. 14-153 (Dec. 22, 2014).

<sup>5</sup> Chief Compliance Officer Duties and Annual Report Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants; Amendments, 82 Fed. Reg. 21330 (May 8, 2017).

- Consistent with the SEC CCO Rule, the Amendments define “senior officer” in the CCO Rule as “the chief executive officer or other equivalent officer of a registrant.”
- The CFTC declined to incorporate industry comments requesting that the definition accommodate different organizational structures of Registrants by, for example, designating the most senior officer within the Registrant’s swaps business as the “senior officer,” rather than the chief executive officer (“CEO”). The CFTC repeatedly emphasized the importance of the CCO having a direct reporting line to the highest executive-level at the Registrant and escalating issues to that level if necessary to address matters not resolved to the CCO’s satisfaction.

*Chief Compliance Officer Duties*

- Duty to Administer Compliance Policies and Procedures
  - Consistent with the SEC CCO Rule, the Amendments will limit the scope of the CCO’s duties in administering each of the Registrant’s policies and procedures to those policies and procedures relating to the Registrant’s business as an FCM, SD or MSP, as applicable, rather than policies and procedures related to compliance with all provisions of the CEA and CFTC regulations.
  - However, the CFTC declined to follow the SEC in providing further guidance that “administer” means “reviewing, evaluating, and advising” the Registrant on its compliance policies and procedures.<sup>6</sup> Instead, the CFTC noted that “the role of the CCO, under the Dodd-Frank Act, goes beyond the customary and traditional

<sup>6</sup> Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 81 Fed. Reg. 29960, 30057 (May 13, 2016).

advisory role of a CCO and requires more active engagement.”

- The CFTC went on to note that the CCO may be able to fulfill his or her role by actively engaging in processes involving “reviewing, evaluating, and advising” on compliance issues, and other personnel may have day-to-day responsibilities for implementing compliance procedures, but the CCO role requires escalating significant issues to the board or senior officer if others are not addressing those issues in a reasonably satisfactory manner.
- Duty to Resolve Conflicts of Interest
  - The current CCO Rule includes a duty for the CCO to resolve any conflicts of interest. The Amendments would align the rule with the SEC CCO Rule by qualifying the duty with a reasonableness standard and a materiality standard (*i.e.*, a duty to “take reasonable steps” to resolve “material” conflicts of interest). The Amendments would further limit the scope of the duty to include only material conflicts relating to the Registrant’s business as an FCM, SD or MSP.
  - The CFTC did not adopt a fixed standard for materiality in this context. Instead, it suggested Registrants themselves make such determinations based on the relevant facts and circumstances.
  - The CFTC also declined to state that CCOs have a duty to minimize, rather than resolve, conflicts, as the CFTC views this as inconsistent with the language in the CEA. However, the CFTC recognized that in addition to eliminating conflicts if reasonably practicable, resolution can also include
- mitigating conflicts to the point of being immaterial.
- Again, the CFTC emphasized its vision for a more active CCO role by noting that the requirement to “take reasonable steps” will require active involvement in conflict resolution, including identifying and advising on conflicts of interest as well as escalating unresolved conflicts to the board of directors or senior officer.
- Duty to Ensure Compliance
  - The CFTC declined to amend the CCO’s general duty to take reasonable steps to ensure compliance with the CEA to conform to the SEC CCO Rule, which solely requires the CCO to take reasonable steps to ensure that the Registrant establishes, maintains and reviews written compliance policies and procedures. The CFTC specifically noted that, in its view, the statutory text of the CEA requires more of the CCO, such as a reasonable level of involvement in compliance monitoring, identifying noncompliance or potential noncompliance events, and advising on the mitigation and correction of compliance activities.
  - Even though the CFTC stated that the CCO may reasonably rely on other personnel to implement many of the policies and procedures in the course of their regular business activities, the CFTC further emphasized that a CCO must escalate issues to senior management when necessary.
- Duty to Remediate Noncompliance Issues
  - The Amendments would, consistent with the SEC CCO Rule, add reasonableness standards to the

current obligations for the CCO to ensure that the Registrant:

- establishes, maintains and reviews the applicable policies and procedures to remediate noncompliance issues identified by the CCO; and
  - establishes written procedures for the handling, management response, remediation, retesting and resolution of noncompliance issues.
- In each case, under the Amendments the CCO will be required to “take reasonable steps” to ensure such policies are established and that such policies are “reasonably designed” to achieve their purpose.
  - In addition, the CCO is no longer required to consult with the board of directors or senior officer in connection with establishing procedures to remediate noncompliance issues identified by the CCO, even though particular issues can still require escalation.
  - The CFTC indicated that the noncompliance issues identified by the CCO will continue to include, as a source, all complaints that can be validated, whether written or verbal. The SEC, by contrast, clarified that under its rules a “complaint that can be validated” means “a written complaint that can be supported upon a reasonable investigation.”

#### CCO Annual Report

- Description of the Registrant’s WPPs
  - The Amendments will continue to require a CCO to describe the Registrant’s WPPs as part of the

CCO Annual Report, but clarify that the description is limited to WPPs relating to a Registrant’s business as an FCM, SD or MSP. This description should provide a narrative describing the different types of WPPs, how they work as a whole system or program, and how the Registrant puts them into practice.

- Assessment of the Effectiveness of the Policies and Procedures
  - The Amendments will eliminate the requirement for the CCO Annual Report to identify and assess each WPP for each regulatory requirement under the CEA and CFTC regulations. Instead, the CCO may submit a summary of WPPs relating to its business as an FCM, SD or MSP, as applicable, and detailed discussions of a Registrant’s annual assessment and recommended improvements.
  - The CFTC noted, however, that the CCO must still conduct an underlying assessment of the WPPs to comply with the CCO Rule requirements, which may include the use of sub-certifications or other methodologies currently employed by Registrants.
- Resources Set Aside for Compliance
  - The Amendments clarify that the CCO 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, which is consistent with the SEC CCO Rule.

- Although the CFTC received comments advocating for a clarification that the discussion of resources in the CCO Annual Report does not need to include any sort of quantitative assessment, the CFTC declined to provide such clarification, noting that in certain areas, such as the number of compliance personnel and budgetary information, quantitative information would be appropriate in order to properly assess the adequacy of such resources.
- Material Noncompliance Issues
  - The CCO Annual Report must include a description of any material noncompliance issues.
  - The CFTC declined to adopt a definition for “material noncompliance issue,” noting that given the differences in size and nature of businesses among Registrants, materiality should be individually assessed by each Registrant, and that Registrants should continue to define and implement their own materiality standards as part of the CCO Annual Report.
- Furnishing the CCO Annual Report
  - Under the Amendments, the CCO Annual Report must be furnished to (1) the board of directors *or* the senior officer and (2) the audit committee (or equivalent body), if one exists. There is no obligation for a Registrant to form an audit committee merely to satisfy the CCO Rule.
  - For Registrants with an audit committee (or an equivalent body), the CCO Annual Report must be furnished to such committee by the earlier of (i) its next scheduled meeting after the CCO Annual Report is furnished to the CFTC and (ii) 90 days after the CCO Annual Report is furnished to the CFTC.
- By contrast, the SEC CCO Rule requires delivery to both the board *and* the senior officer, as well as the audit committee. The CFTC acknowledged that the divergence with the SEC in this area is necessary given the greater diversity in corporate forms and organization structures among Registrants than among SEC-regulated entities.
- Certification
  - The Amendments retain the requirement for the CCO, under penalty of law, to sign and certify that the CCO Annual Report is accurate and complete, but they add a materiality qualifier that the report is accurate and complete “in all material respects.” This qualifier aligns the certification requirement with the SEC CCO Rule.
  - The CFTC declined to define or further clarify the meaning of “material” in this context, other than to note that it is consistent with the related duty to amend and recertify the CCO Annual Report if material errors or omissions are identified.
- Affiliated and Dual Registrants
  - The Amendments 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 CCO Annual Reports in the form that best suits the Affiliated Registrants. To the extent that Affiliated Registrants submit joint reports, the CCO or CEO for each Registrant must certify the applicable contents of the CCO Annual Report.

- The Amendments also allow Registrants registered in more than one capacity (“**Dual Registrants**”) to submit a single CCO Annual Report if:
  - the statutory requirements for the CCO Annual Report are clearly addressed and identifiable as they apply to the Dual Registrant in each of its registered capacities;
  - the CCO Annual Report clearly delineates the allocations of shared compliance programs, resources or other elements related to compliance; and
  - the Registrant complies with all of the requirements to certify and furnish the CCO Annual Report for each of its registrations.
- As noted above, the Amendments include a new Appendix C that supersedes Advisory 14-153.
- The guidance in Appendix C is generally consistent with the guidance included in Advisory 14-153, other than eliminating the requirement to identify and assess a WPP for each and every applicable regulatory requirement under the CEA and CFTC regulations.
- Because the CCO Annual Report no longer includes an obligation to identify a WPP applicable to each regulatory requirement, Appendix C emphasizes the need for the CCO Annual Report to discuss the Registrant’s WPP assessment process.

#### Volcker Rule

- Although the CFTC noted that the industry has raised important considerations regarding the relationship between the CCO Rule and the compliance requirements of the Volcker Rule,<sup>7</sup> the CFTC declined to address any issues with respect to Volcker Rule compliance at this time, but noted that it may address this issue in the future.

#### Substituted Compliance

- The CFTC clarified that existing substituted compliance determinations with respect to the CCO Rule are not affected by the Amendments.

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- Appendix C to Part 3 – Guidance on the Application of Rule 3.3(e), Chief Compliance Officer Annual Report Form and Content (“Appendix C”)

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<sup>7</sup> Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5807 (Jan. 31, 2014).



APPENDIX A

§ 3.1 Definitions.

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(j) Senior officer. Senior officer means the chief executive officer or other equivalent officer of a registrant.

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§ 3.3 Chief Compliance Officer.

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(d) Chief compliance officer duties. The chief compliance officer's duties shall include, but are not limited to:

- (1) Administering each of the registrant's policies and procedures ~~reasonably designed to ensure compliance with~~ relating to its business as a futures commission merchant, swap dealer, or major swap participant that are required to be established pursuant to the Act and Commission regulations;
- (2) In consultation with the board of directors or the senior officer, taking reasonable steps to resolve ~~ing~~ any material conflicts of interest ~~that may arise;~~ relating to the registrant's business as a futures commission merchant, swap dealer, or major swap participant that may arise;
- (3) Taking reasonable steps to ensure compliance with the Act and Commission regulations relating to the ~~swap dealer's or major swap participant's swaps activities, or to the futures commission merchant's~~ registrant's business as a futures commission merchant, swap dealer or major swap participant;
- (4) Taking reasonable steps to ensure the registrant ~~E~~establishing, maintains, and reviews written policies and procedures, ~~in consultation with the board of directors or the senior officer, for the~~ reasonably designed to remediate ~~ion~~ of noncompliance issues identified by the chief compliance officer through ~~a~~ any means, including any compliance office review, look-back, internal or external audit finding, self-reported ~~ing error, or validated~~ to the Commission and other appropriate authorities, or complaint that can be validated;
- (5) Taking reasonable steps to ensure the registrant ~~E~~establishing written procedures, ~~in consultation with the board of directors or the senior officer,~~ reasonably designed for the handling, management response, remediation, retesting, and ~~elosing~~ resolution of noncompliance issues; and
- (6) Preparing and signing the annual report required under paragraphs (e) and (f) of this section.

(e) Annual report. The chief compliance officer annually shall prepare a written report that covers the most recently completed fiscal year of the futures commission merchant, swap dealer, or major swap participant, ~~and provide the annual report to the board of directors or the senior officer.~~ The annual report shall, at a minimum, contain a description of:

- (1) ~~Contain a description of the~~ The written policies and procedures, ~~including the code of ethics and conflicts of interest policies,~~ of the futures commission merchant, swap dealer, or major swap participant described in paragraph (d) of this section, including the code of ethics and conflicts of interest policies;

(2) The futures commission merchant's, swap dealer's, or major swap participant'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;

~~(2) Review each applicable requirement under the Act and Commission regulations, and with respect to each:~~

~~(i) Identify the policies and procedures that are reasonably designed to ensure compliance with the requirement under the Act and Commission regulations;~~

~~(ii) Provide an assessment as to the effectiveness of these policies and procedures; and~~

~~(iii) Discuss a~~Areas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance;

~~(3) List any material changes to compliance policies and procedures during the coverage period for the report;~~

~~(4) Describe the~~The financial, managerial, operational, and staffing resources set aside for compliance with respect to the Act and Commission regulations relating to its business as a futures commission merchant, swap dealer or major swap participant, including any material deficiencies in such resources; ~~and~~

~~(5) Describe any~~Any material non-compliance issues identified; and the corresponding action taken; ~~and~~

~~(6) Any material changes to compliance policies and procedures during the coverage period for the report.~~

(f) Furnishing the annual report to the Commission and related matters.

(1) Furnishing the annual report. ~~(4)~~ Prior to furnishing the annual report to the Commission, the chief compliance officer shall provide the annual report to the board of directors or ~~the~~ senior officer of the futures commission merchant, swap dealer, or major swap participant for its review.

~~Furnishing the annual report to the board of directors or the senior officer shall be recorded in the board minutes or otherwise, as evidence of compliance with this requirement.~~

(ii) If the futures commission merchant, swap dealer, or major swap participant has established an audit committee (or an equivalent body), then the chief compliance officer shall furnish the annual report to the audit committee (or equivalent body) not later than its next scheduled meeting after the annual report is furnished to the Commission, but in no event more than 90 days after the applicable date specified in paragraph (f)(2) of this section for furnishing the annual report to the Commission.

(iii) A written record of transmittal of the annual report to the board of directors or the senior officer, and audit committee, if applicable, shall be made and maintained in accordance with Commission Regulation § 1.31.

(2) Furnishing the annual report to the Commission. (i) Except as provided in paragraph (f)(2)(ii) of this section, the annual report shall be furnished electronically to the Commission not more than 90 days after the end of the fiscal year of the futures commission merchant, swap dealer, or major swap participant.



(ii) The annual report of a swap dealer or major swap participant that is eligible to comply with a substituted compliance regime for paragraph (e) of this section pursuant to a comparability determination of the Commission may be furnished to the Commission electronically up to 15 days after the date on which the comparable annual report must be completed under the requirements of the applicable substituted compliance regime. If the substituted compliance regime does not specify a date by which the comparable annual report must be completed, then the annual report shall be furnished to the Commission by the date specified in paragraph (f)(2)(i) of this section.

(3) Certification. The report shall include a certification by the chief compliance officer or chief executive officer of the registrant 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.

(4) Amending the annual report. The futures commission merchant, swap dealer, or major swap participant shall promptly furnish an amended annual report if material errors or omissions in the report are identified. An amendment must contain the certification required under paragraph (f)(3) of this section.

(5) Extensions. A futures commission merchant, swap dealer, or major swap participant may request from the Commission an extension of time to furnish its annual report, provided the registrant's failure to timely furnish the report could not be eliminated by the registrant without unreasonable effort or expense. Extensions of the deadline will be granted at the discretion of the Commission.

(6) Incorporation by reference and related registrants. (i) Prior reports. A futures commission merchant, swap dealer, or major swap participant may incorporate by reference sections of an annual report that has been furnished within the current or immediately preceding reporting period to the Commission.

(ii) Dual registrants. If ~~the~~ futures commission merchant, swap dealer, or major swap participant is registered in more than one capacity with the Commission, ~~and must submit more than one annual report,~~ an annual report submitted as one registrant may incorporate by reference sections in the annual report furnished within the current or immediately preceding reporting period as the other registrant. A dual registrant may submit one annual report that addresses the requirements set forth in paragraphs (e), (f)(1) and (f)(3) of this section with respect to each registration capacity.

(iii) Affiliated registrants. If a futures commission merchant, swap dealer, or major swap participant controls, is controlled by, or is under common control with, one or more other futures commission merchants, swap dealers, or major swap participants, and each of the affiliated registrants must submit an annual report, an affiliated registrant may incorporate by reference in its annual report sections from an annual report prepared by any of its affiliated registrants furnished within the current or immediately preceding reporting period. Affiliated registrants may submit one annual report that addresses the requirements set forth in paragraphs (e), (f)(1) and (f)(3) of this section with respect to each affiliated registrant.

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