

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Parts 1, 3, and 23

RIN 3038-AC96

#### 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

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Final rule.

**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is adopting regulations to implement certain provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These regulations set forth reporting and recordkeeping requirements and daily trading records requirements for swap dealers (SDs) and major swap participants (MSPs). These regulations also set forth certain duties imposed upon SDs and MSPs registered with the Commission with regard to: Risk management procedures; monitoring of trading to prevent violations of applicable position limits; diligent supervision; business continuity and disaster recovery; disclosure and the ability of regulators to obtain general information; and antitrust considerations. In addition, these regulations establish conflicts-of-interest requirements for SDs, MSPs, futures commission merchants (FCMs), and introducing brokers (IBs) with regard to firewalls between research and trading and between clearing and trading. Finally, these regulations also require each FCM, SD, and MSP to designate a chief compliance officer, prescribe qualifications and duties of the chief compliance officer, and require that the chief compliance officer prepare, certify, and furnish to the Commission an annual report containing an assessment of the registrant's compliance activities.

**DATES:** The rules are effective June 4, 2012. Specific compliance dates are discussed in the supplementary information.

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##### I. Background

The Commission is hereby adopting § 23.200 through § 23.205<sup>1</sup> setting forth reporting and recordkeeping requirements and daily trading records requirements for SDs and MSPs, as required under sections 4s(f) and 4s(g) of the Commodity Exchange Act (CEA);

<sup>1</sup> Commission regulations referred to herein are found at 17 CFR Ch. 1.

§ 23.600 through § 23.607 setting forth certain duties imposed upon SDs and MSPs with regard to: (1) Risk management procedures; (2) monitoring of trading to prevent violations of applicable position limits; (3) diligent supervision; (4) business continuity and disaster recovery; (5) conflicts of interest policies and procedures; (6) disclosure and the ability of regulators to obtain general information; and (7) antitrust considerations, as required under section 4s(j) of the CEA; § 3.3 requiring FCMs, SDs, and MSPs to designate a chief compliance officer, prescribing qualifications and duties of the chief compliance officer, and requiring the chief compliance officer to prepare, certify, and furnish to the Commission an annual report containing an assessment of the registrant's compliance activities, as required under sections 4d(d) and 4s(k) of the CEA; and § 1.71 setting forth certain duties imposed on FCMs and IBs with regard to implementing conflicts of interest policies and procedures, as required under section 4d(c) of the CEA; as well as amendments to § 3.1 to add chief compliance officers to the definition of "principal" and to add a new definition of "board of directors."

##### II. Comments on the Notices of Proposed Rulemaking

The final rules adopted herein were proposed in five separate notices of proposed rulemaking.<sup>2</sup> Each proposed rulemaking was subject to an initial 60-day public comment period and a re-opened comment period of 30 days.<sup>3</sup> The Commission received a total of approximately 114 comment letters directed specifically at the proposed rules.<sup>4</sup> The Commission considered

<sup>2</sup> See 75 FR 76666 (Dec. 9, 2010) (Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants (Recordkeeping NPRM)); 75 FR 71397 (Nov. 23, 2010) (Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants (Duties NPRM)); 75 FR 70152 (Nov. 17, 2010) (Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers (FCM/IB Conflicts NPRM)); 75 FR 71391 (Nov. 23, 2010) (Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants (SD/MSP Conflicts NPRM)); and 75 FR 70881 (Nov. 19, 2010) (Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant (CCO NPRM)).

<sup>3</sup> See 76 FR 25274 (May 4, 2011) (extending or re-opening comment periods for multiple Dodd-Frank proposed rulemakings).

<sup>4</sup> Comment files for each proposed rulemaking can be found on the Commission Web site, [www.cftc.gov](http://www.cftc.gov).

each of these comments in formulating the final regulations.<sup>5</sup>

The Chairman and Commissioners, as well as Commission staff, participated in numerous meetings with representatives of potential SDs and MSPs, existing FCMs, trade associations, public interest groups, traders, and other interested parties. In addition, the Commission has consulted with other U.S. financial regulators including: (i) The Securities and Exchange Commission (SEC); (ii) the Board of Governors of the Federal Reserve System; (iii) the Office of the Comptroller of the Currency; and (iv) the Federal Deposit Insurance Corporation. Staff from each of these agencies has had the opportunity to provide oral and/or written comments to this adopting release, and the final regulations incorporate elements of the comments provided. The Commission intends to work with the Federal Deposit Insurance Corporation (FDIC) to establish appropriate information-sharing arrangements to ensure that the FDIC has the information it needs to exercise authority under Title II of the Dodd-Frank Act or the Federal Deposit Insurance Act with regard to any SD or MSP registered with the Commission.

The Commission is mindful of the benefits of harmonizing its regulatory framework with that of its counterparts in foreign countries. The Commission has therefore monitored global advisory, legislative, and regulatory proposals, and has consulted with foreign regulators in developing the final regulations.

#### A. Regulatory Structure

The proposed regulations did not differentiate between SDs and MSPs that may be a division of a larger entity or institution, but not a separate legal entity. The proposed regulations also did not differentiate between SDs and MSPs, but, rather, applied identical rules to both types of entities. The proposals, however, solicited comments on whether certain provisions of the proposed regulations should be modified or adjusted to reflect the differences among SDs or MSPs. In addition, the proposed regulations tracked the scope of the statutory text, and did not, by their terms, apply only to the swap activities of SDs and MSPs.

In its comment letter, Cargill, Incorporated (Cargill) argued that the proposed rules should recognize Congressional intent to permit a

business with a swap dealing division to be subject to SD regulation only for the activities of that division. Cargill recommended that the Commission make clear that the Commission's regulations only apply to the swap dealing business of an SD that is a division of a larger company, and not to the other business activities of the company.

MetLife, Inc. (MetLife), the Managed Funds Association (MFA), BlackRock, and the Asset Management Group of the Securities Industry and Financial Markets Association (AMG) each argued that the Dodd-Frank Act does not require that the Commission to apply the same rules to MSPs as those applied to SDs and that MSPs should not be subject to the same regulations as SDs because MSPs do not engage in market-making activities.

The Securities Industry and Financial Markets Association (SIFMA) and the Federal Home Loan Banks (FHLBs) each recommended that the Commission's regulations should allow registrants that are regulated by a prudential regulator to comply with the Commission's regulations on a substituted compliance basis by complying with comparable regulations of their prudential regulator.

In response to Cargill's comment, the Commission is including a new definition of "swaps activities" in the final regulations, as follows: "*Swaps activities* means a registrant's activities related to swaps and any product used to hedge such swaps, including, but not limited to, futures, options, other swaps or security-based swaps, debt or equity securities, foreign currency, physical commodities, and other derivatives."

The Commission is using this term in the final regulations to (i) limit the scope of the risk management requirements in § 23.600 to only the swap activities of SDs and MSPs; (ii) define the extent of the recordkeeping requirement in § 23.201; and (iii) limit the scope of the duties and responsibilities of the chief compliance officer of an SD or MSP in § 3.3 to the swaps activities of SDs and MSPs.<sup>6</sup>

The Commission is not modifying the regulations to differentiate between SDs and MSPs. The Commission observes that no provision of sections 4s(f), (g), (j), and (k) of the CEA, as added by the Dodd-Frank Act, differentiates between the duties and requirements of SDs and those of MSPs. The Commission thus

has determined that the intent of sections 4s(f), (g), (j), and (k) is to apply the same requirements to MSPs and SDs, and the Commission is taking the same approach in the final regulations. The Commission believes that to the extent the final regulations are not applicable to an MSP's activities, the MSP is not burdened by being subject to the regulations.

The Commission has considered but rejected a substituted compliance regime with respect to the final rule for registrants subject to regulation by a prudential regulator. The Commission notes that section 4s(e) of the CEA grants prudential regulators exclusive authority to prescribe capital and margin requirements for SDs and MSPs that are banks, but does not extend such authority to any other part of section 4s. Because SDs and MSPs will be registrants of the Commission, the Commission has determined that its interest in ensuring that all registrants are subject to consistent regulation outweighs any burden that may be placed on registrants that are subject to regulation by a prudential regulator. However, the Commission observes that many of its final regulations are modeled on prudential regulations and supervision. Thus the two regimes would be broadly consistent.

#### B. Reporting, Recordkeeping, and Daily Trading Records Requirements for SDs and MSPs

As added by section 731 of the Dodd-Frank Act, sections 4s(f) and 4s(g) of the CEA established reporting and recordkeeping requirements and daily trading records requirements for SDs and MSPs.

Section 4s(f)(1) requires SDs and MSPs to "make such reports as are required by the Commission by rule or regulation regarding the transactions and positions and financial condition of the registered swap dealer or major swap participant." In the Recordkeeping NPRM, the Commission proposed regulations, pursuant to sections 4s(f)(1)(B)(i) and (ii) of the CEA, prescribing the books and records requirements of "all activities related to the business of swap dealers or major swap participants," regardless of whether or not the entity has a prudential regulator.

In addition, the Commission proposed regulations in the Recordkeeping NPRM pursuant to section 4s(g)(1) of the CEA, requiring that SDs and MSPs "maintain daily trading records of the swaps of the registered swap dealer and major swap participant and all related records (including related cash and forward transactions) and recorded

<sup>5</sup> The Commission also reviewed the proposed rule of the Securities and Exchange Commission concerning business conduct standards for security-based swap dealers and major security-based swap participants. See 76 FR 42396 (July 18, 2011).

<sup>6</sup> In addition, the Commission anticipates that under its further definition of "swap dealer," an SD that has applied for and received a limited purpose designation from the Commission will be subject to these regulations only for the categories or activities for which the limited purpose designation is granted.

communications, including electronic mail, instant messages, and recordings of telephone calls.” The Commission notes that section 4s(g)(3) requires that daily trading records for each swap transaction be identifiable by counterparty, and section 4s(g)(4) specifies that SDs and MSPs maintain a “complete audit trail for conducting comprehensive and accurate trade reconstructions.” The Commission received 14 comment letters in response to the Recordkeeping NPRM and considered each in formulating the final rules.

### *C. General Records Requirement—§ 23.201*

Proposed § 23.201 set forth the records that SDs and MSPs must maintain. The records required under the proposed rule included full and complete swap transaction information, including all documents on which swap information is originally recorded.

#### 1. Additional Types of Records To Be Retained

In the Recordkeeping NPRM, the Commission requested comments regarding whether additional types of records other than those specified in the proposed rules should be required to be kept by SDs and MSPs. The Commission also requested comment regarding whether drafts of documents should be kept.

The Working Group of Commercial Energy Firms (The Working Group) commented that the current proposal is sufficient and any additional record retention requirements would be of little value to the Commission. Chris Barnard, however, recommended that drafts of documents should also be kept, arguing that the decision process leading up to a final document can be very informative. In order to regulate the use of high-frequency and algorithmic trading strategies, Better Markets, Inc. (Better Markets) recommended that the Commission require SDs and MSPs that employ high-frequency and algorithmic trading strategies to maintain records of each strategy employed including a description of the strategy and its objectives and the algorithms employed, and to maintain a record of every order, cancellation, and trade that occurs in the implementation of each strategy, indexed to the electronic record of the strategy description and properly time stamped.

Having considered these comments and the comments discussed below regarding specific recordkeeping requirements, the Commission has determined that the record retention requirements as proposed are sufficient

and has not included any additional requirements in the final rules. With respect to Better Markets’ comment, the Commission notes that pursuant to § 23.600(d)(9), as adopted in this release and discussed further below, SDs and MSPs are required to ensure that use of trading programs is subject to policies and procedures governing their use, supervision, maintenance, testing, and inspection, and that such policies and procedures are subject to a recordkeeping requirement pursuant to § 23.600(g).

#### 2. Reliance on Records of Swap Data Repositories

The proposed regulations did not address whether an SD or MSP may rely on reporting a swap to a swap data repository (SDR) as a means of meeting their recordkeeping requirements. Proposed § 23.203(b)(2) required records of any swap to be kept for the life of the swap and for a period of five years following the termination, maturity, expiration, transfer, assignment, or novation date of the swap.

The International Swaps and Derivatives Association (ISDA) and SIFMA (together, ISDA & SIFMA) requested that the Commission clarify the extent to which SDs and MSPs may rely upon SDRs to retain records beyond the time periods that registrants currently retain such records. ISDA & SIFMA did not elaborate on the current retention periods for swaps records, nor did they explain how this approach would work in the absence of established SDRs for all types of swaps.

At this time, the Commission has determined not to permit SDs and MSPs to rely solely on SDRs to meet their recordkeeping obligations under the rules. The Commission believes that reliance on SDRs may be a cost-efficient alternative in the future, but such reliance would be premature at the present time. Additionally, the Commission believes that SDs and MSPs must maintain complete records of their swaps for the purposes of risk management. The data that is required to be reported to an SDR may not be sufficient for these purposes.

#### 3. Transaction Records Maintained in a Form and Manner Identifiable and Searchable by Transaction and Counterparty—§§ 23.201(a)(1), 23.202(a), and 23.202(b)

Proposed § 23.201(a)(1) required SDs and MSPs to keep transaction records in a form identifiable and searchable by transaction and by counterparty. Proposed §§ 23.202(a) and 23.202(b) also required SDs and MSPs to keep daily trading records for each swap and

any related cash or forward transaction as a separate electronic file identifiable and searchable by transaction and counterparty.

ISDA & SIFMA recommended that the decision whether to maintain each transaction record as a separate electronic file be left to the reporting counterparties. ISDA & SIFMA argued that SDs and MSPs routinely store data across a number of systems, and that aggregating transaction data from all systems into a single electronic file would require enormous investment across market participants and would require a substantial implementation period.

The Working Group argued that tying records of unfilled or cancelled orders, correspondence (e.g., voice records, email, and instant messages), journals, memoranda, and other records required by proposed § 23.201(a)(1) to each individual transaction in a manner that is identifiable and searchable by transaction would create an enormous technical burden, likely requiring the review, sorting, and assignment of such data to each transaction manually by individual employees. The Working Group recommended therefore that the Commission allow SDs and MSPs to maintain records of the required information in the form and manner currently employed by such firms, not in a single comprehensive file, if such records would be readily accessible and could be provided to the Commission within a reasonable amount of time following a request.

The Commission agrees with the comments, in part, and is modifying the proposed rules to remove the provision in § 23.202(a) and § 23.202(b) that requires each transaction record to be maintained as a separate electronic file. The Commission believes that this modification will make the requirement less burdensome for SDs and MSPs because it will allow such registrants to maintain searchable databases of the required records without the added cost and time needed to compile records into individual electronic files. The Commission notes that the rule, as modified, does not require the raw data in such databases to be tagged with transaction and counterparty identifiers so long as the SD or MSP can readily access and identify records pertaining to a transaction or counterparty by running a search on the raw data. In response to The Working Group’s comments, the Commission confirms that swap records can be maintained under current market practice so long as the records are readily accessible, are identifiable and searchable by transaction and counterparty, and otherwise meet the

requirements of § 1.31, as required under § 23.203.

However, the Commission observes that section 4s(g)(3) of the CEA requires registrants to “maintain daily trading records for each counterparty in a manner and form that is identifiable with each swap transaction.” In accordance with this statutory provision, the rules clarify that such trading records should be searchable by transaction and by counterparty. Maintaining records in this manner may prove costly for some SDs and MSPs, but this approach is required by statute and necessary for accurate audit trail construction, which is paramount for successful enforcement of trade practice cases.

#### 4. Business Records—§ 23.201(b)

As proposed, § 23.201(b) required SDs and MSPs to keep full, complete, and systematic business records, including records related to corporate governance, financial records, complaints, and marketing and sales materials.

The Working Group acknowledged that market participants presently retain records that would qualify as business records under the proposal, although not in a single comprehensive file. The Working Group recommended that the Commission permit these records to be retained as they currently are in the normal course of business, as long as such records can be readily accessed and provided to the Commission upon request. For example, many entities retain financial records within their accounting departments, while marketing and sales materials would be retained separately within another division. The Working Group also recommended that the Commission clarify that when a subsidiary is determined to be an SD or MSP, but its parent company is not, business records should only be required to be retained for the subsidiary.

In response to The Working Group’s comments, the Commission confirms that the rule does not require SDs and MSPs to keep the required business records in a single comprehensive file. So long as SDs and MSPs are keeping full, complete, and systematic business records that are available for inspection or disclosure, the requirements of § 23.201(b) would be met. The Commission also notes that the rule applies only to registered SDs and MSPs, and, therefore, the rules would not apply to the parent company of a registrant unless the parent company is also an SD or MSP.

#### 5. Records of Complaints Received—§ 23.201(b)

Proposed § 23.201(b) required SDs and MSPs to retain a record of complaints received, certain identifying information about the complainant, and a record of the disposition of the complaint.

MFA commented that the requirement to retain a record of complaints is inappropriate for MSPs because, except in the event such entities are registered as commodity trading advisors or commodity pool operators: (a) Entities that may be classified as MSPs would not be members of NFA or similar organizations; and (b) the filing of such complaints against entities that may be classified as MSPs is neither customary nor consistent with such entities’ activities in the market.

Having considered MFA’s comment, the Commission is adopting the rule as proposed. MSPs are, by definition, market participants that have a substantial position in swaps, that have outstanding swaps that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. financial markets, or that are highly leveraged. Consequently, the Commission believes it is possible that a record of complaints, or a pattern of complaints, made against an MSP could be of regulatory value to the Commission. The Commission also notes that pursuant to the Commission’s MSP registration rule, each MSP registered with the Commission is also required to be a member of at least one registered self-regulatory organization (SRO).<sup>7</sup>

#### 6. Records of Marketing and Sales Materials—§ 23.201(b)(4)

Proposed § 23.201(b)(4) required SDs and MSPs to retain copies of all marketing and sales presentations, advertisements, literature, and communications, and a record of the SD’s or MSP’s compliance with applicable Federal requirements, Commission regulations, and the rules of any SRO related to marketing and sales materials.

MFA commented that because MSPs are not market makers, they do not produce such materials for public

dissemination. Therefore, MFA felt that the concerns about SD marketing and sales materials that necessitate the SDs’ recordkeeping requirement are inapplicable to MSPs.

The Commission has decided not to remove MSPs from the relevant provisions of the rule because MSPs would need to comply with the recordkeeping requirement only to the extent that they produce such materials. To the extent that an MSP does not produce marketing or sales materials, the requirements of the rule would be inapplicable.

#### 7. Records of Date and Time of Reports To Swap Data Repositories and Data Reported in Real-Time—§ 23.201(c) and § 23.201(d)

Proposed § 23.201(c) required SDs and MSPs to retain a record of the date and time the SD or MSP reported data or information to SDRs under proposed Part 45. Proposed § 23.201(d) required SDs and MSPs to retain a record of the date and time the SD or MSP reported information for purposes of real-time public reporting under proposed Part 43.

With regard to such records, The Working Group requested that the Commission clarify that the record of the date and time of reports to SDRs and for real-time public reporting be to the minute, and not to the second.

The proposed rule did not specify the form of the depiction of time in records of reports made under parts 43 or 45, other than to say that the record must include the “date and time.” The Commission confirms that SDs and MSPs may record time for the purpose of § 23.201 in their discretion, so long as they comply with any independent requirements under Parts 43 and 45.

#### 8. Records of a “Rationale” for Certain Swap Determinations—§ 23.201(d)(2) & (3)

Proposed § 23.201(d)(2) and (3) required SDs and MSPs to retain a record of the rationale for reporting a less specific data field than is required under the proposed real-time public reporting requirements in part 43, and a record of the rationale for determining that a swap is a large notional swap as required under proposed part 43.

The Working Group requested clarification as to what the Commission is seeking with respect to a “rationale” for these scenarios. The Working Group questions what purpose this information would serve, or what benefit the Commission hopes to derive for purposes of carrying out its duties under the CEA.

<sup>7</sup> See 17 CFR 170.16 Registration of Swap Dealers and Major Swap Participants, 77 FR 2613 (Jan. 19, 2012) (stating “Each person registered as a swap dealer or a major swap participant must become and remain a member of at least one futures association that is registered under section 17 of the Act and that provides for the membership therein of such swap dealer or major swap participant, as the case may be, unless no such futures association is so registered.”), available at [www.cftc.gov](http://www.cftc.gov).

The Commission has determined that any substantive recordkeeping requirements necessary for compliance with Part 43 will be taken up in that part and thus has deleted the proposed "rationale" requirements from § 23.201.

#### D. Daily Trading Records—§ 23.202

Section 4s(g)(1) of the CEA requires that SDs and MSPs maintain daily trading records of their swaps and "all related records (including related cash and forward transactions)." Section 4s(g)(1) also requires that SDs and MSPs maintain recorded communications, including electronic mail, instant messages, and recordings of telephone calls. Section 4s(g)(2) provides that the daily trading records shall include such information as the Commission shall require by rule or regulation. Proposed § 23.202 prescribed daily trading record requirements, which would include trade information related to pre-execution, execution, and post-execution data.

##### 1. Records of Pre-Execution Trade Information—§ 23.202(a)(1)

Proposed § 23.202(a)(1) required SDs and MSPs to make and keep records of pre-execution trade information, including records of all oral and written communications concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a swap, however communicated.

The Air Transport Association of America, Inc. (ATA) commented that the current telephone recording systems in use by SDs and MSPs may not meet all of the proposed rule's requirements, and that implementing telephone recording systems that are compliant with the requirements would impose a significant additional cost. The ATA's members recognized that there may be benefits from the recording requirement, but they are uncertain that those benefits outweigh the costs of purchasing new, or upgrading existing, telephone phone recording and retrieval systems. The ATA is concerned that the cost of complying with all of the various rules proposed by the Commission will erect unnecessarily high barriers to entry for SDs, foreclosing all but the largest firms from acting as SDs.

MFA commented that it would be inappropriate to impose on MSPs the additional burden of maintaining a record of all oral communications made or received because the SDs with which MSPs enter into swaps would record such information. For the same reasons, MFA commented that the Commission should not require MSPs to create records of the date and time of

quotations received or the date and time of execution of each swap and each related cash or forward transaction.

The Working Group argued that even if technology exists to record the required data in a format searchable by transaction and counterparty, it would not be possible to identify pre-execution data specified by the Commission as being applicable to a specific trade because traders and other commercial employees typically engage in ongoing dialogue with counterparties over an extended period of time and do not initiate communications specific to a single trade. The Working Group commented that it would be extremely difficult and time consuming to review manually each communication by a specific trader to determine which conversations or documents ultimately led to the execution of a particular swap and then assign that communication to a unified file.

ISDA & SIFMA asserted that where pre-execution records are maintained today they are captured prior to the execution of a swap and as such they are not linked to a trade. ISDA & SIFMA argued that while it may be possible potentially to search by counterparty with some investment in additional technology, it would not be possible to search by transaction because the infrastructure to link to a transaction is not in place today and the procedural and technical feasibility to do so has not been contemplated nor evaluated. ISDA & SIFMA strongly recommended that the Commission limit the rule to a description of data required as part of a trading record without dictating how such data should be stored and, in particular, that the Commission exclude oral communications from the electronic searchability requirement.

Having considered these comments, the Commission is modifying the proposed rule to remove the requirement that each transaction record be maintained as a separate electronic file, which should be less burdensome for SDs and MSPs because it will allow these registrants to maintain searchable databases of the required records without the added cost and time needed to compile the required records into individual electronic files. The Commission notes that section 4s(g)(3) of the CEA requires registrants to "maintain daily trading records for each counterparty in a manner and form that is identifiable with each swap transaction." The rule as adopted clarifies that such counterparty records must be searchable by transaction and by counterparty. Maintaining records in this form may prove costly for some

registrants, but such form is mandated by the CEA.

However, in light of commenters' concerns, the Commission is adopting § 23.206, which delegates to the Director of the Division of Swap Dealer and Intermediary Oversight the authority to establish an alternative compliance schedule for requirements of § 23.202 that are found to be technologically and economically impracticable for an SD or MSP affected by § 23.202. The purpose of § 23.206 is to facilitate the ability of the Commission to provide a technologically practicable compliance schedule for affected SDs or MSPs that seek to comply in good faith with the requirements of § 23.202.

In order to obtain relief under § 23.206, an affected SD or MSP must submit a request for relief to the Director of the Division of Swap Dealer and Intermediary Oversight. SDs and MSPs submitting requests for relief must specify the basis in fact supporting their claims that compliance with § 23.202 would be technologically or economically impracticable. Such a request may include a recitation of the specific costs and technical obstacles particular to the entity seeking relief and the efforts the entity intends to make in order to ensure compliance according to an alternative compliance schedule. Relief granted under § 23.206 shall not cause a registrant to be out of compliance or deemed in violation of any registration requirements.

Such requests for an alternative compliance schedule shall be acted upon by the Director of the Division of Swap Dealer and Intermediary Oversight or designees thereto within 30 days from the time such a request is received. If not acted upon within the 30 day period, such request will be deemed approved.

The Commission notes that some commenters to a proposed Commission rulemaking to amend § 1.35,<sup>8</sup> which would require voice recording for futures and swap trading by FCMs and other registrants, raised questions about statements made in the preamble of the Recordkeeping NPRM. In that preamble, the Commission stated that proposed § 23.202 "would not establish an affirmative new requirement to create recordings of all telephone conversations if the complete audit trail requirement can be met through other means, such as electronic messaging or trading."<sup>9</sup> For avoidance of doubt, the Commission notes that the rule requires

<sup>8</sup> See Comments to Adaptation of Commission Regulations to Accommodate Swaps, 76 FR 33066, 33088–89 (June 7, 2011), available on the Commission's Web site: [www.cftc.gov](http://www.cftc.gov).

<sup>9</sup> See Recordkeeping NPRM, 75 FR at 76668.

a record of “all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the execution of a swap.” Thus, to the extent this pre-execution trade information does *not* include information communicated by telephone, the Commission confirms that an SD or MSP is under no obligation to create recordings of its telephone conversations. If, however, any of this pre-execution trade information is communicated by telephone, the SD or MSP must record such communications.

With respect to MFA’s comments, section 4s(g)(4) of the CEA applies to both SDs and MSPs. Consequently, the audit trail requirements of the proposed rules apply equally to both SDs and MSPs because it is necessary that all Commission registrants have complete and accurate daily trading records. Moreover, the Commission notes that MFA did not provide any factual support for its assertion that every swap entered by an MSP would have an SD as the counterparty.

#### 2. Records of Source and Time of Quotations—§ 23.202(a)(1)(ii)

Proposed § 23.202(a)(1)(ii) required SDs and MSPs to make and keep a record of the date and time, using Coordinated Universal Time (UTC), by timestamp or other timing device, for each quotation provided to, or received from, a counterparty prior to execution of a swap.

The Working Group argued that the Commission should not require a timestamp for every quote given or received, as the timestamp is unnecessary, overly burdensome, and would not assist in trade reconstruction. Further, The Working Group argued that most entities do not currently capture or store this information, that it would be difficult to do so, particularly given that quotations may be developed by multiple sources, and retention of the time of quotations will add additional compliance costs on market participants. The Working Group also requested clarification as to the meaning of “reliable timing data for the initiation” of a transaction.

MFA commented that the Commission should not require MSPs to create records of the date and time of quotations received or the date and time of execution of each swap and each related cash or forward transaction. MFA argued that since SDs should keep such records in connection with their market-making activities, to require an MSP customer to maintain the same records would be duplicative and a

significant and unnecessary burden on MSPs.

Having considered these comments, the Commission is adopting the rule as proposed. As noted above, the Commission observes that section 4s(g)(4) of the CEA requires both SDs and MSPs to maintain a complete audit trail for conducting comprehensive and accurate trade reconstructions. The Commission therefore believes that the audit trail requirements of the rule should apply to both SDs and MSPs because it is necessary that all Commission registrants have complete and accurate daily trading records. As explained above, no support has been offered for MFA’s assertion that an SD will be the counterparty to every swap executed with an MSP. Additionally, a comprehensive and accurate trade reconstruction necessarily entails a reconstruction of the sequence of events leading up to a trade and that this sequence cannot be reconstructed accurately without reliable timing information. It is noteworthy that commenters were unable to provide any alternative to the timestamp requirement. Therefore, the Commission is retaining the timestamp requirement in the final rule.

With respect to The Working Group’s concern regarding the “reliable timing data” requirement, the Commission confirms that the form of “reliable timing data” could be a timestamp, but the exact form is left to the discretion of the registrant.

#### 3. Timestamp for Quotations Using Universal Coordinated Time (UTC)—§ 23.202(a)(1)(ii)

The proposed regulation required SDs and MSPs to record the time of each quotation provided to or received from a counterparty prior to execution using Universal Coordinated Time.

ISDA & SIFMA commented that the value derived by moving the industry to UTC appears minimal when compared to the costs involved. ISDA & SIFMA provided the Commission with no quantitative data regarding these purported additional costs.

Having considered ISDA & SIFMA’s comment, the Commission is adopting the rule as proposed. The use of UTC in the rule reflects a consistent approach taken by the Commission in this rule and the Commission’s final rules for real-time public reporting<sup>10</sup> and the swap data reporting rule.<sup>11</sup> By requiring the use of UTC in § 23.202, the

Commission is ensuring that the requirements of Part 23, Part 43, and Part 45 remain consistent to the extent possible.

#### 4. Records of Time of Execution—§ 23.202(a)(2)(iv)

Proposed § 23.202(a)(2)(iv) required SDs and MSPs to record the date and time of execution of each swap to the nearest minute.

The Working Group argued that the proposed rule conflicts with both the proposed real-time reporting rule and proposed swap data recordkeeping and reporting rule, which required that the time of execution be displayed to the second, rather than minute. The Working Group requested that the Commission be consistent in all of its recordkeeping and reporting rules, and further requested that the Commission adopt a minute requirement, rather than displaying to the second.

The Commission is adopting the rule as proposed. The Commission notes that the “nearest minute” standard is the standard for futures orders under existing § 1.35. The Commission also notes that the final swap data recordkeeping and reporting rule does not require the time of execution be displayed to the second.<sup>12</sup> While the proposed real-time reporting rule would require a registrant to record the time of execution to the second in some instances, the Commission believes recordkeeping to the nearest minute is sufficient for purposes of maintaining daily trading records and is consistent with § 1.35.

#### 5. Records of Reconciliation Processes—§ 23.202(a)(3)(iii)

Proposed § 23.202(a)(3)(iii) required SDs and MSPs to keep records of portfolio reconciliation results, categorized by transaction and counterparty.

ISDA & SIFMA commented that maintaining records of reconciliation processes by transaction and counterparty may be particularly problematic because this data is not required to be captured in other markets, such as securities or bond markets, and significant additional infrastructure development would thus be required before this data could be captured and stored. ISDA & SIFMA recommended an ongoing dialogue between the Commission and the industry to understand the requirements for systems needed to meet the

<sup>10</sup> See Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182, 1251 (Jan. 9, 2012).

<sup>11</sup> See Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136, 2212 (Jan. 13, 2012).

<sup>12</sup> See Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136, 2212, 2215 (Jan. 13, 2012).

requirements of the proposed rule, in particular the degree to which retained data will need to be identifiable and searchable.

The records of portfolio reconciliation results required under the rule are the minimum needed to monitor an SD's or MSP's compliance with the Commission's proposed § 23.502 on portfolio reconciliation.<sup>13</sup> Thus, the Commission is adopting the rule as proposed.

#### 6. Daily Trading Records for Cash and Forward Transactions Related to a Swap—§ 23.202(b)

Proposed § 23.202(b) required SDs and MSPs to keep daily trading records, similar to those SDs and MSPs are required to keep for swaps, for related cash and forward transactions, defined under proposed § 23.200 as “a purchase or sale for immediate or deferred physical shipment or delivery of an asset related to a swap where the swap and the related cash or forward transaction are used to hedge, mitigate the risk of, or offset one another.”

The Working Group urged the Commission to recognize that, although participants in physical energy commodity markets use swaps and futures to hedge underlying physical positions, they do not, as a general matter, execute such transactions specifically for the purpose of hedging a specified underlying physical position. Rather, according to The Working Group, the predominant practice in physical energy markets is to hedge underlying physical positions on a portfolio or aggregate basis. Given the wide use of portfolio hedging in energy markets, The Working Group believes it would be difficult for energy market participants to link physical positions with arguably “related” swap transactions. The Working Group believes that compliance with proposed § 23.202(b) would impose a large number of very expensive and burdensome requirements on millions of physical transactions that are undertaken by commercial energy firms that are also parties to swap transactions.

ISDA & SIFMA commented that hedging and risk mitigation activities referred to in the proposed daily trading records rule are typically not executed with respect to specific trades; rather they are executed against the overall positions of business units such as trading desks and that it would not be

possible to link cash and forward transactions to a specific swap. ISDA & SIFMA also commented that the reference to “hedge” also requires clarity to know the extent to which it comports with existing definitions in the CEA.

Having considered these comments, the Commission is adopting the rule as proposed. The Commission notes that section 4s(g)(1) of the CEA requires registrants to “maintain daily trading records of their swaps \* \* \* and related records (including related cash and forward transactions) \* \* \*.” Rule § 23.200 defines “related cash and forward transactions” as “a purchase or sale for immediate or deferred physical shipment or delivery of an asset related to a swap where the swap and the related cash and forward transaction are used to hedge, mitigate the risk of, or offset one another.” The Commission observes that the definition requires that a “related cash and forward transaction” be related to at least one swap, but does not prohibit such transaction from being related to more than one swap, or a swap from being related to more than one related cash or forward transaction. Therefore, the Commission believes the commenters' concerns that compliance with the rule is not possible in the context of portfolio hedging is misplaced. In addition, in response to the comments received, the Commission confirms that this definition is used solely for purposes of SD and MSP recordkeeping and is not intended to define hedging transactions for any other purpose or any other Commission regulation.

#### E. Records; Retention and Inspection—§ 23.203

##### 1. Swap and Related Cash or Forward Record Retention Period—§ 23.203(b)(2)

Proposed § 23.203(b)(2) required SDs and MSPs to retain records of any swap or related cash or forward transaction until the termination or maturity of the transaction and for a period of five years after such date.

MFA commented that the vast majority of its members do not currently keep records of transactions for five years following the termination, expiration, or maturity of the transactions and compliance with this rule would be burdensome and costly. MFA recommended that the Commission not impose this record retention requirement on MSPs.

The Working Group argued that the long-term electronic storage of significant amounts of pre-execution communications will prove costly over the proposed five-year period. The

Working Group recommended that the Commission re-evaluate whether all records subject to the proposed rule's retention requirements require a five year retention period.

ISDA & SIFMA recommended that further analysis and consultation be performed on the costs and benefits of holding records of all oral and written communications that lead to execution of a swap for the life of a swap plus five years. ISDA & SIFMA commented that they would be supportive of a voice recording obligation aligned to the rules of the UK Financial Services Authority, which are to retain recordings for a minimum period of six months.

By contrast, Chris Barnard recommended that records should be required to be kept indefinitely rather than the general five years under the proposal.

Having considered these comments, the Commission notes that proposed revisions to Commission regulation § 1.31 require retention of swap transaction records for a period of five years following the termination, expiration, or maturity of a swap,<sup>14</sup> and that § 23.203 is consistent with retention requirements under the final swap data reporting rule.<sup>15</sup> However, in response to commenters' concerns regarding retention of pre-execution trade information, the Commission is revising the rule to require that voice recordings need be kept for only one year. The Commission believes that the one-year retention period for voice recordings will enable the Commission to execute its enforcement responsibilities under the CEA adequately while minimizing the costs imposed on SDs and MSPs.

##### 2. “Readily Accessible”—§ 23.203(b)(1) and (b)(2)

The proposed regulation required SDs and MSPs to have both general records and swaps and related cash or forward transaction records readily accessible for the first two years of the applicable retention period.

The Working Group recommended that the Commission clarify whether the requirement that retained records be “readily accessible” means readily accessible by the registrant or by the Commission.

In response, the Commission observes that the term “readily accessible” has been the operative standard in § 1.31 of the Commission's regulations for several years. Specifically, § 1.31 requires that

<sup>14</sup> See Adaptation of Commission Regulations to Accommodate Swaps, 76 FR 33066, 33088 (June 7, 2011).

<sup>15</sup> See 17 CFR 45.2, Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136, 2198 (Jan. 13, 2012).

<sup>13</sup> See Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519, 81531 (Dec. 28, 2010).

“[a]ll books and records required to be kept by the Act or by these regulations shall be kept for a period of five years from the date thereof and shall be readily accessible during the first 2 years of the 5-year period.” In response to The Working Group’s request for clarification, the Commission expects a registrant to be able to access such records promptly, and such records “shall be open to inspection by any representative of the Commission or the United States Department of Justice.”<sup>16</sup>

### 3. Records To Be Retained in Accordance With Commission Regulation 1.31—§ 23.203(b)

Proposed § 23.203(b) required SDs and MSPs to maintain records in accordance with existing § 1.31.

The Working Group commented that § 1.31 appears to apply to written documents, including electronic images of such documents, and does not seem suitable for electronic records such as those in a trading system, that do not originate from a written document. To be made workable for purposes of complying with the Commission’s proposed requirements, The Working Group recommended that § 1.31 be revised to reflect current technologies and industry practices relating to digitized data storage.

The Commission has considered The Working Group’s comment, but is adopting the rule as proposed. The Commission believes that The Working Group’s concerns about § 1.31 have been addressed by a subsequent rule proposal to amend § 1.31 to reflect current technologies and industry practices related to digitized data storage.<sup>17</sup> If these amendments are finalized, the Commission believes that § 1.31 will be compatible with electronic records in a trading system and other records that do not originate from a written document.

#### F. Duties of SDs and MSPs

As part of an overall business conduct regime for SDs and MSPs, section 4s(j) of the CEA, as added by section 731 of the Dodd-Frank Act, sets forth certain duties for SDs and MSPs, including the duty to: (1) Monitor trading to prevent violations of applicable position limits; (2) establish risk management procedures adequate for managing the day-to-day business of the SD or MSP; (3) disclose to the Commission and to

applicable prudential regulators<sup>18</sup> general information relating to swaps trading, practices, and financial integrity; (4) establish and enforce internal systems and procedures to obtain information needed to perform all of the duties prescribed by Commission regulations; (5) implement conflict-of-interest systems and procedures; and (6) refrain from taking any action that would result in an unreasonable restraint of trade or impose a material anticompetitive burden on trading or clearing. In its Duties NPRM, the Commission proposed six regulations to implement section 4s(j), specifically addressing risk management, monitoring of positions limits, diligent supervision, business continuity and disaster recovery, the availability of general information, and antitrust considerations. The Commission’s proposed conflicts of interest policies and procedures were the subject of the separate SD/MSP Conflicts NPRM and are discussed below. The Commission received 20 comment letters in response to the Duties NPRM and considered each in formulating the final rules.

#### G. Risk Management Program for SDs and MSPs—§ 23.600

The Commission proposed § 23.600, which required SDs and MSPs to establish and maintain a risk management program reasonably designed to monitor and manage the risks associated with their business as an SD or MSP. Proposed § 23.600 specifically required the risk management program established by SDs and MSPs to consist of written policies and procedures; to have its risk management policies and procedures approved by the governing body of the SD or MSP; and to establish a risk management unit independent from the business trading unit to administer the risk management program.

##### 1. Definitions—§ 23.600(a)

The Commission proposed definitions of “affiliate,” “business trading unit,” “clearing unit,” “governing body,” “prudential regulator,” and “senior management.”<sup>19</sup> The definitions set

<sup>18</sup> This term is defined for the purposes of this rulemaking and has the same meaning as section 1(a)(39) of the CEA, which includes the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Association, and the Federal Housing Finance Agency.

<sup>19</sup> No comments were received on the proposed § 23.600(a) definitions of “affiliate,” “clearing unit,” or “prudential regulator.” With the exception of one change to the definition of “prudential regulator”, the Commission has decided to adopt those definitions as proposed.

forth in § 23.600(a) will apply only to provisions contained in § 23.600. The Commission is adopting the definitions largely as proposed, with the exceptions discussed below.

##### a. Business Trading Unit—§ 23.600(a)(2)

SIFMA recommended that (i) the Commission modify the definition of “business trading unit” to delete the phrase “or is involved in” and replace it with “directly engaged in” to avoid inclusion of risk management, legal, credit, and operations personnel, all of whom could be deemed to be “involved in” business trading unit activities; and (ii) the Commission clarify that independent financial control functions that perform price verification for internal purposes (as opposed to providing prices to clients) are excluded from the business trading unit.

The Commission did not intend to include risk management, legal, credit, and operations personnel in the definition and has revised the definition to exclude such personnel. However, the Commission does not believe that only those personnel “directly engaged in” pricing, trading, sales, marketing, advertising, solicitation, structuring, or brokerage activities sufficiently captures those personnel intended to be included by the definition for purposes of the rule. Thus, the Commission is modifying the proposed definition to exclude risk management, legal, credit, and operations personnel, but also to include specifically personnel exercising direct supervisory authority over the performance of business trading unit functions. Per SIFMA’s recommendation, the Commission also has modified the definition to exclude price verification for risk management purposes from the list of business trading unit functions. The Commission believes that the definition as revised will be less burdensome for registrants, but retains the original intent of the definition.

##### b. Governing Body and Senior Management—§ 23.600(a)(3) and (4)

Cargill recommended that the Commission expand the definitions of governing body and senior management to include the governing body or senior management of the division of a larger company. Cargill, SIFMA, and MetLife also recommended that the Commission permit a management committee or board committee to serve the function of a governing body. SIFMA further requested that the Commission confirm that governing body and senior management approvals required under the proposed rules may occur at the holding company level.

<sup>16</sup> Regulation 1.31 further provides that “[a]ll such books and records shall be open to inspection by any representative of the Commission or the United States Department of Justice.”

<sup>17</sup> See Adaptation of Commission Regulations to Accommodate Swaps, 76 FR 33066, 33088 (June 7, 2011).

SIFMA recommended that the Commission not limit the definition of “senior management” to direct reports of the chief executive officer, but include any other officer having supervisory or management responsibility (including at the consolidated group level) for any organizational unit, department or division. BG Americas & Global LNG (BGA) argued that the requirement that the risk management unit report directly to a senior officer that reports directly to the CEO is too rigid and does not reflect the reality of most energy trading companies.

In response to commenters, the Commission is modifying the proposed definition of “governing body” to allow an SD or MSP to designate as its governing body “(1) a board of directors; (2) a body performing a function similar to a board of directors; (3) any committee of a board or body; or (4) the chief executive officer of a registrant, or any such board, body, committee or officer of a division of a registrant, provided that the registrant’s swaps activities for which registration with the Commission is required are wholly contained in a separately identifiable division.” The Commission believes that under this definition the governing body of an SD or MSP could include a board committee or the governing body or senior management of a division, provided that the swaps activities of an SD or MSP are wholly contained in a separately identifiable division.

Likewise, in response to commenters, the Commission is modifying the proposed definition of “senior management” to provide increased flexibility in registrant governance structures. The Commission is revising the proposed definition to require only that senior management consist of officers of the SD or MSP that have been “specifically granted the authority and responsibility by the registrant’s governing body to fulfill the requirements of senior management.”

The Commission believes that the increased flexibility permitted by the revised definitions of “governing body” and “senior management” will be less burdensome for SDs and MSPs, but retains the Commission’s intent to have accountability at the highest level of management.

## 2. Scope of Risk Management Program—§ 23.600(b)

The proposed regulations required SDs and MSPs to establish, document, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the business of the

SD or MSP and the Risk Management Program to take into account risks posed by affiliates and take an integrated approach to risk management at the consolidated entity level.

The Working Group, MetLife, and the Office of the Comptroller of the Currency argued that § 23.600 should be limited to the risks associated with swaps activities, and not other business lines in which the SD or MSP may engage. The Working Group also recommended that the rule be revised to require the risk management program to take into account only swaps-related risks posed by affiliates and take an integrated approach to risk management at the consolidated entity level to the extent the SD or MSP deems necessary to enable effective risk and compliance oversight.

Based on these comments, the Commission has determined that the risk management rules will be limited in scope to apply only to the swaps activities of SDs and MSPs and is modifying proposed § 23.600(b)(1) as recommended by The Working Group.

On the other hand, the Commission has rejected The Working Group’s recommendation that SDs and MSPs consider only swaps-related risks posed by affiliates. The Commission believes that an SD or MSP should be aware of all risks posed by affiliates, and the rule should require the SD’s or MSP’s Risk Management Program to be integrated into overall risk management considerations at the consolidated entity level. However, the Commission is modifying proposed § 23.600(c)(1)(ii) to reflect the fact that Risk Management Programs within an SD or MSP may not have the authority to direct other divisions of a larger company.

Further, the Commission recognizes that some SDs and MSPs will be part of a larger holding company structure that may include affiliates that are engaged in a wide array of business activities. The Commission understands with respect to these entities, that in some instances, the top level company in the holding company structure is in the best position to evaluate the risks that an affiliate of an SD or MSP may pose to the enterprise, as it has the benefit of an organization-wide view and because an affiliate’s business may be wholly unrelated to swaps activities. Therefore, to the extent an SD or MSP is part of a holding company with an integrated risk management program, the SD or MSP may address affiliate risks and comply with § 23.600(c)(1)(ii) through its participation in a consolidated entity risk management program.

## 3. Flexibility To Design Risk Management Program—§ 23.600(b)

The proposed regulation required a registrant’s risk management program to include certain enumerated elements: identification of risks and risk tolerance limits; periodic risk exposure reports; a new product policy; policies and procedures to monitor and manage market risk, credit risk, liquidity risk, foreign currency risk, legal risk, operational risk, and settlement risk; use of central counterparties; compliance with margin and capital requirements; and monitoring of compliance with risk management program.

The Working Group and the Edison Electric Institute (EEI) commented that proposed § 23.600 requires a level of detail in the Risk Management Program not provided for in the Dodd-Frank Act, and recommended that the final rules be flexible enough to allow firms to adapt their existing compliance and risk management measures, and not cause firms to add entirely new compliance or risk management infrastructure.

Having considered these comments, the Commission is adopting the rule substantially as proposed. The Commission believes that the requirements of the rules represent prudent risk management practices, but do not prescribe rigid organizational structures. The Commission also believes the “policies and procedures” approach provides an adequate amount of flexibility that will allow registrants to rely upon any existing compliance or risk management capabilities to meet the requirements of the proposed rules. The Commission further believes that nothing would prevent firms from relying upon existing compliance and risk management programs to a significant degree.

## 4. Risk Management Policies and Procedures—§ 23.600(b)(2)

Proposed § 23.600(b)(2) required that a registrant’s risk management program be described in written policies and procedures, that such policies and procedures be approved in writing by the registrant’s governing body, and that such policies and procedures be provided to the Commission upon registration and following any material change.

SIFMA recommended that the Commission clarify that written risk management policies and procedures need not be documented in a single, consolidated set, so long as such policies and procedures address all of the elements of the risk management program required by the proposed rules. Cargill commented that registrants

should not be required to furnish risk management policies and procedures to the Commission, as such policies and reports can be obtained by the Commission by special call or reviewed during examinations. By way of contrast, Chris Barnard recommended that the Commission expand the reporting requirement to include public disclosure to allow for market participants to assess a registrant's approach to risk management and increase confidence in the swap markets.

In response to SIFMA's and Cargill's comments, the Commission is modifying the proposed rule to provide that an SD's or MSP's written policies and procedures must be provided upon application for registration to the Commission, or to a futures association registered under section 17 of the CEA, if directed by the Commission, but thereafter only upon request of the Commission. Additionally, the Commission confirms that, so long as the required policies and procedures are maintained in a reasonably useable and accessible fashion, the rule is not intended to mandate the form or manner of documentation or retention.

With respect to Mr. Barnard's recommendation, the Commission is not adopting a public disclosure requirement because registrants' risk management policies and procedures may contain sensitive or proprietary information.

#### 5. Risk Management Unit— § 23.600(b)(5)

Proposed § 23.600(b)(5) required SDs and MSPs to establish a risk management unit that reports directly to senior management, that is independent from the business trading unit, and that has sufficient authority and resources to carry out the risk management program required by the proposed regulations.

SIFMA recommended that the Commission clarify that different risk management processes may be managed by independent control functions, organized by relevant discipline or specialization, and that such functions, so long as they comply with the independence and other requirements applicable to the risk management unit, need not be part of a single risk management unit. To facilitate a functional working relationship, The Working Group recommended that the Commission clarify that separation of the risk management unit and business trading unit requires only separate and independent oversight of business unit and risk management unit personnel, but not actual physical separation of such personnel.

BGA recommends that the Commission allow the risk and trading units to report to a shared senior officer, as long as the senior officer does not participate in directing, organizing, or executing trades. According to BGA, this would be consistent with the Federal Energy Regulatory Commission's requirement for achieving independence between franchised public utilities and their market-regulated power sales affiliates, and would achieve the appropriate level of independence without requiring companies to overhaul their existing management structures.

Better Markets commented that simply requiring Risk Management Unit independence is inadequate and recommends that the Commission ensure independence with rules similar to those proposed to ensure independence of research analysts in proposed § 23.605, while Cargill requested that the Commission provide greater flexibility in how SDs arrange monitoring and compliance of their risk management program, rather than rigidly requiring complete independence from the business trading unit.

Having considered these comments, the Commission is adopting the rule as proposed. While § 23.600(b)(5) does not require a registrant's risk management unit to be a formal division in the registrant's organizational structure, the Commission expects that an SD or MSP will be able to identify all personnel responsible for required risk management activities as its "risk management unit" even if such personnel fulfill other functions in addition to their risk management activities. In addition, § 23.600(b)(5) permits SDs and MSPs to establish dual reporting lines for risk management personnel performing functions in addition to their risk management duties, but the rule would not permit a member of the risk management unit to report to any officer in the business trading unit for any non-risk management activity. The Commission believes that such dual reporting invites conflicts of interest and would violate the rule's risk management unit independence requirement.

As requested by The Working Group, the Commission confirms that independence of the risk management unit from the business trading unit does not require physical separation.

The Commission notes that per the revised definition of "senior management" discussed above, the risk management unit will not be required to report to an officer that reports directly to the CEO, but to ensure the

independence of the risk management unit, the rule would not permit the risk management unit and business trading unit to report to a shared senior officer. The Commission also believes, however, that reporting line independence is sufficient to ensure accountability for the independence of the risk management unit, and, therefore, is not requiring firewalls of the type required in § 23.605 to ensure research analysts are free from conflicts of interest, as proposed by the Better Markets comment.

#### 6. Risk Measurement Frequency— § 23.600(c)(4)

Proposed § 23.600(c)(4) required registrants to measure their market, credit, liquidity, and foreign currency risk daily.

MetLife commented that the daily risk measuring required by the proposed rule may be excessive for some MSPs, may require substantial information technology and human capital investments, and recommended that the frequency of risk measuring should be determined by an MSP's risk management unit and governing body, rather than be mandated by the Commission.

The Commission is adopting the rule as proposed. MSPs are, by definition, market participants that have a substantial position in swaps, and have outstanding swaps that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. financial markets, or are highly leveraged. Therefore, the Commission believes that it is entirely appropriate to require such market participants to measure their market, credit, liquidity, and foreign currency risk at least daily.

#### 7. Approval of Exceptions to Risk Tolerance Limits—§ 23.600(c)(1)(i)

Proposed § 23.600(c)(1)(i) required that risk tolerance limits be approved by an SD's or MSP's senior management and governing body and that exceptions to such limits be approved, at a minimum, by a supervisor in the risk management unit.

SIFMA recommended that, subject to aggregate risk limits established for the relevant trading supervisor's authority, trading supervisors, rather than risk management personnel, should have the authority to approve risk tolerance limit exceptions. SIFMA argued that the required quarterly risk exposure reports provided to a registrant's senior management and governing body are an adequate check on decision-making by trading supervisors.

In response to SIFMA's comments, the Commission is revising proposed § 23.600(c)(1)(i) to remove the provision that requires risk management personnel to approve exceptions to risk tolerance limits. Instead, the Commission has determined that exceptions, along with the risk tolerance limits, must be subject to written policies and procedures. With this change, SDs and MSPs are free to grant discretion to trading supervisors to approve risk tolerance limit exceptions within the overall risk tolerance limits approved by the registrant's senior management and governing body.

#### 8. New Product Policy—§ 23.600(c)(3)

Proposed § 23.600(c)(3) required SDs and MSPs to include a new product policy in their risk management programs. The proposed regulations required that such policies include an assessment of the risks of any new product prior to engaging in transactions and specifically required an assessment of potential counterparties; the product's economic function; pricing methodologies; legal and regulatory issues; market, credit, liquidity, foreign currency, operational, and settlement risks; product risk characteristics; and whether the product would alter the overall risk profile of the registrant.

The Working Group recommended that the regulations require only that (i) before an SD or MSP offers a new product, it must conduct due diligence that is commensurate with the risks associated with such product, and (ii) the decision to offer the product be approved by appropriate risk management and business unit personnel. In addition, the Working Group suggested that the Commission provide that the determination as to whether a product is "new" should be left to the SD or MSP.

SIFMA recommended that (i) the Commission clarify that a registrant may structure its new product approval framework so as to focus on only those risk elements that are deemed to be relevant to the product at issue, rather than rigidly following the enumerated list in § 23.600(c)(3); (ii) the Commission allow registrants to provide contingent or limited preliminary approval of new products at a risk level that would not be material to the registrant, in order to provide registrants with the opportunity to obtain experience with the product and to facilitate development of appropriate risk management processes for such product; and (iii) the Commission harmonize its new product policy rules with existing regulatory guidance in this

area from banking regulators, the SEC, and SROs.

In response to the commenters' suggestions, the Commission confirms that the list of risks in § 23.600(c)(3)(ii) only need be considered if relevant to the new product, and the Commission is modifying the first sentence of the proposed rule to include the phrase "all relevant risks associated with the new product."

In response to SIFMA's recommendation, the Commission also is revising the proposed rule to permit SDs and MSPs to grant limited preliminary approval of new products (i) at a risk level that would not be material to the registrant, and (ii) solely for the purpose of facilitating development of appropriate operational and risk management processes for such product.

The Commission is not making any other changes to the rule as proposed. The new product policy was adapted from existing banking and SEC guidance in this area, and the Commission believes the rule as proposed provides adequate guidance with respect to the factors to be considered in determining whether a product is "new" and whether the product presents new risks that should be addressed prior to engaging in any transaction involving the new product.

#### 9. Reporting of Risk Exposure Reports to the Commission—§ 23.600(c)(2)(ii)

Proposed § 23.600(c)(2)(ii) required SDs and MSPs to provide their senior management and governing body with quarterly Risk Exposure Reports detailing the registrant's risk exposure and any recommendations for changes to the risk management program, and copies of these reports were required to be furnished to the Commission within five business days of providing them to senior management.

The Working Group recommended that the Commission provide a standard form of report for any report to be required under the proposed rules, and to clarify what the governing body or senior management is expected to do with information delivered under the rules. The Working Group and Cargill also recommended that Risk Exposure Reports should be required to be submitted to the Commission only upon request so as not to drain Commission resources.

The Commission is not modifying the proposed rule to require SDs' and MSPs' periodic Risk Exposure Reports to be submitted to the Commission only upon request. As discussed below, the rule will require SDs and MSPs to provide these reports to their senior

management and governing body no less than quarterly, thus the Commission believes that also furnishing the reports to the Commission quarterly will not be an additional burden.

In response to The Working Group, the Commission has determined not to provide a standard, prescriptive form for the report; rather the form of the report is left to the discretion of the registrant.

In response to The Working Group's request for clarification about what management is supposed to do with Risk Exposure Reports, the Commission believes these reports will serve important informational purposes related to the key risks associated with the registrants' swaps activities and help to ensure accountability at the highest levels for those swap activities of registrants.

#### 10. Reporting to Senior Management and/or Governing Body—§ 23.600(c)(2)(i)

Proposed § 23.600(c)(2)(i) required SDs and MSPs to provide their senior management and governing body with Risk Exposure Reports detailing the registrant's risk exposure, and any recommendations for changes to the risk management program, quarterly and upon any material change in the risk exposure of the registrant.

The Working Group and Cargill each commented that Risk Exposure Reports should be provided to senior management and governing body annually. The Working Group argued that quarterly reporting would be too costly and burdensome, would take resources away from risk monitoring, and the frequency may force firms to disclose risk exposures before remedial steps can be taken.

The Commission is adopting the rule as proposed. The Commission does not believe that provision of Risk Exposure Reports to senior management and the governing body of a registrant four times a year is overly burdensome, but rather will provide management with the information necessary to monitor and make adjustments to risk levels in a timely manner.

#### 11. Frequency of Review, Testing, and Audit—§ 23.600(e)

Proposed § 23.600(e) required SDs and MSPs to review and test their risk management programs quarterly using internal or external auditors independent of the business trading unit.

The Working Group, Cargill, and MetLife each recommended that both the frequency and the scope of audits of the risk management program be left to the discretion of the registrant, so long

as such audits are effective and are conducted at least annually. The Working Group and Cargill argued that this regime would provide the desired results without the unnecessary cost and administrative burden imposed by the proposed rules. The Working Group also recommended that the Commission define or clarify what “testing” of the Risk Management Program requires.

Having considered these comments, the Commission is modifying proposed § 23.600(e) to require only *annual* testing and audit of an SD’s or MSP’s Risk Management Program. The Commission has determined not to specify testing procedures at this time, but to leave the design and implementation of testing procedures to the reasonable judgment of each registrant.

#### 12. Risk Categories—§ 23.600(c)(4)

As proposed, § 23.600(c)(4) required SD and MSP risk management programs to include, at a minimum, certain enumerated elements, including policies and procedures to monitor and manage market risk, credit risk, liquidity risk, foreign currency risk, legal risk, and operational risk.

SIFMA recommended that the Commission clarify that so long as the enumerated risks in § 23.600(c)(4) are systematically monitored and managed, the Commission does not intend to require that each enumerated risk be subject to distinct risk management processes.

While the rule requires that each enumerated risk must be the subject of distinct risk management policies and procedures, Commission does not intend to mandate specific risk management processes. The specific methods of monitoring and managing all risks associated with the swaps activities of an SD or MSP are left to the discretion of the registrant.

#### 13. Market Risk—§ 23.600(c)(4)(i)

Proposed § 23.600(c)(4)(i) required SDs and MSPs to measure their market risk daily, including exposure due to unique product characteristics, volatility of prices, basis and correlation risks, leverage, sensitivity of option positions, and position concentration. The proposed rule would require that if valuation data is derived from pricing models, that such models be validated by qualified, independent persons.

The Working Group recommended that metrics for options, particularly the sensitivity for options, be required to be measured on a frequency less than daily, as metrics can require complex calculations, some of which must be done outside the trading or risk

management system. The Working Group also recommended that the Commission clarify that models may be verified by independent, but internal, qualified persons.

In response to The Working Group’s comments, the Commission clarifies that, to the extent that an input for measurement of market risk has a reasonable degree of accuracy over a period longer than one day, it would be permissible for a registrant’s risk management policies to reflect the conclusion that such an input would not need to be calculated daily for purposes of the daily measurement of a registrant’s market risk. The Commission also is modifying the proposed rule to clarify that pricing models may be verified by qualified, independent internal persons.

#### 14. General Ledger Reconciliation—§ 23.600(c)(4)(i)(C)

The proposed regulations required SDs and MSPs to reconcile profits and losses resulting from valuations with the general ledger at least once each business day.

The Working Group commented that, to the extent that transaction valuations are tracked daily, they ordinarily would be tracked in the firm’s trading or risk management system, not the general ledger system. The Working Group recommended that consolidation to the general ledger only be required monthly.

Having considered these comments, the Commission has determined that the rule need not require daily reconciliation to the general ledger in order to address the need to manage the risk of a failure to account properly for profits and losses. The Commission therefore is revising the proposed rule to require only that SDs and MSPs have policies and procedures to ensure “periodic reconciliation of profits and losses resulting from valuations with the general ledger.”

#### 15. Establishment of Credit Limits Prior to Trading—§ 23.600(d)(2)

Proposed § 23.600(d)(2) required that SDs and MSPs have policies and procedures requiring traders to transact only with counterparties for whom credit limits have been established.

The Working Group recommended that the Commission allow discretion to make exceptions to the requirement that trades only be executed with counterparties for which credit limits have been established for certain limited risk transactions. Arguing that some transactions carry no counterparty credit risk and that some SDs and MSPs may hedge their counterparty credit

risk, SIFMA recommended that, instead of requiring establishment of credit limits prior to trading, the Commission require only that a credit risk evaluation be made prior to trading.

The Commission is adopting the rule as proposed. The Commission observes that the rule does not define “credit limit” and thus provides sufficient discretion to SDs and MSPs to implement policies addressing limited counterparty credit risk transactions.

#### 16. Credit Risk Measurement—§ 23.600(c)(4)(ii)(A)

Proposed § 23.600(c)(4)(ii)(A) required SDs and MSPs to have credit risk policies and procedures providing for daily measurement of overall credit exposure to ensure compliance with counterparty credit limits.

Better Markets argued that the Commission’s proposal for rules relating to credit risk are inadequate insofar as they do not provide guidance on how credit risk is to be measured. Better Markets recommended that the Commission’s rules relating to management of credit risk require measurement of credit risk using the same techniques employed by derivatives clearing organizations (DCOs) registered with the Commission. Better Markets also specifically recommended that the Commission require credit risk policies of SDs and MSPs to address (i) the risk posed by collateral triggers (like credit rating downgrades) that may require immediate funding under stressful circumstances, and (ii) the credit risk of futures commission merchants (FCMs) acting for the SD or MSP as its clearing member.

Having considered Better Market’s comments, the Commission is adopting the rule as proposed. The Commission believes it need not specify a credit risk measurement methodology because the adequacy of a registrant’s individual credit risk measurement methodology will be assessed upon a review of a registrant’s policies and procedures during registration or upon examination. The Commission also believes that credit risk to FCMs would be covered by the required monitoring and risk management of clearing members by DCOs and the Commission.

#### 17. Liquidity Risk—§ 23.600(c)(4)(iii)(B)

The proposed rules required SDs and MSPs to test their procedures for liquidating all non-cash collateral in a timely manner and without significant effect on price.

SIFMA argued that firms assess the types of collateral that they are willing to accept based on the risk, volatility,

liquidity, and other characteristics of the collateral and additionally establish conservative haircuts for the valuation of collateral, not through testing by actual or simulated disposition of collateral. SIFMA therefore recommended that the Commission not require testing of liquidation procedures by simulated disposition, but only require policies and procedures for identifying acceptable collateral and establishing appropriate haircuts, taking into account reasonably anticipatable adverse price movements.

The proposed rule was not intended to impose a requirement that registrants test collateral liquidation procedures by means of actual or simulated disposition. However, to clarify this matter, the Commission is revising the proposed rule to require policies and procedures that “assess” rather than “test” procedures to liquidate all non-cash collateral in a timely manner without significant effect on price.

#### 18. Foreign Currency Risk— § 23.600(c)(4)(iv)

Proposed § 23.600(c)(4) required SDs and MSPs to measure the amount of capital exposed to fluctuations in the value of foreign currency daily.

The Working Group recommended that the Commission permit the frequency of measurement of capital exposed to fluctuations in the value of foreign currency to be left to the discretion of the firm, rather than mandating daily measurement.

The Commission believes that the foreign exchange markets are fluid and quick moving, and, therefore, the requirement for daily measurement is not excessive. Accordingly, the Commission is adopting the rule as proposed with respect to foreign currency risk.

#### 19. Legal Risk—§ 23.600(c)(4)(v)

Proposed § 23.600(c)(4)(v) required SDs’ and MSPs’ risk management policies and procedures to address determinations that transactions and netting arrangements entered into by the registrant have a sound legal basis and documentation tracking to ensure completeness of transaction documentation.

SIFMA recommended that the Commission require only policies and procedures to identify and evaluate the legal risks arising in connection with the registrant’s business.

The Commission is making no changes to the rule as proposed. The Commission believes that the two enumerated requirements with respect to legal risk are of special importance with respect to trade processing and risk

measurement, but are by no means exhaustive of the legal risks arising in connection with a registrant’s business, all of which must be identified by the registrant’s risk management policies and procedures.

#### 20. Operational Risk—§ 23.600(c)(4)(vi)

Proposed § 23.600(c)(4)(vi) required SDs and MSPs to establish policies and procedures for managing operational risks, including procedures accounting for reconciliation of all operating and information systems.

The Working Group and SIFMA recommended that the Commission clarify what is meant by “reconciliation of operating and information systems,” as information contained in systems may be reconciled, but systems themselves may not be.

Chris Barnard recommended that the proposed rule be expanded and be more specific about the types of operational risk to be monitored and controlled, arguing that operational risk failures effectively allow other types of risk, such as credit risk and market risk to be excessive. Mr. Barnard also recommended that the proposed rule be expanded to require management for the increased risks inherent in using programs or models from external providers or vendors to avoid using “black boxes” without controls and review.

The Commission agrees with commenters that data within operating and information systems should be reconciled, rather than the systems themselves. Consequently, the Commission is modifying the proposed rule to refer to reconciliation of data within operating and information systems. As modified, the Commission believes that the rule is sufficiently specific to enable SDs and MSPs to establish policies and procedures for adequately managing operational risks, and as such, the Commission is making no changes to the rule based on Mr. Barnard’s comments. Nonetheless, the Commission notes that Mr. Barnard’s concern about black boxes is addressed, in part, by the requirement to have policies and procedures governing the use and supervision of trading programs under proposed § 23.600(d)(9), as discussed further below.

#### 21. Use of Central Counterparties— § 23.600(c)(5)

Proposed § 23.600(c)(5) required SDs and MSPs to establish policies and procedures related to central clearing of swaps, including policies that require the use of clearing when a swap is subject to a mandatory clearing determination issued by the

Commission, policies setting forth conditions for the voluntary use of central clearing as a means of mitigating counterparty credit risk, and policies requiring diligent investigation into the adequacy of financial resources and risk management procedures of any central counterparty through which the registrant clears.

The Working Group argued that the adequacy of resources and risk management at CCPs registered with the Commission should be monitored by the Commission, not individual firms. EEI requested that the Commission clarify that proposed § 23.600(c)(5) is not seeking to require SDs to use central clearing to mitigate risk if clearing is not required under a valid exemption.

The Commission is adopting the rule regarding use of central counterparties as proposed. The Commission’s registration of a central counterparty as a DCO is based on a determination that the applicant meets core principles under the Commodity Exchange Act and Commission regulations. It does not, however, serve as a substitute for the due diligence of registrants who must evaluate the use of a central counterparty in light of their own circumstances. In addition, SDs and MSPs may elect to clear swaps that are not required to be cleared on a voluntary basis through central counterparties that are not registered with the Commission. In those instances, an SD or MSP engaging in some manner of due diligence prior to submitting a swap for clearing would be part of a prudent risk management program. In response to EEI’s comment, the Commission observes that the rule would require only that registrants evaluate the use of central clearing as a means of mitigating counterparty credit risk and as part of their overall risk management strategy. Moreover, the rule expressly notes the exception from mandatory clearing that is provided for under section 2(h)(7) of the CEA.

#### 22. Business Trading Unit—§ 23.600(d)

As proposed, § 23.600(d) required SDs and MSPs to establish policies and procedures that require all trading policies to be approved by the governing body of the registrant.

The Working Group recommended that the governing body of an SD or MSP be permitted to delegate approval of trading policies to those with expertise.

The revisions to the definition of governing body discussed above, which allows for a governing body to consist of a committee or the CEO, sufficiently address the Working Group’s concerns.

The Commission thus has made no changes to the rule.

23. Transaction Entry by Traders—  
§ 23.600(d)(5)

Proposed § 23.600(d)(5) required SDs and MSPs to establish policies and procedures that require each trader to follow established policies and procedures for executing and confirming all transactions. Further, in a discussion about the independence of the risk management unit in the preamble to the proposal, the Commission stated that “personnel responsible for recording transactions in the books of the swap dealer or major swap participant cannot be the same as those responsible for executing transactions.”

The Working Group requested clarification about requirements for transaction entry based on the statements made in the preamble to the proposal. The Working Group argued that if the reference to recording transactions in the books of a firm is intended to refer to entries into the general ledger system, then the Working Group agreed that this process should be subject to the usual segregation of duties requirements that protect the general ledger system, but that there is no reasonable basis to prohibit individuals who execute transactions from entering the information regarding such transactions into a firm’s trading or risk management system.

BGA commented that typical practice is for traders to enter the trade into the deal monitoring system, and then the risk control group performs a daily review of all new and amended trading activity. BGA explained that the mid-office risk control review is followed by a second review of the trade activity performed by the back-office confirmations group, which generates confirmations and performs portfolio reconciliations to match key trade attributes with counterparties. BGA requested clarification that the reference to “recording transactions in the books” in the proposal preamble is not intended to restrict the initial recording of the trade into the deal capture system by the trader, but refers to the daily review and confirmation and portfolio reconciliation processes performed by the mid and back offices.

SIFMA requested that the Commission confirm that compliance with the rule would not preclude trading personnel from entering the trades they execute into a registrant’s trade capture system, provided that the registrant has appropriate policies and procedures reasonably designed to identify the entry of fictitious trades or

the failure to accurately enter actual trades.

In response to these comments, the Commission confirms that the rule is not intended to restrict the initial recording of trades into a trade capture system by the trader. Rather, the rule requires traders to follow established policies and procedures governing trade execution and confirmation.

24. Monitoring of Trading—  
§ 23.600(d)(4) & (d)(9)

As proposed, § 23.600(d)(4) required SDs and MSPs to establish policies and procedures designed to monitor each trader throughout the trading day to prevent the trader from exceeding any limit to which the trader is subject, or from otherwise incurring undue risk. The proposed regulations also require registrants to ensure that trade discrepancies are brought to the immediate attention of senior management and are documented.

The Working Group, with respect to internal limits, recommended that daily monitoring should be at the product desk level, not the trader level, as market practice is to set internal limits at the desk level. Also, the Working Group and SIFMA requested that the Commission clarify that “monitor each trader throughout the trading day” does not mean continuous monitoring, and recommended that the Commission remove the requirement that firms monitor traders to prevent traders from “incurring undue risk” because the meaning of the phrase is ambiguous. The Working Group also recommended that the Commission define “trade discrepancies” and add a materiality standard to the escalation requirement.

MetLife commented that intraday monitoring of traders may be excessive for some MSPs, especially MSPs that use swaps only for hedging purposes. MetLife recommended that the Commission allow the type of monitoring and its frequency to be determined by an MSP’s risk management unit and governing body.

Having considered these comments, the Commission is revising the proposed rule to require monitoring be performed to prevent the incurrence of “unauthorized risk” rather than “undue risk.” The Commission believes this formulation better reflects the intent of the rule, which is to ensure that SDs and MSPs have instituted safeguards against the risk of losses to the firm due to rogue trading.

In response to The Working Group’s comment requesting a definition of “trade discrepancies,” the Commission notes that the term “trade discrepancies” is intended to refer to

any discrepancies between the SD or MSP and its counterparties and to any discrepancies in records or systems of the SD or MSP. Also in response to The Working Group’s recommendation that the proposed rule be modified to add a materiality standard for reporting of trade discrepancies to management, the Commission is modifying the rule to require that only trade discrepancies that are not immaterial, clerical errors be brought to the immediate attention of management of the business trading unit. The rule continues to require that all trade discrepancies be documented.

The Commission has made no other changes to the rule based on the comments received. The Commission believes that prudent risk management requires intraday monitoring of traders to detect prohibited activity that may be otherwise undetectable. The Commission notes that the rule requires monitoring of traders to prevent traders from “exceeding any limit to which the trader is subject” but does not specify the types of limits to be monitored. Thus, the Commission observes that the setting of limits requiring intraday monitoring is left to the discretion of each SD and MSP.

In addition, the Commission is finalizing the requirement that SDs and MSPs have policies and procedures governing the use and supervision of trading programs under proposed § 23.600(d)(9), but deleting the term “algorithmic” from the rule text. This rule is an important measure for ensuring that SDs and MSPs monitor their trading activities. In addition to the risk management requirements under this rule, the Commission notes that the use of trading programs would be subject to, among other things, any applicable prohibitions on disruptive trading practices under the CEA and Commission regulations. The Commission also anticipates addressing the related issues of testing and supervision of electronic trading systems and mitigation of the risks posed by high frequency trading.

25. Brokers—§ 23.600(d)(8)

Proposed § 23.600(d)(8) required SDs and MSPs to establish policies and procedures to ensure that the risk management unit reviews broker’s statements, reconciles brokers’ charges to estimates, reviews and monitors broker’s commissions, and initiates payment to brokers.

The Working Group, SIFMA, and MetLife each recommended that the risk management unit not be tasked with reviewing brokers’ statements, monitoring commissions or initiating broker payments, as these functions are

currently handled by operations or other control units.

The Commission agrees with commenters that review of brokers' statements, monitoring commissions or initiating broker payments need not be performed by risk management personnel. The Commission is revising the proposed rule to replace this requirement with a requirement that risk management policies and procedures include periodic audit of broker's statements and payments by persons independent of the business trading unit. This change provides the relief requested by commenters while maintaining the requirement that risks connected to the use of brokers are adequately monitored and managed.

#### H. Monitoring of Position Limits—§ 23.601

To implement section 4s(j)(1) of the CEA, the Commission proposed § 23.601 in the Duties NPRM, which required SDs and MSPs to establish policies and procedures to monitor, detect, and prevent violations of applicable position limits established by the Commission, a designated contract market (DCM), or a swap execution facility (SEF), and to monitor for and prevent improper reliance upon any exemptions or exclusions from such position limits. Proposed § 23.601 also required SDs and MSPs to: (i) Convert all swap positions into equivalent futures positions using the methodology set forth in Commission regulations; (ii) provide training to all relevant personnel on applicable position limits on an annual basis and promptly upon any change to applicable position limits; (iii) test its procedure for monitoring and preventing position limit violations for adequacy and effectiveness each month; (iv) audit its position limit procedures annually; (v) implement an early warning system designed to alert senior management when position limits are in danger of being breached; and (vi) report any detected violation of applicable position limits to the registrant's governing body and to the Commission. Only four market participants and trade groups provided comments on the Commission's proposal.

##### 1. Monitoring for Violations of Position Limits—§ 23.601(a)

The Working Group argued that it is not possible to determine whether transactions that individual traders enter into violate position limits without placing the transactions in the context of an entire portfolio and any relevant hedge exemptions. The Working Group requested clarification that the requirement for intraday

monitoring of traders under proposed § 23.600(d)(4) does not require monitoring of individual traders for violations of position limits, and that monitoring for violations of position limits is only required in the context of aggregate swaps and futures portfolios.

The Commission believes that The Working Group's request for clarification is outside the scope of these rules. The level at which monitoring for violations of position limits will be required is subject to the final position limit rules,<sup>20</sup> and the Commission directs SDs and MSPs to review new § 151.7 of the final position limit rules for guidance when establishing the Position Limit Procedures required by this rule.

BGA expressed concern about the requirement that an SD or MSP "prevent violations" of position limits established by the Commission. BGA argued that despite having a robust compliance program, it is impossible for an SD or MSP to "prevent violations" because a company cannot before-the-fact prevent a trader from entering a deal that causes a position limit violation. Thus, BGA recommended that the Commission clarify that as long as an SD or MSP provides training on the position limits and establishes and enforces policies for monitoring, detecting, and curing violations, they will have met the obligation to "prevent violations."

The Commission agrees with BGA that SDs and MSPs should be held to a standard of reasonableness in regard to efforts to prevent violations of position limits. The Commission therefore is revising the proposed rule to state that "[e]ach swap dealer and major swap participant shall establish and enforce written policies and procedures that are *reasonably* designed to monitor for and prevent violations of applicable position limits \* \* \*" (modification to rule text in italics).

##### 2. Training on Applicable Position Limits—§ 23.601(c)

SIFMA recommended that the Commission revise § 23.601(c) to provide that a change in position limit levels will not trigger "training," but only require effective notification. The Commission agrees with SIFMA's view and is revising the proposed rule accordingly.

<sup>20</sup> See 17 CFR 151.7, Position Limits for Futures and Swaps, 76 FR 71626, 71692 (Nov. 18, 2011) (adopting 17 CFR 151.7 pertaining to the aggregation of positions).

##### 3. Diligent Monitoring and Diligent Supervision To Ensure Compliance—§ 23.601(d)

SIFMA recommended that the Commission clarify that monitoring for compliance with position limits need not be performed by risk management personnel, but may be performed by independent compliance, operations, or supervisory personnel.

The rule does not require that position limit monitoring be performed by risk management personnel, nor was such a requirement intended. The Commission confirms that monitoring procedures may be conducted at the discretion of the SD or MSP.

##### 4. Reporting Violations to the Governing Body and the Commission—§ 23.601(e)

The Working Group and MetLife doubted the utility of alerting the governing body of nonmaterial violations of position limits as required under proposed § 23.601(e), and recommended that the Commission require alerting the governing body only when a violation is material and allow registrants to define escalation procedures based on materiality in their Position Limit Procedures.

The Commission does not believe that reporting of position limit violations to the governing body of the registrant should be subject to a materiality standard and is adopting the rule as proposed. The Commission intends the reporting rule to ensure accountability for compliance with position limits at the highest levels of management and believes applying a materiality standard to such reporting would undermine the intention of the rule and introduce unnecessary complication for registrants trying to determine how much of a breach would amount to a material breach. However, the Commission observes that a registrant's governing body could take into account the magnitude of the breach and other facts and circumstances in remediating its monitoring program. For instance, a governing body would respond differently to small, inadvertent breaches that are promptly corrected than larger, repeated violations.

With respect to reporting of position limit violations to the Commission, The Working Group argued that the reporting of on-exchange violations of position limits to the Commission is already done by DCMs and will likely be the responsibility of SEFs as well, so SDs and MSPs should not be required to report on-exchange violations to avoid inundating the Commission with redundant information. The Working Group conceded, however, that if

position limit rules require the aggregation of exchange-traded swaps and over-the-counter swaps, then SDs and MSPs should be required to report position limit violations that occur because of over-the-counter swaps, but recommended that such reporting requirement be subject to a materiality standard.

The Commission agrees that on-exchange position limit violations need not be reported to the Commission by registrants, as they will be reported by DCMs or SEFs and has modified the final rule accordingly.

#### 5. Testing and Audit of Position Limit Procedures—§ 23.601(f) and (h)

With respect to monthly testing of Position Limit Procedures required under proposed § 23.601(f) and annual audit required under proposed § 23.601(h), SIFMA recommended that testing and audit of Position Limit Procedures be required only annually and not be required to be done all at the same time. The Working Group recommended that testing only be required on a semi-annual basis (or on a more frequent basis as the firm might determine to be effective), and MetLife requested that the Commission permit the frequency of testing to be determined by an MSP based on the extent of its swap activities. MetLife also recommended that there be a clear exemption from testing requirements for MSPs that do not trade in swaps for which position limits have been established. SIFMA requested that the Commission clarify that testing should consist of testing for accurate capture of all relevant desk positions by position reporting systems and that § 23.601(h) be revised to allow for “agreed upon procedures” for external auditors.

Having considered these comments, the Commission has determined that monthly testing of Position Limit Procedures by registrants may be unduly burdensome, but believes that only annual or semi-annual testing would be inadequate as such could allow violations to remain undetected for long periods. The Commission therefore is modifying the proposed rule to require quarterly testing, and, in response to the comment of MetLife, only if the registrant trades in swaps for which position limits have been established. The annual audit requirement is being adopted as proposed. In response to the request of SIFMA, the Commission confirms that testing of Position Limit Procedures is expected to entail testing of the accuracy of capture of all relevant desk positions by position reporting systems.

#### 6. Quarterly Reporting of Compliance With Position Limits—§ 23.601(g)

With respect to quarterly reporting of compliance with position limits to the chief compliance officer, senior management, and governing body under proposed § 23.601(g), The Working Group recommended that the proposed rule should be revised to require only annual reports to the entity’s senior management and governing body.

As stated above, the Commission intends the reporting rule to ensure accountability for compliance with applicable position limits at the highest levels of management. The Commission believes that the burden of quarterly reporting is outweighed by the benefit of timely notification to decision makers within the SD and MSP of the entity’s record of compliance with applicable position limits, thus providing a timely opportunity to adjust or revise Position Limit Procedures to prevent future violations, if necessary.

#### I. Diligent Supervision—§ 23.602

Proposed § 23.602 was intended to implement section 4s(h)(1)(B) of the CEA, which requires each SD and MSP to conform with Commission regulations related to diligent supervision of the business of the SD and MSP. The proposed regulations required SDs and MSPs to establish a system to supervise all activities relating to its business performed by its partners, members, officers, employees, and agents, that such system be reasonably designed to achieve compliance with the CEA and Commission regulations, that such system designate a person with authority to carry out the supervisory responsibilities of the SD or MSP, and that all such supervisors meet qualification standards that the Commission finds necessary or appropriate.

The Working Group recommended that the Commission not require designation of a single individual with responsibility for supervision, but should allow for designation of a reporting line and that designated supervisors should be permitted to delegate supervisory authority. The Working Group also recommended that SDs and MSPs be given discretion to determine supervisor qualifications, rather than meet “qualification standards as the Commission finds necessary or appropriate.”

MFA recommended that the Commission clarify that the rules do not impose any new (a) fiduciary obligations or duties (i.e., duties beyond those to which participants in the futures and derivatives markets would

otherwise be subject to by agreement or by operation of common law), or (b) supervisory duties on market participants. MFA argued that proposed § 23.602 (Diligent Supervision) is similar to the NFA’s supervision rule for FCMs (Compliance Rule 2–9), and MFA is concerned that § 23.602 may impose fiduciary and supervisory obligations on registrants similar to those that the NFA imposes on FCMs with respect to third parties.

In response to The Working Group’s first comment, the Commission is revising the proposed rule to require “at least one person” rather than “a person” be designated with authority to carry out supervisory responsibilities, which should permit SDs and MSPs more flexibility in designing and implementing the required supervisory system. With respect to the remaining comments of The Working Group, the Commission believes that full accountability for compliance with the CEA and Commission regulations is best served by requiring designation of individuals with supervisory responsibility and that reporting line responsibility is not adequate.

With respect to MFA’s comments, the Commission observes that the rule relates generally to the supervision necessary to achieve compliance with the CEA and Commission regulations by the registrant. Many of the specific activities to be supervised are subject to the CEA and other Commission rules that are outside the scope of this rulemaking. The Commission does not intend that § 23.602 impose a fiduciary duty on SDs or MSPs beyond that which would otherwise exist.

Other than the foregoing, the Commission has adopted the rule as proposed.

#### J. Business Continuity and Disaster Recovery—§ 23.603

Proposed § 23.603 required SDs and MSPs to establish a business continuity and disaster recovery plan that includes procedures for and the maintenance of back-up facilities, systems, infrastructure, personnel, and other resources to achieve the timely recovery of data and documentation and to resume operations generally within the next business day. The proposed regulations also required SDs and MSPs to have their business continuity and disaster recovery plan tested annually by qualified, independent internal audit personnel or a qualified third party audit service.

Tellefsen and Company, L.L.C. (Tellefsen) commented that most, if not all, of potential SDs have the technology and network infrastructure in place to

achieve a next day recovery time objective. However, Tellefsen recommended that the Commission carefully evaluate the business continuity management capabilities of MSPs before establishing a hard date by which these metrics must be in place, as the Commission may have greatly underestimated the time and scope of work for firms to develop, implement and test their business continuity management capabilities (Tellefsen estimates 68–200 person days). The Working Group also argued that the Commission should not require next business day recovery for non-systemically important SDs or MSPs, but should only require recovery “reasonably promptly.”

The Working Group argued that the Commission should not require staffing of back-up facilities to avoid the burden of requiring two persons for the same job. The Working Group also recommended that the Commission should not require annual testing of the business continuity and disaster recovery plan by independent auditors because independent audits would be too costly.

SIFMA recommended that the Commission clarify that an SD’s or MSP’s business continuity and disaster recovery plan may be part of a consolidated plan established for the various entities in a holding company group if they share common personnel, premises, resources, systems, and infrastructure. SIFMA also recommended that the Commission permit SDs and MSPs subject to the business continuity and disaster recovery requirements of a prudential regulator, or other regulator determined to be comparable by the Commission, to comply with § 23.603 on a substituted compliance basis.

The Commission believes that Tellefsen’s concerns regarding the ability of MSPs to comply with the required recovery period will be addressed through the phased implementation of the rule, discussed below.

In response to The Working Group’s comment regarding staffing of back-up facilities, the Commission is modifying the proposed rule to clarify that, so long as prompt recovery is reasonably ensured, SDs and MSPs may provide for alternative staffing of back-up facilities as required under the circumstances. The Commission also agrees with the Working Group that annual testing may be performed by qualified internal personnel and is modifying the proposed rule accordingly. However, the Commission believes that independent audits are required to

ensure that business continuity and disaster recovery plans remain in compliance with the rule, but that annual audits would be unnecessary and unduly burdensome and costly. Therefore, the Commission is revising the proposed rule to require independent audits only every three years.

The Commission believes that all SDs and MSPs may be critically important to the proper functioning of the swaps market. SDs are critical participants in the swap market and MSPs may, by definition, have exposures that could have serious adverse effects on the financial stability of the United States. Therefore, the Commission continues to believe that a one business day recovery period is the necessary objective for SDs’ and MSPs’ business continuity and disaster recovery plans. Accordingly, the Commission is not modifying the final rule in this respect.

In response to SIFMA’s comments, the Commission confirms that so long as a consolidated business continuity and disaster recovery plan established for the various entities in a holding company group that includes an SD or MSP, or any such plan that is required by a prudential regulator of the SD or MSP, meets the requirements of the rule, such SD or MSP would be in compliance with the Commission’s rule. The Commission believes that this result is contemplated by the rule as proposed and so is not modifying the rule in this respect.

#### *K. General Information: Availability for Disclosure and Inspection—§ 23.606*

Proposed § 23.606 required SDs and MSPs to make available for disclosure and inspection by the Commission and the SD’s or MSP’s prudential regulator, all information required by, or related to, the CEA and Commission regulations.

The Working Group recommended that the Commission clarify what is meant by “available for disclosure” if such is different from “available for inspection.” The Working Group also argued that SDs and MSPs should not be required to revise information systems to store information specifically required by each Commission rule, because storage would require extensive investigation that is unnecessary to ensure compliance with the rule.

Having considered The Working Group’s comments, the Commission is adopting the rule as proposed. The Commission does not believe the rule specifies or requires any particular storage medium or methodology, but rather only requires SDs and MSPs to have information systems capable of

producing the required information promptly. The Commission also has determined not to define further “available for disclosure” or “available for inspection” because it believes these terms as employed in the rule have their plain meanings.

#### *L. Antitrust Considerations—§ 23.607*

Proposed § 23.607 prohibited SDs and MSPs from adopting any process or taking any action that results in any unreasonable restraint of trade or imposes any material anticompetitive burden on trading or clearing, unless necessary or appropriate to achieve the purposes of the CEA. The proposed rule also required SDs and MSPs to adopt policies and procedures to prevent such actions.

SIFMA agreed with the Commission’s proposed policies and procedures approach. SIFMA argued however that § 23.607(a) goes further, by imposing a blanket prohibition on a registrant adopting any process or taking any action that results in any unreasonable restraint of trade, or imposes any material anticompetitive burden on trading or clearing (unless necessary or appropriate to achieve the purposes of the CEA). SIFMA expressed concern that, given the counterparty rescission and private right of action provisions of the CEA, this prohibition could introduce additional private liability that is unnecessary in light of the enforcement authority of the Commission and antitrust authorities and existing private rights of action under the antitrust laws. SIFMA therefore recommended that the Commission delete § 23.607(a) and instead rely upon the policies and procedures requirement included in § 23.607(b).

Having considered SIFMA’s comments, the Commission is adopting the rule as proposed. The blanket prohibition in § 23.607(a) is taken directly from the statutory provision and appropriately implements the prohibition in section 4s(j)(6) of the CEA.

#### *M. Conflicts of Interest Policies and Procedures by SDs, MSPs, FCMs, and IBs—§ 23.605, § 1.71*

As discussed above, section 4s(j) of the CEA, as added by section 731 of the Dodd-Frank Act, sets forth certain duties for SDs and MSPs, including the duty to implement conflict-of-interest systems and procedures. Specifically, section 4s(j)(5) mandates that SDs and MSPs implement conflict-of-interest systems and procedures that “establish structural and institutional safeguards to ensure that the activities of any person

within the firm relating to research or analysis of the price or market for any commodity or swap or acting in a role of providing clearing activities or making determinations as to accepting clearing customers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open access and the business conduct standards described in this Act.”

Section 4s(j)(5) further requires that such systems and procedures “address such other issues as the Commission determines to be appropriate.” Proposed § 23.605, as set forth in the SD/MSP Conflicts NPRM, addressed the statutory mandate of section 4s(j)(5).

In relevant part, section 732 of the Dodd-Frank Act amended section 4d of the CEA by creating a new subsection (c), which mandates that the Commission “require that futures commission merchants and introducing brokers implement conflict-of-interest systems and procedures.” New section 4d(c) mandates that such systems and procedures “establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in trading or clearing activities might potentially bias the judgment or supervision of the persons.” New section 4d(c) further requires that such systems and procedures “address such other issues as the Commission determines to be appropriate.” Proposed § 1.71, as set forth in the FCM/IB Conflicts NPRM, addressed the statutory mandate of section 4d(c).

As proposed, §§ 23.605 and 1.71 were identical in all material respects. The Commission received 29 comment letters to the SD/MSP Conflicts NPRM and 26 comment letters to the FCM/IB Conflicts NPRM. Many commenters provided comments addressing identical provisions or issues in both proposed rules. The discussion below thus addresses comments to both proposed rules unless otherwise indicated.

#### 1. Compliance Oversight by Self-Regulatory Organizations (SROs)

Although proposed §§ 23.605 and 1.71 prescribed the implementation of conflict-of-interest policies and procedures by SDs, MSPs, FCMs, and

IBs, the proposal did not address compliance oversight by SROs. Nonetheless, the Commission received comments on whether the conflict-of-interest policies and procedures mandated under sections 4s(j)(5) and 4d(c) of the CEA should be prescribed by the Commission or by an SRO.

The Futures Industry Association (FIA), ISDA, and SIFMA, in a joint comment, argued that an SRO should oversee and enforce the conflict-of-interest requirements on SDs, MSPs, FCMs, and IBs. FIA, ISDA, and SIFMA stated that SROs would be in a better position than the Commission to address the likely need for future amendments to the rule. The comment suggested that the Commission establish a framework governing the implementation of conflict-of-interest policies and procedures, and instruct the appropriate SRO to write detailed compliance requirements within that framework, including the execution of audit and compliance functions, and the issuance of specific guidance that would be subject to the Commission’s review and approval. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Michael Greenberger and UNITE HERE commented that the monitoring and enforcement of the implementation of conflict-of-interest policies and procedures for SDs and MSPs should be carried out by the Commission, as opposed to SROs.

Having considered the comments, the Commission is adopting the rule as proposed on this issue. Unlike section 15D of the Securities Exchange Act of 1934, which mandated that conflict-of-interest rules be adopted either by the SEC, or by a registered securities association or national securities exchange, sections 4s(j)(5) and 4d(c) of the CEA as added by sections 731 and 732 of the Dodd-Frank Act, respectively, direct the CFTC to promulgate such rules. The Commission will continue to collaborate with SROs on conflict-of-interest policies and procedures, particularly with respect to their effectiveness.

#### 2. Exemptive Relief

The Commission’s proposal in the FCM/IB NPRM did not expressly address issues surrounding the Commission’s exemptive authority. Nonetheless, the Committee on Futures and Derivatives Regulation of the New York City Bar Association argued that, due to the unprecedented scope and breadth of the Commission’s rulemakings, the Commission will encounter situations it had not

previously considered, rules that do not operate in the manner intended, or unintended consequences when the rules are applied in a specific context. In such situations, exemptive relief would be appropriate and the Commission should prepare for such situations by providing Commission staff with the authority to grant exemptive relief in each rule. Having considered the comment, the Commission does not believe it appropriate to address exemptive relief in this rule. Rather, any person may submit a request for an exemptive, no-action or interpretive letter, in accordance with the procedures set forth in Commission Regulation 140.99.<sup>21</sup> Further, should any person, in the future, believe that an amendment to a Commission regulation is warranted, such person may petition the Commission for an amendment in accordance with the procedures set forth in Commission Regulation 13.2.<sup>22</sup>

#### 3. Consistent Conflicts-of-Interest Treatment Between FCMs/IBs and SDs/MSPs

Pierpont Securities Holdings LLC expressed agreement with the Commission’s proposal to apply § 23.605 and § 1.71 in a manner that is consistent with one another. The consistency is particularly important in situations where a FCM is an affiliate of, or dually registered as, an SD or MSP. The Commission acknowledges the comment and notes its belief that such consistent treatment is reasonable and reflects the statutory directives and policy goals underlying sections 4d(c) and 4s(j)(5) of the CEA, as amended by sections 732 and 731 of the Dodd-Frank Act, respectively.

#### 4. Definitions—§ 23.605(a), § 1.71(a)

##### a. Business Trading Unit—§ 23.605(a)(2), § 1.71(a)(2)

The proposed rules defined the term “business trading unit” as “any department, division, group, or personnel of a [SD, MSP, FCM, or IB] or any of its affiliates, whether or not identified as such, that performs or is involved in any pricing, trading, sales, marketing, advertising, solicitation, structuring, or brokerage activities on behalf of a [SD, MSP, FCM, or IB].”

The Commission received a comment from the FHLBs, and a joint comment from FIA, ISDA, and SIFMA, arguing that the Commission should clarify that § 23.605(a)(2) and § 1.71(a)(2) apply to traditional “front office” functions and not to those functions that support the

<sup>21</sup> 17 CFR 140.99.

<sup>22</sup> 17 CFR 13.2.

front office, such as legal, compliance, operations, credit, and human resources functions. FIA/ISDA/SIFMA noted that in order to fulfill legal, compliance, and risk management functions, firms are integrated such that the exclusion of such control and/or support functions should be excluded from the definitions of business trading unit and clearing unit. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

In the preambles of the SD/MSP and FCM/IB NPRMs, the Commission noted that the proposed rules are not intended to hinder the execution of sound risk management programs by SDs, MSPs, FCMs, IBs, or by any affiliate of an SD, MSP, FCM, or IB. The Commission's proposals largely addressed the issue raised by the commenters in the proposed definitions of "non-research personnel" at § 23.605(a)(5) and § 1.71(a)(5), which carved out legal and compliance personnel from those definitions. In addition, the final rule modified the definition of non-research personnel to those employees who are not directly responsible for, or otherwise not directly involved in, research or analysis intended for inclusion in a research report. The Commission believes its prior statements and these changes should clarify the scope of the definitions.

Nonetheless, upon reviewing the comments, the Commission has determined it appropriate to modify the definitions. The rule language, as originally proposed, is amended in the final rules to: (1) Clarify that the term includes those persons who directly perform or exercise supervisory authority over the performance of the tasks listed in the rule, and not those who merely are "involved in" such activities, such as the legal, compliance, human resources, risk management, operations, and other support functions; and (2) exclude price verification for risk management purposes from the types of pricing activities covered by the definitions. The Commission believes that these changes will address the issues raised by the commenters while ensuring that the rule text properly reflects the intent of the Commission.

**b. Clearing Unit—§ 23.605(a)(3), § 1.71(a)(3)**

The proposed rules defined the term "clearing unit" as "any department, division, group, or personnel of a [SD, MSP, FCM, or IB] or any of its affiliates, whether or not identified as such, that performs or is involved in any proprietary or customer clearing

activities on behalf of a [SD, MSP, FCM, or IB]."

Similar to the concerns raised in comments on the proposed definition of "business trading unit," FIA, ISDA, and SIFMA, in a joint comment, argued that the Commission should clarify that § 23.605 and § 1.71 applies to traditional "front office" functions and not to functions that support the front office, such as legal, compliance, operations, credit, and human resources functions. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

As stated above with respect to the comments received on the proposed definition of "business trading unit," the Commission noted in the preambles to the SD/MSP and FCM/IB Conflicts NPRMs that the proposed rules are not intended to hinder the execution of sound risk management programs by SDs, MSPs, FCMs, IBs, or by any affiliate of an SD, MSP, FCM, or IB. The NPRMs largely addressed the issue raised by the commenters in the proposed definitions of "non-research personnel" at § 23.605(a)(5) and § 1.71(a)(5), which carved out legal and compliance personnel from that definition. The Commission reiterates its prior statements on this issue, which should make clear the scope of the definitions.

Nonetheless, upon reviewing the comments, the Commission has determined it appropriate to modify the definitions. The rule language, as originally proposed, is amended in the final rules to clarify that the term includes those persons or groups who perform or exercise supervisory authority over the performance of the tasks listed in the rules, and not those who merely are "involved in" such activities. The Commission believes that these changes will address the issues raised by the commenters while ensuring that the rule text properly reflects the intent of the Commission.

**c. Non-Research Personnel—§ 23.605(a)(5)**

The proposed rule defined the term "non-research personnel" as "any employee of the business trading unit or clearing unit, or any other employee of the [SD] or [MSP] who is not directly responsible for, or otherwise involved with, research concerning a derivative, other than legal or compliance personnel."

EI argued that the Commission should limit the definition of non-research personnel to include only those persons involved with trading, pricing,

or clearing activities, and not to other areas.

Upon reviewing the comment, the Commission is adopting the language as originally proposed. The Commission believes that changing the language in the manner suggested by the commenter would increase the risk that SDs or MSPs might attempt to evade the restrictions set forth in the rule.

**d. Public Appearance—§ 23.605(a)(6), § 1.71(a)(6)**

The proposed rules defined the term "public appearance" as "any participation in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons, or interview or appearance before one or more representatives of the media, radio, television or print media, or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning a derivatives transaction.<sup>23</sup> This term does not include a password-protected webcast, conference call, or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current research report or other documentation that contains the required applicable disclosures, and that the research analyst appearing at the event corrects and updates during the public appearance any disclosures in the research report that are inaccurate, misleading, or no longer applicable."

FIA, ISDA, and SIFMA, in a joint comment, argued that the definition of public appearance (speaking before 15 or more "persons") should articulate that the term "person" includes both a customer that is a natural person and one that is an entity. For example, if a single institutional customer sends 16 employees to a forum held by an SD, MSP, FCM, or IB, each of those employees should not be counted as a "person;" rather, employees from a single institutional customer should be deemed to be one "person" at that forum, for purposes of the rule. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Upon reflection, the Commission agrees with the commenters, and is altering the rules to incorporate the

<sup>23</sup> The Commission notes that SD and MSP communications with counterparties and potential counterparties also are addressed in the Commission's external business conduct standards rules. See Subpart H of Part 23 of the Commission's Regulations, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734 (Feb. 17, 2012).

recommendation offered by the commenter. Specifically, the Commission is modifying the rule to clarify that the term “persons” in this context refers to either natural persons or entities. Thus, for example, if a single entity sends multiple natural persons as representatives to a public speaking activity that may be subject to the rule, such natural persons would be counted as a single “person” for purposes of determining whether the public speaking activity meets the definition of “public appearance.”

e. Research Department—§ 23.605(a)(8), § 1.71(a)(8)

The proposed rules defined the term “research department” as “any department or division that is principally responsible for preparing the substance of a research report relating to any derivative on behalf of a [SD, MSP, FCM, or IB], including a department or division contained in an affiliate of a [SD, MSP, FCM, or IB].”

FIA, ISDA, and SIFMA, in a joint comment, argued that the scope of “research department,” and the restrictions imposed by the proposed rules concerning research departments, should not apply to the global affiliates of an SD, MSP, FCM, or IB. FIA/ISDA/SIFMA posited that the imposition of such restrictions on global affiliates would create significant logistical hurdles and expenses for multinational firms, especially in situations where an affiliate has no significant interaction with the SD, MSP, FCM, or IB. Further, FIA/ISDA/SIFMA suggested that local regulations governing non-US affiliates may not permit such non-US affiliates to comply with the rules. As an alternative, FIA/ISDA/SIFMA suggested that the Commission limit the rules to requiring disclosure “on third party research reports,” and focus the Commission’s enforcement resources on SDs, MSPs, FCMs, and IBs that attempt to evade the rule by moving research analysts to affiliates. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Upon reviewing the comments, the Commission has determined it appropriate to adopt the rules as originally proposed. The Commission believes that the alternatives suggested by FIA/ISDA/SIFMA would increase the risk of evasion by multinational registrants. Such risk of evasion outweighs any benefit to be derived from the proffered alternative. However, to clarify any ambiguity that may exist in the rules adopted herein, the Commission confirms that a holding company need not examine the research

functions of all of its affiliates under these rules; rather, a holding company needs only to look at those research groups doing research on behalf of an SD, MSP, FCM, or IB. In light of its stated intent, the Commission believes that the cost-effectiveness of the rules will be promoted.

f. Research Report—§ 23.605(a)(9), § 1.71(a)(9)

The proposed rules defined the term “research report” as: “[A]ny written communication (including electronic) that includes an analysis of the price or market for any derivative, and that provides information reasonably sufficient upon which to base a decision to enter into a derivatives transaction.” However, the proposals expressly excluded four categories of communications from coverage by the definitions.

FIA, ISDA, and SIFMA, in a joint comment, argued that the exclusions from the definition of “research report” should be expanded to include general market discussions and other communications that are not “research reports” in other regulatory contexts. The definitions should be limited to those research reports analyzing a specific derivative or futures transaction. Exclusions set forth in other regulatory contexts—specifically NASD Rule 2711(a)(9)(A) and SEC Regulation AC—should be included in the Commission’s definitions of “research report.” FIA/ISDA/SIFMA further argued that communications produced by a business trading unit labeled as a “trading/sales desk product” and as “non-research” should be excluded from the definitions of research report. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

EEL argued that the Commission should exclude from the definition any communication between an SD or MSP, and its regulator, concerning hedging activity. The commenter posited that firms with small trading operations should be permitted to publish occasional research reports to justify trading decisions, without being subject to the rules set forth in the SD/MSP Conflicts NPRM.

The National Futures Association (NFA) argued that the definition in proposed § 1.71(a)(9) was too broad and suggested that the definition be limited to reports containing material information at a level of detail that amounts to “a call to action to the customer,” or that could have a price impact on the market for a particular product. NFA also argued that the

definition should include an exception for general market commentary, similar to NASD Rule 2711. Newedge USA LLC (Newedge) also argued that the definition in proposed § 1.71(a)(9) was too broad, because any discussion of a derivative that references the underlying physical commodity or financial instrument could be deemed to provide “information reasonably sufficient upon which to base a decision to enter into a derivatives transaction.” Newedge contended that the definition of research report should be restricted to “any written communication \* \* \* including an analysis of the price/market for any specific derivative contract, and that provides information reasonably sufficient upon which to base a decision to enter into a transaction involving such specific derivative contract.”

ADM Investor Services Inc. commented on the differences between daily research reports and weekly and monthly research reports, arguing that proposed § 1.71(a)(9) unnecessarily threatened existing industry practices, particularly with respect to opening and closing comments or intraday market comments by IBs, which do not consist of detailed research but could be covered by the proposed definition of “research report.”

Having considered the comments, the Commission has determined it appropriate to modify the exclusions to the definitions of “research report,” as that term was proposed in the SD/MSP and FCM/IB Conflicts NPRMs. Specifically, the Commission agrees with FIA/ISDA/SIFMA’s recommendation that “commentaries on economic, political, or market conditions” and “statistical summaries of multiple companies’ financial data, including listings of current ratings” should be excluded from the definitions of research report. With regard to the exclusion for commentaries on economic or market conditions, the Commission believes that there are distinguishing characteristics between research reports setting forth factual statements about the market for specific derivatives and commentaries that provide opinion on general economic, political, or market conditions. Accordingly, the Commission has modified the rules to incorporate those two exclusions into the definitions of “research report.”

However, the Commission does not believe that other types of communications should be excluded from the definitions, because they could represent the core focus of a research department doing research on behalf of an SD, MSP, FCM, or IB, e.g., asset

classes, economic variables commonly referenced in derivatives, and on-the-run swap rates. Adopting the NASD 2711 exclusion for analysis concerning economic variables (e.g. rates, inflation) that are commonly referenced in derivatives, would create an exception that would swallow the rule. For example, research conducted on trends in the interest rate, gold, or oil markets are inextricably linked to the swap markets that reference those underlying assets or rate.

The Commission believes that the changes adopted herein will increase consistency with NASD Rule 2711, which was promulgated pursuant to section 15D of the Securities Exchange Act. The Commission believes that the rules, in final form, provide SDs, MSPs, FCMs, and IBs with sufficient flexibility concerning solicitation materials generated by the trading unit, given the exclusion from coverage of “[a]ny communication generated by an employee of the business trading unit that is conveyed as a solicitation for entering into a derivatives transaction, and is conspicuously identified as such.”<sup>24</sup>

#### 5. Policies and Procedures—§ 23.605(b)

As proposed, § 23.605(b) required each SD and MSP to “adopt and implement written policies and procedures reasonably designed to ensure that the [SD] or [MSP] and its employees comply with the provisions of this rule.” Chris Barnard commented that the prevention of SDs and MSPs from engaging in activities with actual, perceived, or potential conflicts of interest will improve transparency and confidence in the markets, and will reduce risk. The Commission acknowledges the comment and is adopting § 23.605(b) without revision.

#### 6. Research Analysts and Research Reports—§ 23.605(c), § 1.71(c)

##### a. Separation of Research Analysts From Business Trading Unit and Clearing Unit—§ 23.605(c)(1)

Proposed §§ 23.605 and 1.71 prescribed certain restrictions on the relationship between the research department and all non-research personnel. Such restrictions included limitations on influencing the content of research reports, the supervision of

research analysts, and the review or approval of research reports.

With regard to this proposed rule, MFA suggested that the Commission provide additional clarity on the proposed rule by further describing the bright lines of separation between the research department and non-research personnel. For example, the commenter queried whether an SD may house its research department and trading department in the same building or on the same floor, and whether different key cards for entry into each department are required by the rule. Additionally, BlackRock commented that the Commission “should explicitly exempt entities whose research personnel produce reports for internal use only.”

After reviewing the comments, the Commission believes that the comments raised by the commenters may best be addressed through clarification of the underlying intent of the rule. Accordingly, the Commission has determined it appropriate to adopt the rule as it was originally proposed. First, with respect to MFA’s comments, the rule does not expressly require physical separation of the research department and all non-research personnel; however, such separation will be considered by the Commission to be a good practice by registrants in order to minimize the risk of violating the rule. Second, with respect to BlackRock’s comments, the Commission believes that the issue of internal research reports is adequately addressed by proposed § 23.605(a)(9)(iv), which excluded from the definition of “research report” any “internal communications that are not given to current or prospective customers.”<sup>25</sup>

##### b. Conflicts of Interest Adequately Addressed by Existing Commission and NFA Rules

Proposed § 1.71 did not discuss the issue of whether existing Commission and NFA rules adequately address the directives set forth in section 4d(c) of the CEA as amended by section 732 of the Dodd-Frank Act. Nonetheless, the Commission received comments that raised the issue.

NFA commented that certain of its existing rules address issues raised in the Commission’s rule proposal, and that the specific requirements related to research reports that may not be directly applicable to derivatives could have unintended consequences. K&L Gates LLP (on behalf of Peregrine Financial Group Inc.), ADM Investor Services Inc.,

John Stewart & Associates Inc., and Stewart-Peterson Group Inc. each argued that the issues addressed by the proposed rule are already addressed through existing rules.

Swaps and Derivatives Market Association commented that the proposed rules should be adopted as they were originally proposed.

After considering the comments, the Commission has determined it appropriate to adopt the rule, as it was originally proposed, on this issue. Although certain Commission and NFA rules tangentially address the issues set forth in the proposed rule, section 732 of the Dodd-Frank Act directed the Commission to take certain actions beyond the requirements previously promulgated in the rules of the Commission and NFA. Further, given the similarities between section 4d(c) of the CEA as amended by section 732 of the Dodd-Frank Act, and section 15D of the Securities Exchange Act of 1934, the Commission believes that it is important to provide a measure of specificity with respect to the conflict-of-interest policies and procedures mandated under section 4d(c) and § 1.71. Such specificity will promote consistency in the marketplace. Further, by maintaining consistency—to the extent warranted—with NASD Rule 2711, the Commission believes that the proposed rule will minimize disruption to the marketplace, given that such standards are well-established in the financial industry.

##### c. Treatment of Small IBs

As proposed, § 1.71 did not establish a separate standard for small IBs. However, in the preamble of the proposed rule, the Commission expressly invited comment on how these rules should apply to FCMs and IBs, considering the varying size and scope of the operations of such firms. The preamble noted, as an example of how the rule could be adjusted to account for firms of different sizes, that NASD Rule 2711(k) provides an exception from certain requirements for ‘small firms,’ defined to include those firms that over the past three years have participated in ten or fewer investment banking services transactions and generated \$5 million or less in gross investment banking services revenues from those transactions. The Commission solicited comment on whether a similar approach should be adopted for small FCMs and IBs. Moreover, the exceptions to the definition of research report were designed to address issues typically found in smaller firms where individuals in the trading unit perform

<sup>24</sup> The Commission notes that SD and MSP communications with counterparties and potential counterparties are addressed in the Commission’s external business conduct standards rules. See Subpart H of Part 23 of the Commission’s Regulations, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734 (Feb. 17, 2012).

<sup>25</sup> This language is being adopted by the Commission as proposed; however, the provision has been renumbered as § 23.605(a)(9)(vi).

their own research to advise their clients or potential clients.

Several commenters suggested that small IBs should be excepted from the proposed rule. NFA argued that the proposed rule effectively could prohibit the business model of a number of firms that provide an important service to the industry, particularly with respect to agriculture. The commenter suggested that, in adopting an exception for small IBs, the Commission could consider the following factors: A firm's gross annual revenue, number of associated persons, number of annual futures transactions, and nature of the customer base.

National Introducing Brokers Association, ADM Investor Services Inc., John Stewart & Associates Inc., and Stewart-Peterson Group Inc. each argued that implementing the proposed rules would be prohibitively costly, burdensome, and unnecessary for small IBs, particularly for IBs dealing with agricultural commodities, and would force small IBs out of business. Chris Barnard noted that small IBs lack the capacity to carry the proportionately heavier regulatory burden set forth in the proposed rule, and as such, some regulatory mitigation would be beneficial, based on number of staff or revenues. Multiple commenters also commented on the limited market price impact of research reports created or distributed by small IBs, as well as the potential that the normal duties of associated persons may be deemed to be research activities for purposes of the rule.

The Commission recognizes and agrees with certain concerns raised by the commenters. Thus, upon review of the comments, the Commission is adopting a separate regulatory standard for small IBs, reflecting the alternative set forth in the preamble of the proposed rule. Section 4d(c) of the CEA mandates the establishment of "appropriate informational partitions" within FCMs and IBs, and all such firms are bound by that statutory requirement. However, the Commission recognizes that the size of an IB plays a significant role in determining the appropriateness of such partitions. Accordingly, the rule, in its final form, establishes a separate standard for any IB that has generated, over the preceding 3 years, \$5 million or less in aggregate gross revenues from its activities as an IB. This standard is similar to language in NASD Rule 2711 that was raised expressly as a possible alternative in the preamble of the proposed rule.

For any IB meeting those financial requirements, § 1.71(c) of the rule would not apply. Further, § 1.71(b) has been changed to set forth a separate policies

and procedures requirement for small IBs. The recommended language of new § 1.71(b)(2) largely mirrors the statutory requirement of section 4d(c). However, the Commission believes that small IBs should be subject to § 1.71(e) (policies and procedures mandating disclosure of material incentives and conflicts of interest) and § 1.71(f) (recordkeeping and reporting).<sup>26</sup> The Commission believes that these changes to the rule, as originally proposed, will address the concerns raised by the commenters and limit the cost burden imposed on small IBs.

Finally, the Commission notes that commentaries on market conditions have been excluded from the definition of "research report," as discussed above.

#### d. Insider Trading and Futures Markets

Proposed § 1.71 did not address insider trading in the futures markets, or how that issue impacts the implementation of section 732 of the Dodd-Frank Act. Nonetheless, the Commission received comments on the issue. Specifically, K&L Gates LLP (on behalf of Peregrine Financial Group Inc.), John Stewart & Associates Inc., ADM Investor Services Inc., and Stewart-Peterson Group Inc. each argued that the proposed rules inappropriately relied upon established rules in the securities industry, claiming that no ban on insider trading exists in the futures industry. Further, ADM Investor Services Inc. and Stewart-Peterson Group Inc. each contended that only the publication of a U.S. Department of Agriculture market report could have a dramatic effect on the futures market.

Having considered the comments, the Commission has determined not to modify the rule on this issue. Section 732 of the Dodd-Frank Act directed the Commission to take actions concerning conflict-of-interest policies and procedures, and in that provision, Congress included language previously included in section 15D of the Securities Exchange Act of 1934. Section 15D directed that regulatory language be promulgated to implement that statute, and those regulatory standards are now well-established in the financial industry. Given the similarities in statutory language, coupled with the well-established principles set forth in NASD Rule 2711, the Commission believes that it is important to provide a measure of specificity with respect to the conflict-of-interest policies and procedures mandated under section 4d(c) and the

<sup>26</sup> The provisions of § 1.71(d) are applicable only to FCMs.

proposed rule. Such specificity will promote consistency and certainty in the marketplace. Further, by maintaining consistency—to the extent warranted—the Commission believes that the final rule will minimize disruption to the marketplace.

#### e. Exception for FCMs If Engaged in Only a *de minimis* Amount of Proprietary Trading

Proposed § 1.71 did not set forth a *de minimis* exception for FCMs. Nonetheless, the Commission received a comment from Newedge, which argued that FCMs engaging in minimal proprietary trading should not be subject to the provisions relating to research analysts. The commenter stated that the proposed rule would impose unnecessary burdens, and that a firm that engages in only limited proprietary trading does not present a risk of conflicts of interest.

Having considered the comment, the Commission does not believe it appropriate to modify the proposed rule on this issue. The imposition of a *de minimis* exception to the conflicts rule is inconsistent with the statutory directive that Congress set forth in section 732 of the Dodd-Frank Act, which does not distinguish between proprietary trading and trading for the accounts of customers. Moreover, the limited nature of a firm's proprietary trading does not serve to negate the issues intended to be addressed through the statutory mandate.

#### f. Lack of Examples of Research-Related Conflicts of Interest in the Futures Industry

Proposed § 1.71 did not cite specific examples of conflicts of interest in the futures industry, nor did it discuss the prevalence of conflicts in the industry. Nonetheless, the Commission received comments relating to those issues. K&L Gates LLP (on behalf of Peregrine Financial Group Inc.) commented that the Commission failed to cite any evidence of conflicts of interest arising from the publication of research reports. NFA commented that it had issued guidance prohibiting a FCM or IB from trading in a security futures product in anticipation of the issuance of a related research report, but that the commenter was unaware of any instances of conflicts of interest in research reports of security futures products. Further, Senator Carl Levin commented that the Commission should encourage compliance by developing examples of potential or actual conflicts of interest that should be disclosed to investors.

After considering the comments, the Commission has decided not to modify

the proposed rule on this issue. Section 732 of the Dodd-Frank Act directed the Commission to take certain actions concerning conflict-of-interest policies and procedures. Specifically, as noted in the preamble of proposed § 1.71, section 732 “requires, in relevant part, that FCMs and IBs implement conflicts of interest systems and procedures that ‘establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in trading or clearing activities might potentially bias the judgment or supervision of the persons.’” This statutory language draws heavily from section 15D of the Securities Exchange Act, which was established through the Sarbanes-Oxley Act of 2002. The Commission believes that the provisions of the proposed rule relating to conflicts of interest represent a prudent implementation of the statutory directive.

As noted above, the regulatory requirements promulgated pursuant to section 15D—which are similar to the requirements contained in the rule—are now well-established in the financial industry. Given the similarities in statutory language, coupled with the well-established principles set forth in NASD Rule 2711, the Commission believes that the proposed rule will promote consistency and certainty, while minimizing disruption, in the marketplace. With respect to Senator Levin’s recommendation that the Commission should develop examples of potential or actual conflicts of interest, the Commission notes the many examples cited in Senator Levin’s comment letter,<sup>27</sup> but declines to provide additional examples so as not to pre-judge the scope of possible future enforcement actions.

<sup>27</sup> See, e.g., SEC Fact Sheet on Global Analyst Research Settlements, SEC (Apr. 28, 2003), available at <http://www.sec.gov/news/speech/factsheet.htm>; Hans G. Heidle and Xi Li, Is There Evidence of Front-Running Before Analyst Recommendations? An Analysis of the Quoting Behavior of Nasdaq Market Makers, Nov. 10, 2003, available at <http://www.afajof.org>; Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (Dec. 2005), available at <http://www.finra.org/Industry/Issues/ResearchAnalystRules/>.

g. Restriction on Non-Research Personnel From “Influencing the Content” of Research Reports—§ 23.605(c)(1)(i), § 1.71(c)(1)(i)

The proposed rule provided that “[n]onresearch personnel shall not influence the content of a research report of the [SD, MSP, FCM, or IB].”

NFA commented that non-research personnel should be allowed to influence the content of a research report under certain circumstances and, further, that paragraph (i) should be eliminated from proposed § 1.71(c)(1). FIA, ISDA, and SIFMA, in a joint comment, argued that the proposed prohibition on “influencing the content” should be eliminated because it would impair ordinary communications between research and non-research personnel. As an alternative, FIA/ISDA/SIFMA suggested that non-research personnel should be prohibited only from “directing the views and opinions expressed in research reports.” In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Better Markets commented that the Commission should clarify and further restrict the communications covered by the provisions. Specifically, Better Markets argued that § 23.605 and § 1.71 should be expanded not only to prohibit non-research personnel from influencing the content of a research report or any decision to publish a research report, but also any decision not to publish a report or to refrain from including relevant information.

Upon consideration of the comments, the Commission agrees with the suggestions raised by both FIA/ISDA/SIFMA and Better Markets and is incorporating the suggestions into the final rules. Specifically, the Commission is modifying both proposed rules to remove the phrase “shall not influence the content of a research report” and replacing it with the phrase “shall not direct a research analyst’s decision to publish a research report of the [SD, MSP, FCM, or IB], and non-research personnel shall not direct the views and opinions expressed in a research report” The Commission believes that the changes accommodate the concerns raised by the commenters while still reflecting the intent of the proposed rules.

h. Restriction on Research Analyst Supervision by Business Trading Unit or Clearing Unit—§ 23.605(c)(1)(ii), § 1.71(c)(1)(ii)

The proposed rules provided that “[n]o research analyst may be subject to

the supervision or control of any employee of the [SD’s, MSP’s, FCM’s, or IB’s] business trading unit or clearing unit, and no personnel engaged in pricing, trading or clearing activities may have any influence or control over the evaluation or compensation of a research analyst.”

FIA, ISDA, and SIFMA, in a joint comment, suggested that the Commission limit the scope of the rules, whereby employees of business trading and clearing units would be prohibited only from acting as direct supervisors of research analysts. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Upon reviewing the comment, the Commission has decided not to change the language of the proposed rules in the manner suggested by the commenter. Any influence on research analysts by non-research senior management responsible for pricing, trading, or clearing activities would undermine the conflict-of-interest requirements mandated by new sections 4d(c) and 4s(j)(5) of the CEA and set forth in the rules. However, the Commission has determined it appropriate to clarify the language of the rules, as they had been originally proposed, by using the defined terms “business trading unit” and “clearing unit” to designate those personnel who may not have influence or control over the evaluation or compensation of a research analyst.

i. Trading Ahead of Research Report Publication

Proposed § 1.71 did not expressly impose restrictions against trading ahead of the publication of a research report. Senator Carl Levin commented that the Commission should add provisions akin to FINRA Rule 5280 (Trading Ahead of Research Reports) in order to improve the quality of research reports and the integrity of the marketplace. The Commission observes that it did not propose a trading ahead prohibition in its original proposals. However, the Commission believes that the restrictions on communications already included in the rules will minimize the opportunities for such activities to take place.<sup>28</sup> Moreover, the Commission will continue to monitor

<sup>28</sup> The Commission also notes that depending on the facts and circumstances, improperly trading ahead or front running counterparty orders may constitute fraudulent, deceptive or manipulative conduct under sections 4b and 6(c)(1) of the CEA, and § 180.1 of Commission regulations, among other fraudulent, deceptive, and manipulative practices protections under the CEA and Commission regulations.

this issue and may incorporate such a restriction in a future rulemaking.

j. Requirement That Legal/Compliance Personnel Supervise Communication Between Research and Non-Research Personnel—§ 23.605(c)(1)(iv)

The proposed rule permitted non-research personnel to review a research report before its publication “as necessary only to verify the factual accuracy of information in the research report, to provide for non-substantive editing, to format the layout or style of the research report, or to identify any potential conflicts of interest.” However, such review (1) may only be conducted through authorized legal or compliance personnel, and (2) must be properly documented.

EEI commented that the Commission should exempt communications that are factual in nature from oversight by legal and compliance personnel, positing that coverage of such communications would hinder unnecessarily the development of research reports and unnecessarily burden legal/compliance personnel.

After considering the comment, the Commission has decided to promulgate the rule as it was originally proposed. The Commission believes that involvement by legal or compliance personnel in such communications will reduce significantly the risk that non-research personnel will act in an unlawful manner, inadvertently or otherwise.

k. Restrictions on Research Analyst Communications—§ 23.605(c)(2), § 1.71(c)(2)

The proposed rules provided that “[a]ny written or oral communication by a research analyst to a current or prospective counterparty, or to any employee of the [SD, MSP, FCM, or IB], relating to any derivative must not omit any material fact or qualification that would cause the communication to be misleading to a reasonable person.”

FIA, ISDA, and SIFMA, in a joint comment, argued that the proposed rule would burden an affected firm’s operations—especially firms with foreign offices—and suggested that internal communications within a firm should be exempt from the material facts or qualifications required to be communicated to prospective and current customers. FIA/ISDA/SIFMA further noted that neither NASD Rule 2210 nor similar SRO rules contain equivalent restrictions, and that firms should be permitted to consider the nature of the audience when assessing whether a particular communication is misleading. FIA/ISDA/SIFMA also

argued that the phrase “or to any employee” should be struck from proposed §§ 23.605(c)(2) and 1.71(c)(2). In a separate comment, JP Morgan expressed general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Upon review of the comments, the Commission has determined it appropriate to change the rules to eliminate restrictions on communications to employees of an SD, MSP, FCM, or IB. The Commission believes that by deleting the phrase “or to any employee of the [SD, MSP, FCM, or IB],” the cost concerns implicated by requiring registrants to monitor internal communications will be addressed without producing a materially adverse impact on the effectiveness of the rules. To the extent that commenters stated that firms should be permitted to consider the nature of the audience when assessing whether a particular communication is misleading, the Commission notes that such matters will be governed by the Commission’s existing anti-fraud standards.

l. Restriction on Influence of Business Trading Unit and Clearing Unit on Research Analyst Compensation—§ 23.605(c)(3), § 1.71(c)(3)

Proposed §§ 23.605(c)(3) and 1.71(c)(3) provided that an SD, MSP, FCM, or IB “may not consider as a factor in reviewing or approving a research analyst’s compensation his or her contributions to the [SD’s, MSP’s, FCM’s, or IB’s] trading or clearing business” and that “[n]o employee of the business trading unit or clearing unit of the [SD, MSP, FCM, or IB] may influence the review or approval of a research analyst’s compensation.”

FIA, ISDA, and SIFMA, in a joint comment, contended that research management should be able to solicit input from business trading and clearing unit personnel, particularly as non-research personnel may be in a better position to receive feedback from clients concerning the performance of research personnel. FIA/ISDA/SIFMA suggested that the Commission exempt from §§ 23.605(c)(1)(ii) and 1.71(c)(1)(ii) any personnel who occupy non-trading or non-clearing positions, and who are not employed in the business trading or clearing units. FIA/ISDA/SIFMA, as well as Newedge, further argued that research management decisions concerning the performance evaluation of research analysts should be subject to firm-wide compensation guidelines, as long as they are non-discriminatory and non-prejudicial. In a separate comment, JP Morgan expressed a general agreement with the points raised in the

FIA/ISDA/SIFMA letter. Newedge complained of a lack of clarity as to which personnel of a firm engaged exclusively or substantially in clearing activities, and not proprietary trading, would be available to supervise and evaluate research analysts. Newedge also argues that senior officers and employees of departments other than business trading and clearing units should be allowed to have input on compensation decisions.

Michael Greenberger argued that research management should be prohibited from soliciting any input of business trading and clearing units concerning a research analyst’s compensation or performance evaluation, even if the influence is indirect or if research management maintains the ability to make all final decisions on such determinations. Better Markets commented that the provision should be broadened. For example, Better Markets argued that a research analyst’s contribution to the trading business of an affiliate should be prohibited from being considered when determining compensation. The commenter further noted that, in addition to prohibiting a research analyst’s contributions to the trading business from being considered in respect of an analyst’s compensation, “consideration of adverse effects on such trading business” must be also prohibited from being considered.

After considering the comments, the Commission has determined it appropriate to change the language as set forth in the original proposal. As revised, the rules permit personnel of a business trading unit or clearing unit to forward communications by a client or customer to research department management, to the extent that such communications relate to feedback, ratings, and other indicators of a research analyst’s performance provided by the client or customer. The Commission believes that the change will address certain concerns raised by FIA/ISDA/SIFMA and Newedge while not detracting from the policy goals underlying the provision. Beyond that change, the Commission has decided not to modify further the language that was originally proposed. Maintaining a firewall around research analyst compensation decisions is crucial to implementing effective conflict-of-interest policies and procedures. Nonetheless, to address an issue raised by FIA/ISDA/SIFMA, the Commission wishes to clarify the intent of the rule. Specifically, the rule is not intended to prohibit management decisions concerning the performance evaluation of research analysts from being subject

to firm-wide compensation guidelines, as long as they are non-discriminatory and non-prejudicial.

m. Relevance of a Promise of Favorable Research to Futures Market—§ 1.71(c)(4)

As proposed, § 1.71(c)(4) prohibits an FCM or IB from “directly or indirectly offer[ing] favorable research, or threaten[ing] to change research, to an existing or prospective customer as consideration or inducement for the receipt of business or compensation.” K&L Gates LLP (on behalf of Peregrine Financial Group Inc.) commented that the provision may be relevant in the context of research on a particular company, but it has no relevance in terms of a report on soybeans or the Euro.

After reviewing the comment, the Commission has decided not to modify the proposed rule on this issue. The Commission believes that the provision appropriately addresses the statutory directive and is an important component of firewall protection. Moreover, inclusion of this provision will maintain consistency with the conflict-of-interest provisions proposed for SDs and MSPs.

n. Disclosure of Conflicts by Research Analysts in Research Reports and Public Appearances—§ 23.605(c)(5), § 1.71(c)(5)

Proposed §§ 23.605(c)(5)(i) and 1.71(c)(5)(i) required that an SD, MSP, FCM, or IB “disclose in research reports and a research analyst must disclose in public appearances: (1) Whether the research analyst maintains, from time to time, a financial interest in any derivative of a type that the research analyst follows, and the general nature of the financial interest; and (2) any other actual, material conflicts of interest of the research analyst or [SD, MSP, FCM, or IB] of which the research analyst has knowledge at the time of publication of the research report or at the time of the public appearance.”

FIA, ISDA, and SIFMA, in a joint comment, argued that §§ 23.605(c)(5)(i) and 1.71(c)(5)(i) should be limited to disclosing whether a research analyst maintains a relevant financial interest “at the time of publication of the report/time of public appearance,” rather than the phrase “from time to time.” FIA/ISDA/SIFMA also contended that the phrase “any other actual, material conflict of interest of the research analyst” is vague and would be burdensome to implement, requiring coordination among various business units and the creation of special databases in order to comply with the rule. In a separate comment, JP Morgan

expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter. NFA also commented on the difficulty for FCMs to remain current on an analyst’s financial interests, and that the Commission should clarify that the term “of a type that the research analyst follows” (§ 1.71(c)(5)(i)) refers to interest rate swaps, credit swaps, equity swaps, and other commodity swaps, consistent with the characterization of swaps set forth in the Commission’s proposed product definitions.

Senator Carl Levin commented that the Commission should use this rule not only to ensure the integrity of research reports, but also to impose a broader duty on FCMs and IBs to more completely disclose any adverse interest. The commenter suggested that the rule should prohibit firms from betting on the failure of instruments they designed and sold to customers.

EI suggested that the Commission modify the proposed rule to provide a *de minimis* exception from the research analyst financial interest disclosure requirements, and that a research analyst should be required only to identify relevant financial interests.

Upon review of the comments, the Commission is modifying the language of §§ 23.605(c)(5) and 1.71(c)(5) to remove the phrase “from time to time.” The Commission believes that this change will address the issue raised by FIA/ISDA/SIFMA. However, the Commission has determined that a *de minimis* exception would be inappropriate given the difficulty of deciding when a financial interest is *de minimis* in this context. Further, the Commission believes that the cost concerns of FIA/ISDA/SIFMA are misplaced. The rules require disclosure of “any other actual, material conflicts of interest of the research analyst or [SD or MSP] of which the research analyst *has knowledge* at the time of publication of the research report or at the time of the public appearance” (emphasis added).<sup>29</sup> Thus, the disclosure requirement is limited to conflicts of which the research analyst has knowledge, and the SD, MSP, FCM, or IB need not construct the databases suggested by FIA/ISDA/SIFMA in order to comply with the rule.

<sup>29</sup> The Commission notes that in an action brought for failure to disclose a material conflict of interest of an SD or MSP in a research report or public appearance, the onus will be on the SD or MSP to show that they had policies and procedures reasonably designed to ensure that the research analyst had no knowledge of the material conflict of interest of the SD or MSP.

o. Disclosure of Conflicts in Third-Party Research Reports—§ 23.605(c)(5)(iv), § 1.71(c)(5)(iv)

As proposed, §§ 23.605(c)(5)(iv) and 1.71(c)(5)(iv) required that if an SD, MSP, FCM, or IB distributes or makes available third-party research reports, each report must be accompanied by certain disclosures or an internet link to the appropriate disclosures, subject to certain conditions and qualifications.

EI argued that the required disclosures are unnecessary because third-parties are, by definition, independent of an SD or MSP. FIA, ISDA, and SIFMA, in a joint comment, stated that it was unclear what disclosures must be made in connection with the distribution of independent third-party research reports, given that, by definition, the SD, MSP, FCM, or IB has no role in the content or creation of an “independent third-party research report.” In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Upon review of the comments, the Commission is adopting the rule as proposed. Third-party research reports provided by a registrant may be interpreted by recipients as carrying the endorsement of the registrant and may present conflicts-of-interest issues in the same way as research reports originating with the registrant’s own research analysts. The Commission believes that the disclosures will afford recipients with a clear understanding of conflicts posed by a particular report.

p. Application of Proposed Research Conflicts Rules to Research Reports Covering Derivatives and Securities

The proposed rules and accompanying preambles did not address how the proposed requirements would apply to research reports that contain information that is subject to the rule and information that is securities-related.

FIA, ISDA, and SIFMA, in a joint comment, questioned how § 23.605 and § 1.71 would apply to a research report that addresses multiple products (i.e., both derivatives and securities), or to a report discussing a product that may be a derivative, security, or both. FIA/ISDA/SIFMA suggested that only the derivatives section of a report discussing securities and derivatives should be subject to the proposed regulations. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Upon review of the comments, the Commission has decided not to change

the language that was originally proposed. To the extent that securities underlie the derivatives discussed in the report, or to the extent that securities are otherwise intertwined with the discussion of derivatives, the Commission believes that any such discussion of securities should be subject to the Commission's rules. SDs, MSPs, FCMs, and IBs will be registered with the Commission, and the swaps and futures in which they transact will be within the Commission's jurisdiction. Because the value of each swap and future intrinsically may be based on the value of one or more underlying instruments, research reports by SDs, MSPs, FCMs, or IBs that analyze such underlying instruments should be addressed by the conflict-of-interest policies and procedures mandated under sections 4d(c) and 4s(j)(5) of the CEA.

q. Application of Proposed Research Conflicts Rules to Research Analysts Covering Derivatives and Securities

The proposed rules and accompanying preambles did not address how the proposed requirements would apply to research analysts that work with derivatives subject to the Commission's rules and securities subject to rules promulgated by the SEC or FINRA.

FIA, ISDA, and SIFMA, in a joint comment, queried how the rule would apply to research analysts registered with both futures and securities regulators. FIA/ISDA/SIFMA suggested that the Commission confirm that individuals subject to both § 23.605 or § 1.71 and securities regulations must only comply with § 23.605 or § 1.71 when acting in the capacity as a "research analyst," as defined by § 23.605 or § 1.71. FIA/ISDA/SIFMA also raised concerns with respect to inconsistencies between §§ 23.605 and 1.71 and other rules promulgated in the securities or futures context. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Having considered the comments, the Commission confirms that individuals subject to both § 23.605 or § 1.71 and securities regulations must only comply with § 23.605 or § 1.71 when acting in the capacity of a "research analyst," as defined by § 23.605 or § 1.71. SDs, MSPs, FCMs, and IBs will be registered with the Commission, and the swaps and futures in which they transact will be within the Commission's jurisdiction. Because the value of each swap and future intrinsically may be based on the value of one or more underlying instruments, research

reports by SDs, MSPs, FCMs, and IBs analyzing such underlying instruments should be addressed by the conflict-of-interest policies and procedures mandated by new sections 4d(c) and 4s(j)(5) of the CEA.

7. Clearing Activities—§ 23.605(d), § 1.71(d)

a. Separation of Clearing Unit From Business Trading Unit—§ 23.605(d)(1) and (2); Separation of Business Trading Unit and Clearing Unit—§ 1.71(d)(1) and (2)

As proposed, § 23.605(d)(1) provided that "[n]o [SD] or [MSP] shall directly or indirectly interfere with or attempt to influence the decision of any affiliated clearing member of a [DCO] with regard to the provision of clearing services and activities," while proposed § 1.71(d)(1) congruently provided that "[n]o [FCM] shall permit any affiliated [SD] or [MSP] to directly or indirectly interfere with, or attempt to influence, the decision of the clearing unit personnel of the [FCM] with regard to the provision of clearing services and activities. \* \* \*"

Likewise, proposed § 23.605(d)(2) provided that "[e]ach [SD and MSP] shall create and maintain an appropriate informational partition, as specified in section 4s(j)(5)(A) of the Act, between business trading units of the [SD or MSP] and clearing member personnel of any affiliated clearing member of a [DCO]," while proposed § 1.71(d)(2) congruently provided that "[e]ach [FCM] shall create and maintain an appropriate informational partition between business trading units of an affiliated [SD] or [MSP] and clearing unit personnel of the [FCM]."

MFA commented that it supports the prohibition of SDs and MSPs from directly or indirectly interfering with, or attempting to influence, the decision of any affiliated clearing member of a DCO with regard to clearing services and activities, as well as the informational partitions between business trading personnel and personnel of an affiliated clearing member. Pierpont Securities Holdings LLC also supported the Commission's proposals, contending that the informational partitions between a business trading unit and a clearing unit within a large financial institution must be established and maintained as to all personnel, not just supervisory personnel, and the penalties for violating those restrictions must be meaningful.

Swaps and Derivatives Market Association filed two comments on these rules, both of which were supportive of the proposals. In the first comment, the commenter argued that

the proposed separation of trading and clearing units in § 23.605(d) should be expanded so as to require "distant physical separation" of the two. The commenter also expressed support for requiring the use of objective criteria in determining whether to accept clearing customers. In the second letter, the commenter contended that the restrictions set forth in § 23.605(d), as proposed, correctly address key areas where conflicts arise, and that the independence of clearing members is essential to accomplish several policy goals of the Dodd-Frank Act. In the second comment, the commenter stated its belief that the firewalls mandated by the proposed rules "are critical to reducing potential conflicts between the trading unit of an FCM, IB, SD, or MSP and their clearing unit."

Michael Greenberger also expressed support for § 23.605(d), as proposed, noting that attempts to tie clearing decisions to trade execution decisions would raise potential conflicts of interest, which could serve to block access to clearing and prevent competition among execution venues. The commenter also noted that mandatory public disclosure of client acceptance criteria by SDs and MSPs is consistent with legislative intent. Likewise, Pierpont Securities Holdings LLC also expressed support for the Commission's proposal, in particular the requirements that no direct or indirect interference or influence be permitted by the business trading unit on the clearing unit as to (i) whether clearing services will be provided and (ii) how clearing fees will be set.

The Principal Traders Group supported a rule preventing interference by the business trading unit of an SD or MSP, with respect to the decision of an affiliated FCM to accept a client for clearing services, but preferred that the rule be presented in the form recommended by FIA/ISDA/SIFMA below.

In contrast, FIA, ISDA, and SIFMA, in a joint comment, commented that the proposed rules would alter the business operations of integrated financial services firms to the detriment of clients and in a manner disproportionate to achieving the regulatory goals the Commission has identified, including the promotion of effective risk management. The commenters also argued that the Commission's proposed application of the conflicts rules to FCM clearing activities is not contemplated by section 732 of the Dodd-Frank Act. FIA/ISDA/SIFMA argued that the proposed rules would impair an SD's/MSP's ability to follow risk management best practices. FIA/ISDA/SIFMA

recommended that the Commission not adopt the proposed rules, but instead adopt a rule that prohibits an affiliated SD or MSP from obtaining information from an affiliated FCM's clearing personnel concerning transactions conducted by FCM clients with either their own clients or with independent SDs or MSPs. FIA/ISDA/SIFMA also expressed support for a rule that would require each FCM's clearing unit to have independent management that makes its own final decisions regarding clients to which it will offer clearing services as well as the terms for those services. FIA/ISDA/SIFMA also suggested that the Commission clarify that the rule does not mandate that firms publicize client sales and on-boarding decisions.

UBS Securities LLC echoed certain points made in the FIA/ISDA/SIFMA comment, particularly with respect to the ability of a financial services firm to operate its swap clearing business as a partnership with its trading business in order to serve clients, while JP Morgan agreed with the FIA/ISDA/SIFMA comment discussed above. JP Morgan also posited that while "it would be appropriate for the CFTC to issue rules prohibiting any activity intended to restrict open access to clearing, \* \* \* we believe a SD/MSP should be permitted to work and share information with its clearing member affiliate to promote and facilitate a client's access to clearing services or to define the parameters pursuant to which clearing services will be offered."

The FHLBs argued that the proposed rule goes beyond the standards set forth in the Dodd-Frank Act and that the proposed rule "overly restricts the ability of [SDs and MSPs] to run their trading and clearing operations and effectively service the needs of their end-user counterparties." The proposed rule also could inhibit SDs and MSPs "from taking prudent, well-informed and timely actions in situations with respect to the closing out of transactions, in a default scenario or otherwise."

NFA commented that § 1.71(d) is too broad and may negatively impact a firm's ability to share information about customers to make credit and risk determinations. UBS Securities LLC echoed certain of the points made in the FIA/ISDA/SIFMA comment, particularly with respect to the ability of a financial services firm to operate its swap clearing business as a partnership with its trading business in order to serve clients. Newedge commented that the proposed rule would limit firms' ability to coordinate, credit, risk, and other policies, and suggested that rather than prohibiting an affiliated SD or MSP

from interfering with a FCM's decision to provide clearing services, § 1.71(d) should prohibit a FCM from permitting business trading unit personnel of an affiliated SD or MSP from interfering with the FCM's decision to provide clearing services.

Commenters have expressed divergent views on this issue, with some commenters strongly favoring the Commission's proposed rules (and, to a certain extent, requesting that the rule be expanded), while others have advocated that the provision not be adopted. Upon consideration of all the comments, the Commission has determined it appropriate to promulgate the rules largely as they were originally proposed. The separation of the FCM clearing unit from the interference or influence of an affiliated SD or MSP is crucial to promoting open access to clearing. Open access to clearing will be essential for the expansion of client clearing needed for market participants to comply with the mandatory clearing of swaps as determined by the Commission under section 723 of the Dodd-Frank Act. The Commission believes that the promulgation of the language as proposed would be "appropriate," as that term is used in section 4d(c) as amended by section 732 of the Dodd-Frank Act. Moreover, the Commission does not believe the rule will hamper risk management. The Commission notes that it has proposed straight-through processing rules,<sup>30</sup> counterparty clearing documentation rules,<sup>31</sup> and clearing member risk management rules<sup>32</sup> that would, if adopted, minimize the counterparty risk to an SD or MSP with respect to transactions required or intended to be cleared.

In response to commenters' concerns about an FCM's ability to manage a default scenario without the benefit of the trading expertise in the business trading unit, the Commission is modifying proposed § 1.71(d)(2)(i) to permit the business trading unit of an affiliated SD or MSP to participate in the activities of an FCM during an event of default. Specifically, the business trading unit personnel would be permitted to participate in the activities of the FCM, as necessary, during any default management undertaken by a derivatives clearing organization that results from an event of default and for

<sup>30</sup> See Requirements for Processing, Clearing, and Transfer of Customer Positions, 76 FR 13101, 13109 (Mar. 10, 2011).

<sup>31</sup> See Customer Clearing Documentation and Timing of Acceptance for Clearing, 76 FR 45730, 45737 (Aug. 1, 2011).

<sup>32</sup> See Clearing Member Risk Management, 76 FR 45724, 45729 (Aug. 1, 2011).

the purposes of transferring, liquidating, or hedging any proprietary or customer positions as a result of an event of default.

In addition, the Commission is including the term "clearing unit," as defined in § 23.605(a), in the relevant provisions of § 23.605(d). This change will serve to clarify the scope of the informational partition between the SD or MSP and the personnel or division of a clearing member responsible for the provision of clearing services.

To clarify an issue raised by FIA/ISDA/SIFMA, the Commission notes that SDs and MSPs are not required to publicize their client sales and on-boarding decisions; rather, the criteria used in making those decisions should be publicly available and objective. In other words, "all such decisions regarding the acceptance of customers for clearing should be made in accordance with publicly disclosed, objective, written criteria," as stated in the preamble of the proposed rule.

#### b. Division of Clearing Unit Into Self-Clearing Unit and Customer Clearing Unit

The proposed rules did not distinguish between a self-clearing unit (clearing for an SD's or MSP's own trades) and a customer clearing unit (clearing for customers and competitors). However, Swaps and Derivatives Market Association commented that the proposed rules should differentiate between the two units. Having considered that comment, the Commission has decided not to modify the language in the manner suggested by the commenter. The Commission believes that subdividing the clearing unit into two separate sub-units would create an unnecessary complication that could erode the firewall mandated by the statute.

#### c. Prohibition on Business Unit Personnel of an SD or MSP From Supervising Personnel of an Affiliated DCO-Clearing Member—§ 23.605(d)(2); Restrictions on SD and MSP Business Trading Unit Supervision of Clearing Unit of Affiliated FCM—§ 1.71(d)(2)(ii)

As proposed, § 23.605(d)(2) provided that, at a minimum, the § 23.605(d)(2) informational partitions "shall require that no employee of a business trading unit of a [SD] or [MSP] shall supervise, control, or influence any employee of a clearing member of a derivatives clearing organization," while proposed, § 1.71(d)(2)(ii) congruently provided that "[n]o employee of a business trading unit of an affiliated [SD] or [MSP] shall supervise, control, or

influence any employee of a clearing unit of the [FCM].”

FIA, ISDA, and SIFMA, in a joint comment, posited that because employees of a business trading unit and a clearing unit may be supervised by the same manager, §§ 23.605(d)(2) and 1.71(d)(2)(ii) should be amended to prohibit an employee of an SD or MSP from acting as a direct supervisor of any non-management personnel of an affiliated FCM's clearing unit. The commenter also suggested that salespeople be permitted to associate with an SD or MSP and with an affiliated FCM, and be permitted to act for clients at both entities. Further, the commenter argued that a carve-out should be added to §§ 23.605(d) and 1.71(d) enabling an SD parent to exercise risk management over its affiliated FCM (e.g., approving credit and risk parameters for common and distinct customers) in a manner that is non-discriminatory, non-prejudicial, and for the sole purpose of complying with group risk and credit policies and parameters. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

After reviewing the comment, the Commission has decided to adopt the rule with certain modifications. Any influence on clearing unit personnel by upper-level supervisors involved in business trading unit activities would undermine the conflict-of-interest requirements mandated by new sections 4d(c) and 4s(j)(5) of the CEA, as amended by sections 731 and 732 of the Dodd-Frank Act, respectively, and set forth in the rule. Moreover, the Commission does not believe that the rule language should be changed to permit sales personnel to act for both the trading unit and the clearing unit. The risks associated with this approach, in terms of potential undue influence and interference with clearing decisions has been well-supported by commenters, as discussed above.

With regard to proposed § 1.71(d), the Commission is making certain changes to clarify the intent of the rule. In particular, § 1.71(d)(1)(vi) is modified to prohibit an affiliated SD or MSP from interfering with or influencing decisions related to setting a particular customer's fees for clearing services based upon criteria that are not generally available and applicable to other customers of the FCM. Additionally, as proposed § 1.71(d)(2)(i) required that the informational partitions between the business trading unit of the affiliated SD or MSP and the clearing unit personnel of the FCM include a prohibition on any business trading unit personnel

participating in any way with the provision of clearing services. As modified, the rule clarifies that business trading unit personnel may not condition or tie the provision of trading services to the provision of clearing services or otherwise participate in clearing services by improperly incentivizing or encouraging the use of the affiliated FCM.<sup>33</sup> In addition, as discussed above, business trading unit personnel would be permitted to participate in the activities of the FCM in the event of a default.

#### 8. Undue Influence on Customers— § 1.71(e)

As proposed, § 1.71(e) mandated that FCMs and IBs “adopt and implement written policies and procedures that mandate the disclosure to its customers of any material incentives and any material conflicts of interest regarding the decision of a customer as to the trade execution and/or clearing of the derivatives transaction.”

K&L Gates LLP (on behalf of Peregrine Financial Group Inc.) commented that existing Commission regulations already impose risk disclosure requirements on FCMs and IBs, and that the proposed rule inappropriately imports a concept from the securities industry into the futures industry.

Better Markets submitted two comment letters in support of the proposal. In the first comment, the commenter suggested that the rule should extend to the affiliates of an FCM or IB, and that the disclosure should include the nature and amounts of the relevant interests. In the second comment, the commenter suggested that the rule be expanded so that any incentives received by FCMs or SDs in exchange for use of various market infrastructures must be fully disclosed. Swaps and Derivatives Market Association submitted a comment supporting § 1.71(e), as proposed.

Having considered the comments, the Commission has determined it appropriate to adopt the rule as it was originally proposed. The Commission believes that in order to ensure that

<sup>33</sup> The Commission generally would not view as “improper” making available discounted clearing services in connection with trading activities, provided that the business trading unit personnel comply with applicable prohibitions and restrictions on their interactions with the clearing unit. The Commission emphasizes in this regard that in § 1.71(d)(2), the term “improperly” modifies both the term “incentivizing” and the term “encouraging” and that the term “otherwise” is intended to clarify that other “improper” activities, similar to conditioning or tying, could be subject to § 1.71(d)(2). Such “improper” activities are limited to those that wrongfully interfere with, or attempt to influence, a decision of the affiliated FCM's clearing unit personnel specified in § 1.71(d)(1).

counterparties are adequately informed of any material incentives or conflicts prior to the execution of a transaction, it is essential that FCMs and IBs be required to adopt and implement written policies and procedures that require the advance disclosure of such conflicts. In addition to addressing issues of customer protection, the policies and procedures will promote consistency with proposed § 23.605(e). Further, to the extent that Better Markets commented that the rule should be expanded to include disclosures of certain incentives received by FCMs and IBs, the Commission believes that the recommendation is beyond the scope of this rule.

#### 9. Undue Influence on Customers— § 23.605(e)

As proposed, § 23.605(e) mandated that SDs and MSPs “adopt and implement written policies and procedures that mandate the disclosure to its counterparties of any material incentives and any material conflicts of interest regarding the decision of a counterparty: (1) Whether to execute a derivative on a swap execution facility or designated contract market; or (2) Whether to clear a derivative through a derivatives clearing organization.”

FIA, ISDA, and SIFMA, in a joint comment, noted that the proposed rule overlaps with disclosures proposed by the Commission in a separate notice of proposed rulemaking.<sup>34</sup> The commenter argued that the provision should be narrowed and, alternatively, that the Commission could require SDs and MSPs to provide customers with an annual disclosure document describing potential conflicts that may exist among the firm, its affiliates, clients, and employees. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter.

Better Markets submitted two comment letters addressing the provision at issue. In the first comment, the commenter suggested that the Commission extend the disclosure requirements in several respects. In the second comment, the commenter reiterated its belief that incentives of SDs and MSPs received in exchange for use of various market infrastructures should be fully disclosed. Michael Greenberger, UNITE HERE, and Swaps and Derivatives Market Association each submitted comments supporting § 23.605(e), as proposed.

<sup>34</sup> See Business Conduct Standards for SDs and MSPs with Counterparties, 75 FR 80638, 80659 (Dec. 22, 2010).

After considering the comments, the Commission has determined it appropriate to adopt the rule as it was originally proposed. The Commission believes that in order to ensure that counterparties are adequately informed of any material incentives or conflicts prior to the execution of a transaction, it is essential that SDs and MSPs be required to adopt and implement written policies and procedures that require the advance disclosure of such conflicts. In addition to addressing issues of customer protection, the policies and procedures will promote the efficient use of trading facilities and DCOs for swap transactions, by ensuring that counterparties are adequately informed of any material incentives or conflicts of an SD or MSP that could impact the execution and clearing decisions of the counterparty.

*N. Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of an FCM, SD, or MSP*

Section 4d(d) of the CEA, as added by section 732 of the Dodd-Frank Act, requires that each FCM designate an individual to serve as its chief compliance officer (CCO). Likewise, section 4s(k) of the CEA as added by section 731 of the Dodd-Frank Act requires that each SD and MSP designate an individual to serve as its CCO. The CCO NPRM proposed § 3.3(a) to codify these requirements for FCMs, SDs, and MSPs, and prescribed certain qualifications for the position.

Section 4s(k)(2) of the CEA sets forth certain duties to be performed by a CCO of an SD and MSP, and section 4d(d) of the CEA requires the Commission to promulgate rules concerning the duties of a CCO of an FCM. The CCO NPRM proposed § 3.3(d) to codify the duties set forth in section 4s(k)(2) and applied them uniformly to FCMs, SDs, and MSPs.

Section 4s(k)(3) of the CEA requires that the CCO of an SD or MSP annually prepare and sign a report containing a description of the registrant's compliance with the CEA and regulations promulgated under the CEA, and a description of each policy and procedure of the CCO, including the code of ethics and conflicts of interest policies. Proposed § 3.3(e) <sup>35</sup> codified this requirement and applied these requirements to CCOs of FCMs as well.

The Commission received 25 comment letters and Commission staff

<sup>35</sup> The proposed regulations misnumbered the subsections of § 3.3 such that two subsections were designated as "(d)." To avoid confusion, this release re-designates such sections correctly in brackets.

participated in one meeting in response to the CCO NPRM and considered each in formulating the final rules.

1. Identical Rules Applicable to SDs, MSPs, and FCMs

The Commission proposed uniform rules applicable to SDs, MSPs, and FCMs.

Rosenthal Collins Group, LLC (Rosenthal) and Newedge commented that Congress did not intend for CCOs of FCMs to be subject to the same requirements as CCOs for SDs and MSPs, and it is "overkill" for CCOs of "pure" FCMs to be subject to the same requirements as CCOs of SDs and MSPs. However, Rosenthal conceded that an FCM that is also an SD or MSP should comply with the more stringent requirements.

NFA questioned why there was no explanation of the decision to extend identical requirements to CCOs of FCMs. NFA argued that it is more important to harmonize with FINRA Rule 3010 and FINRA Interpretive Material 3010-1, Rule 3012, and Rule 3130 because 55% of FCMs are also broker-dealers (BDs) registered with the SEC.

The FHLBs commented that they are already subject to Federal Housing Finance Agency (FHFA) regulation, such as internal control systems under 12 CFR 917.6, and requested that the Commission defer to this regime because duplicative regulations will not increase transparency and may cause some limited SDs to leave the business.

Better Markets supported extension of the same duties to FCMs because of their critical role in the market that will expand dramatically with the increased use of clearing. The National Society of Compliance Professionals (NSCP) also supported application of identical CCO requirements to all registrants, provided the NSCP's suggested modifications to the rule were made. The Council of Institutional Investors (CII) commented that extending the same duties to CCOs of FCMs would be comprehensive and consistent, and may help mitigate regulatory uncertainties.

FIA and SIFMA agreed with NSCP that the CCO requirements for SDs, MSPs, and FCMs can be harmonized in an identical regime, provided the suggested changes to the rule are made to bring the rule into harmony with the traditional financial services compliance model. FIA and SIFMA also noted that the more traditional compliance model would be consistent with the approach the Commission took

with regard to retail foreign exchange dealers (RFEDs).<sup>36</sup>

With regard to comments that CCOs of FCMs should be subject to different or lesser standards than SDs or MSPs, the Commission notes that FCMs are subject to fiduciary duty standards,<sup>37</sup> and agrees with Better Markets that the role of FCMs likely will grow in importance as client clearing of swaps increases. The Commission also agrees with CII that the Commission has an interest in consistent regulation of its registrants. As discussed below, after considering the comments of NSCP, FIA, SIFMA, and others, the Commission is making a number of changes to the final rule to harmonize the rule to the extent possible with the traditional financial services compliance model. Therefore, the Commission is not promulgating different rules for FCMs. The Commission further notes that whereas the Dodd-Frank Act required that FCMs designate CCOs, the Act did not establish a similar requirement that BDs must designate CCOs under the securities laws. Accordingly, the distinction between treatment of FCMs and BDs has a statutory basis.

In response to comments regarding consistency with RFED and FINRA rules, the Commission believes that the changes to the rule discussed below will broadly harmonize the rule with the standard currently applicable to CCOs of RFEDs and the standards applicable to the CCOs of BDs.

The Commission recognizes that there may be some overlap with FHFA rules for the FHLBs. However, the Commission believes that the two approaches are broadly compatible. For example, the FHFA requires senior management to establish and implement an effective system to track internal control weaknesses and the actions taken to correct them, and to monitor and report to the bank's board on the effectiveness of the internal control system, whereas the Commission's rule requires the CCO to establish, in consultation with the board or the senior officer, procedures for the handling, management response, remediation, retesting, and closing of noncompliance issues, and to have a meeting with the board or senior officer at least once a year. These provisions are compatible if the CCO works in

<sup>36</sup> RFEDs are required to designate a CCO and prepare an annual compliance certification under current Commission regulations. See 17 CFR 5.18(j).

<sup>37</sup> See Joint Report of the SEC and the CFTC on Harmonization of Regulation at 68 (Oct. 16, 2009), available at [www.cftc.gov/PressRoom/PressReleases/pr5735-09](http://www.cftc.gov/PressRoom/PressReleases/pr5735-09) (discussing relevant case law establishing a fiduciary duty standard for FCMs).

consultation with the senior officer (as permitted under § 3.3 as adopted) to establish a monitoring system. The board would receive the benefit of two views on effectiveness of compliance policies—one from managers who implement the policies, and one from a monitor of the managers, who is the CCO.

## 2. Harmonization With CCO Rule of the Financial Industry Regulatory Authority (FINRA)

Although the Commission reviewed and considered the existing FINRA rules for BDs' CCOs, the duties and requirements of a CCO under section 4s(k) of the CEA are far more specific than the general policies, procedures, and testing requirements of the FINRA rule. Thus, the proposed rule necessarily differed in both form and substance from the FINRA rule, which was not mandated by statute.

FIA and SIFMA argued that the proposal should be harmonized with existing precedent for compliance models in the financial services industry (such as those applicable to BDs), and that NFA, of which SDs and MSPs will be required to be members, should have primary responsibility for setting compliance standards.

Newedge argued that jointly registered BD-FCMs should be able to apply the requirements of FINRA Rule 3130, which Newedge considers to be better designed, and only comply with the Commission's rules if no comparable provision exists in Rule 3130. Newedge also argued that NFA has extensive experience dealing with FCM CCOs and is best positioned to determine their proper role.

Rosenthal commented that the substantial experience of FINRA and NFA in dealing with conduct and compliance should be relied upon, with FINRA Rule 3130 as a guide.

Market participants<sup>38</sup> in a May 17, 2011 meeting (May Meeting) with Commission staff stated that the Commission's rules differed from FINRA's rules in three main ways: resolution vs. mitigation of conflicts, the term "ensure compliance" in the Commission's rules, and whether the CEO or the CCO certifies the annual report. The participants also stated that, without revisions to the proposed rule, they would be required to prepare two

annual reports: one for FINRA and one for the Commission.

Having considered these comments, the Commission has determined it is unable to conform the rule fully to match the FINRA standard for CCOs of BDs and still meet the statutory requirements of section 4s(k). However, the Commission believes the purpose of the rule is supplemental to—not contradictory with—the relevant provisions of FINRA Rules 3010, 3012, and 3130.

As explained by commenters, the CCO customarily has acted as an advisor, and has not had the ability to enforce compliance policies by directing staff or making hiring and firing decisions. By way of contrast, new section 4s(k) of the CEA requires that the CCO resolve conflicts of interest, be responsible for administering certain policies and procedures, and ensure compliance with the CEA. While the Commission has attempted to be responsive to the traditional role of compliance officers in the financial services industry, the Commission does not believe that FINRA's rules provide a model that would encompass all of the statutory provisions in section 4s(k). The Commission believes, however, that the changes to the rule discussed below will broadly harmonize the final rule with FINRA standards and allow a CCO of a dual registrant to fulfill the duties required by both rules without undue duplication or contradiction.

Notably, as explained above, the Dodd-Frank Act required that FCMs designate CCOs, whereas the Act did not establish a similar requirement that BDs must designate CCOs under the securities laws. Accordingly, the distinction between treatment of FCMs and BDs has a statutory basis.

## 3. Regulatory Structure

In the CCO NPRM, the Commission requested comment on whether the structure of the proposed rules allows for sufficient flexibility.

EI urged the Commission to follow the Federal Energy Regulatory Commission's approach by setting forth principles or attributes of an effective compliance program while leaving the details to the registrant.

Rosenthal argued that the rule should allow for flexibility because the role of a CCO varies, and should not be a "one size fits all," while NSCP commented that the proposed rules "strike an appropriate balance" between aspirational standards and forcing all entities to conform to one standard. Cargill commented that if the scope of the rules is limited to a registrant's swap dealing division, the provisions in the

proposed rule are "in general reasonable and provide flexibility so that each swap dealer can apply the general requirements to its own business structure."

Commodity Markets Council (CMC) requested that the Commission clarify whether registration as an SD due to activities in one commodity would require compliance obligations for all activities of an integrated firm, require compliance obligations on the activities of an involved affiliate, or require compliance obligations for just those activities in the underlying commodity.

NFA and the FHLBs commented that the rules should explicitly permit the CCO to share any other executive role, such as CEO, to provide flexibility for smaller firms. NFA also argued that the rules should recognize that compliance expertise may reside with more than one individual, and thus the Commission should consider allowing an entity to designate multiple CCOs, so that each CCO's primary area of responsibility is defined, and each CCO should be required to perform duties and responsibilities with respect to their defined area. NFA also recommended that CCOs explicitly be permitted to consult with other employees, outside consultants, lawyers, and accountants.

Newedge, Hess Corporation (Hess), and The Working Group argued that affiliated FCM/SD/MSPs that are separate legal entities should be permitted to share the same CCO to increase compliance efficiency. The Working Group also argued that the CCO of affiliated registrants should be allowed to report to a board of an affiliated entity that controls both entities. Better Markets, on the other hand, commented that a senior CCO should have overall responsibility of each affiliated and controlled entity, even if individual entities within the group have CCOs. Better Markets also recommended that the rule require the CCO office to be located remotely from the trading floor.

In response to EEI's recommendation that the Commission set forth general principles akin to those required by FERC, the Commission observes that the statutory regime established by Congress would not permit such an approach.

The Commission agrees with commenters that CCOs should be permitted to "wear multiple hats." In other words, the Commission confirms that a CCO may share additional executive responsibilities and/or be an existing officer within the entity. This is particularly appropriate in smaller firms, which may lack sufficient scale to employ a stand-alone CCO. However, employing a stand-alone CCO may be

<sup>38</sup> Representatives from the SEC and Commission staff met with industry participants including representatives of FIA, SIFMA, UBS Financial Services, Inc., MF Global, Morgan Stanley, JPMorgan Chase & Co., Pershing, Alliance Bernstein, and Newedge USA on May 17, 2011. See <http://comments.cftc.gov/PublicComments/>.

appropriate in a larger firm, depending on the scale of its operations and degree of the CCO's responsibilities.

Additionally, the Commission confirms that nothing in the rules would prohibit multiple legal entities from designating the same individual as CCO, but the rule as adopted will require the CCO to report to each entity's board or senior officer, rather than to the board or senior officer of a consolidated corporate parent.

The Commission has determined not to permit designation of multiple CCOs with delineated areas of responsibility because this arrangement would not comply with sections 4d(d) and 4s(k) of the CEA, which require FCMs, SDs, and MSPs to "designate an individual to serve as chief compliance officer." In response to NFA's concern about CCOs being able to rely on the expertise of others, the annual report certification language in the rule as adopted containing the qualifier "to the best of his or her knowledge and reasonable belief" would permit the CCO to rely on other experts for statements made in the annual report.

As previously noted, the Commission is clarifying in the final rules that the CCO's duties extend only to the activities of the registrant that are regulated by the Commission, namely, swaps activities of SDs and MSPs and the derivatives activities included in the definition of FCM under section 1(a)(28) of the CEA.

#### 4. Public Availability of the Annual Report

The Working Group commented that it is likely that the annual report will not be considered confidential information protected from Freedom of Information Act requests, and could expose registrants to legal and reputational risk if made public. The Working Group also argued that the report may force firms to make disclosures prior to having remedial actions agreed with the Commission and put into effect, and could grant valuable insight to competitors. The Working Group recommended that the Commission take steps to ensure that the information remains confidential and should make explicit that there is no private right of action for misstatements and inaccurate content in the report. EEI also expressed concern about disclosure of confidential or proprietary information if the report would be made public. FIA and SIFMA recommended that the Commission make the report nonpublic by including it in the list of exempted items in Commission regulation § 145.5.

In response to these comments, the Commission notes that a registrant may request confidential treatment under § 145.9 for information submitted to the Commission under these regulations. Accordingly, an FCM, SD, or MSP must petition for confidential treatment of its annual report under § 145.9 if it wants the Commission to determine that a particular annual report should be subject to confidentiality.

#### 5. Definitions—§ 3.1

Proposed amendments to Part 3 of the Commissions regulations in the CCO NPRM added chief compliance officers to the definition of "principal" in § 3.1(a)(1), and added definitions of "compliance policies" and "board of directors" at § 3.1(g) and (h), respectively.

##### a. Definition of "Principal"—§ 3.1(a)(1)

The proposed regulations modified the definition of "principal" in Part 3 to include a CCO as an example of a person "having the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the entity's activities that are subject to regulation by the Commission."

Rosenthal argued that declaring the CCO to be a principal adds no incentive for qualified individuals to become a CCO because he or she could be liable outside his/her area of competence or control. Rosenthal also argued that it should be the firm's responsibility to comply, with ultimate responsibility for compliance placed with the firm's senior management. EEI argued that the proposal is overly prescriptive, that requiring the CCO to be a principal would require significant changes to current practice, and that the reporting structure should be left to each individual firm. On the other hand, Cargill commented that the requirement to be listed as a principal applies statutory disqualification standards that are clear and objective.

NFA recommended that the proposed change to the definition of "principal" be modified to mention the CCO earlier in the definition rather than listing the position as an example of a person with supervisory authority over business personnel (i.e., a position with power to exercise a controlling influence). NFA stated that the rule should clarify that the CCO is not a line supervisor, nor does the CCO have supervisory authority over personnel.

FIA and SIFMA argued that, although the FINRA CCO rules require the CCO to register as a "general securities principal," FINRA has explicitly stated that this "does not create the

presumption that a chief compliance officer has supervisory responsibilities or is otherwise a control person." FIA and SIFMA recommended that the Commission make a similar qualifying statement when promulgating the final rules.

Considering these comments, the Commission is modifying the proposed rule to list the position of CCO within the definition of principal separately for each type of entity as recommended by NFA, rather than as an example of someone in a position to exercise a controlling influence. The Commission believes that this modification addresses the issue sufficiently, without the need to incorporate the qualifying statement recommended by FIA and SIFMA. However, this change should not be interpreted to undermine the CCO's ability to fulfill the CCO's duties as provided for under the CEA and by Commission regulation.

##### b. Definition of Compliance Policies—§ 3.1(g)

The proposed regulations defined "compliance policies" broadly to include all policies required to be adopted or established by the registrant pursuant to the CEA and regulations, including a code of ethics.

The Working Group requested that the Commission clarify that the proposed rules do not require that a firm must adopt a code of ethics, but only that in its annual report the firm provide a description of a code of ethics to the extent that it has one.

The National Whistleblowers Center (NWC) recommended that the Commission establish a rule that provides contact with internal compliance departments with the same whistleblower protection as contacts with the Commission. NWC also recommended that the Commission require registrants to adopt a code of ethics and conduct that contain rigorous whistleblower protections. Finally, NWC recommended that the Commission require an effective compliance program with the following components: Consistent enforcement of the company's code of conduct; professional management of the help line; vigorous enforcement of non-retaliation policies; effective compliance and ethics risk-assessment; integration of clear, measurable compliance and ethics goals into the registrant's annual plan; direct access and reporting by the CCO to a compliance-savvy board; strong compliance and ethics infrastructure; compliance audits to uncover law-breaking; CEO action to promote compliance; and shared learning within the registrant.

In order to achieve maximum consistency across the CCO provisions for SDs, MSPs, FCMs, DCOs, SDRs, and SEFs, the Commission has deleted the definition of “compliance policies” from the rule. The Commission believes this definition is unnecessary given the overall changes to the scope of the review required by the annual report, discussed below. The changes to the scope of the review of the annual report track the language of the statute in that the annual report will require a description of the written policies and procedures, including a code of ethics and conflicts of interest policies. The annual report separately will require a description of material compliance with the CEA and Commission regulations.

In response to The Working Group’s comment, the Commission notes that the statute requires that the CCO prepare and sign an annual report that contains a description of each policy and procedure, including the code of ethics and conflicts of interest policies. Whether a firm decides to adopt a separate code of ethics in furtherance of this requirement is left to its discretion.

In response to NWC’s comments, the Commission takes note of NWC’s points related to whistleblowers as sound practices. However, these additional requirements, such as requiring specific whistleblower provisions in codes of ethics or conduct are outside the scope of this rulemaking.

#### 6. Designation of Chief Compliance Officer—§ 3.3(a)

Proposed § 3.3(a) required each SD, MSP, and FCM to designate an individual as a CCO and provide the CCO with the full responsibility and authority to develop and enforce, in consultation with the board or senior officer, appropriate policies and procedures to fulfill the duties set forth in the CEA and regulations.

EI argued that a CCO should work in concert with business and control functions to assure appropriate policies are in place, but that the proposed rules go beyond what is required by the CEA by inappropriately imposing upon the CCO full responsibility to develop and enforce all policies. Newedge also commented that CCOs generally do not have full responsibility to develop and enforce compliance policies, and cites a Security Industry Association White Paper that states: “\* \* \* there is a huge difference between the role of the Compliance Department and its personnel, and the overall broad firm responsibility ‘to comply’ with applicable rules and regulations. The Compliance Department plays an integral support function for firm

compliance programs, but only senior management and business line supervisors ultimately are responsible for ensuring firm compliance with laws and regulations.”

Rosenthal commented that the Commission’s rules should be revised in a manner that reflects the view that the CCO is only an advisor to management and should not be viewed as an enforcer of policies within the FCM, as that would represent a ten-year step backward in governance.

In an attempt to balance the traditional role of compliance officers in the financial service industry with the statutory requirements and policy objectives of promoting a strong culture of compliance, the Commission is revising proposed § 3.3(a) to (i) remove the requirement that a CCO be provided with “full” responsibility and authority; (ii) remove the requirement that a CCO “enforce” policies and procedures; (iii) limit the responsibilities of the CCO to the “swaps activities” of SDs and MSPs, and the FCMs’ derivatives activities included in the definition of FCM under section 1(a)(28) of the CEA; and (iv) clarify that a CCO need only develop policies and procedures to fulfill the duties set forth in, and ensure compliance with, the CEA and Commission regulations. The Commission is making the changes to § 3.3(a) to alleviate commenters’ concerns about the use of the term “enforce” and about the scope of the CCO’s duty to develop policies and procedures.

#### 7. Reporting Line—§ 3.3(a)(1) & (2)

Proposed § 3.3(a)(1) required that the CCO report to the board of directors or the senior officer of a registrant, that the board or senior officer approve the compensation of the CCO, and that the board or senior officer meet with the CCO at least once a year to discuss the effectiveness of compliance policies and their administration by the CCO. Proposed § 3.3(a)(2) also prohibited the board or senior officer of a registrant from delegating its authority over the CCO, including the authority to remove the CCO.

The CCO NPRM requested comment on the degree of flexibility in the reporting structure, including whether it would be more appropriate for a CCO to report to the board or the senior officer; whether the board or the senior officer is a stronger advocate on compliance matters; whether the proposed reporting structure should address issues related to affiliates; and whether the rule should include a provision requiring a majority of the board to remove the CCO. The proposal also requested

comment regarding whether it is necessary to adopt rules for the CCO regarding conflicts of interest between compliance interests, commercial interests, and ownership interests of a registrant.

Cargill recommended that the definition of board of directors be expanded to include a governing body of a division, such as a management committee, if the SD registration applies to activities within a division of a larger company, rather than the company as a whole. Cargill also recommended that the Commission add a definition of “senior officer” and that it include a senior officer of a division, because a division might be more familiar with the swaps activities of an SD. Cargill and The Working Group each argued that a requirement that a CCO can be removed only by a majority of the members of a governing body would be inflexible, and should not be added to the rules.

The Working Group argued that the CCO should be allowed to report to a board of an affiliated entity that controls both the affiliate and the registrant. The Working Group also argued that the CCO should be permitted to operate under the direction of other corporate officers, even middle level officers, so that the CCO is not an independent inspector general that operates outside the traditional reporting structure within a corporate entity. EEI also argued that the proposal is overly prescriptive and recommends that the reporting structure be left to each individual firm. Similarly, FIA and SIFMA commented that although the board is the ultimate supervisory authority, the CCO should not be required to directly report to it. Instead, firms should be free to determine the reporting structure as long as independence and authority as a control function is maintained. FIA and SIFMA recommended, for example, that the CCO be allowed to report to the chief legal officer or the chief risk officer.

On the other hand, Rosenthal commented that the CCO should report to the board or, if the registrant is not a corporation, to the senior officer. Rosenthal also commented that the CCO should be prohibited from receiving any transaction or customer-based compensation to insulate the CCO from potential conflicts. NSCP also agreed that CCOs should report to senior management and have compensation set by managers that are not influenced by the profitability of particular business units. NSCP noted that new Organizational Sentencing Guidelines consider whether individuals with operational responsibility for compliance and ethics have direct

reporting obligations to the governing authority or an appropriate subgroup thereof (like an audit committee of a board), which the proposed rules would require. NSCP recommended that a provision be added to the proposed rules to make it illegal for a registrant to coerce a CCO improperly, similar to the one for CCOs of investment companies and independent public accountants.

Better Markets and Chris Barnard recommended that decisions to designate or terminate a CCO, as well as compensation decisions, be prescribed as the sole responsibility of independent members of the board of directors, or audit committee, acting by majority vote, and not the responsibility of the executive officer. Better Markets also recommended that both the board and the senior officer be required to meet with the CCO to discuss the effectiveness of compliance policies, and that such meetings be held at least quarterly. Better Markets further recommended that the CCO's duties be performed in consultation with both the board and the senior officer.

National Whistleblowers Center (NWC) recommended that the term "senior officer" be defined as the CEO or chairman of the board, and should not be the general counsel or a subordinate employee to the CEO. NWC believes that the rule should permit the CCO to report to the full board at any time with no interference from a board committee or a CEO. NWC also argued that the rule should prohibit termination of the CCO unless the CCO is presented the opportunity to address the board.

MetLife requested that the definition of board of directors include "(or committee of such board or governing body)" to permit it to continue its current practice of delegating particular responsibilities to expert committees of the whole board (i.e., audit, finance, investments, risk, and compensation). NFA also sought additional flexibility in the reporting structure for CCOs, provided that the firm's business unit is not permitted to impose undue pressure on a CCO regarding compliance.

Newedge recommended that the CCO be required to meet at least quarterly with the board or senior officer to discuss the effectiveness of compliance policies.

The Working Group believes it is not necessary to address conflicts of interest between compliance interests and commercial interests in the rule because the independent audit requirements imposed by the Sarbanes Oxley Act already address such conflicts.

Having considered these comments, the Commission will not permit CCOs to report to committees of a board of directors. Section 4s(k) of the CEA requires the CCO to "report directly" to the board or the senior officer of the SD or MSP. In other contexts (for example the risk management duties rules for SDs and MSPs discussed above), reporting to committees of the board is permitted. However, in this context, the Commission believes that the statutory requirement that the CCO report directly to the board or senior officer does not afford such discretion. The Commission is guided by the policy objectives of section 4s(k) in reaching the same conclusion with regard to FCMs, and observes that no currently registered FCM requested that the CCO report to a committee of the board. Indeed, Rosenthal, and FCM, agreed with the requirement that CCOs for FCMs report to a board of directors if the entity has one, or the senior officer, if the entity does not have a board.

In response to Cargill's comments, the Commission notes that under the CEA and under the rules as adopted, a registrant may elect to have the CCO report to the senior officer of the registrant. Because, "senior officer" is not defined, if a division of a larger company is a registered SD, then the CCO of such registrant could report to the senior officer of that division.

In order to preserve CCO independence, the Commission is not changing the requirement that only the board or the senior officer can hire, set compensation for, and remove the CCO. However, in order to promote consistency among the CCO rules for registrants and registered entities, the Commission is modifying proposed § 3.3(a)(1) and (2) to (i) require only that the CCO and board or senior officer meet once a year and at the election of the CCO, but not mandate the content of such meeting; and (ii) to clarify that only the board or senior officer may remove the CCO.

The Commission believes that additional requirements, such as providing the CCO an opportunity to address the board prior to removal, requiring more frequent meetings between the CCO and the board or senior officer, restricting the composition of CCO compensation, or mandating independent director approval, would be overly prescriptive and unnecessary to achieve the purposes of the rule. Similarly, the Commission believes that a provision prohibiting improper coercion is unnecessary because the rule adequately ensures CCO independence through a direct reporting line to the board or

senior officer and by requiring compensation decisions to be made by the board or a senior officer.

#### 8. Qualifications—§ 3.3(b)

As proposed, § 3.3(b) required the CCO to have the background and skills appropriate for fulfilling the responsibilities of the position, and prohibited an individual who is statutorily disqualified under sections 8a(2) or 8a(3) of the CEA from serving.<sup>39</sup> The proposal requested comments regarding whether additional limitations should be placed on CCOs, such as a prohibition on designating a registrant's counsel as CCO.

NFA argued that the statement that no individual disqualified from registration under section 8a(2)–(3) of the CEA may serve as a CCO is redundant because an SD, MSP, or FCM's registration could be denied or revoked under section 8a(2)–(3) of the CEA if any principal of the registrant is subject to a statutory disqualification. NFA argues that inclusion of this qualification in the proposed rule could appear to convey a different standard for CCOs than for other principals.

Cargill commented that the requirement for a CCO to have "the background and skills appropriate" is a commendable aspirational goal but is too vague a standard for Federal law, and is best reserved as a business decision. Cargill agreed that the requirement to be listed as a principal applies statutory disqualification standards that are clear and objective.

Newedge recommended that CCOs be required to pass a specific compliance examination and obtain a specific compliance license, as is the case in the securities world. On the other hand, NSCP does not believe that CCOs should have to pass a qualification exam or otherwise have a certain number of years in the industry, given the diversity of the registrant community. The Working Group also commented that wide latitude for qualifications of a CCO is necessary.

EEI argues that the general counsel and other attorneys should be allowed to be the CCO because they are subject to ethics considerations and a prohibition on conflicts in their representation. NFA also recommended that the CCO be permitted to be an attorney who represents the registrant or its board as long as the conflict can be

<sup>39</sup>These CEA sections contain an extensive list of matters that constitute grounds pursuant to which the Commission may refuse to register a person, including, without limitation, felony convictions, commodities or securities law violations, and bars or other adverse actions taken by financial regulators.

managed and duties discharged. Rosenthal and Hess felt that persons with legal training may be well-suited as CCOs, and that the rule requirement to demonstrate compliance proficiency is reasonable. To the contrary, Better Markets argued that a CCO should not be permitted to be an attorney that represents the SD, MSP, or FCM, or its board because the potential conflict would disqualify such an attorney.

Having considered these comments, the Commission is adopting the rule substantially as proposed, with only a technical change to clarify the references to sections 8a(2) and 8a(3) of the CEA. The Commission believes it is important for the “Qualifications” section of the rule to put registrants on notice of the possible disqualification of CCO candidates pursuant to the CEA. The benefit of such notice outweighs the concern of creating an appearance of a different standard for CCOs than for other principals. The Commission is retaining the “background and skills” qualification in the final rule because the standard effectively will prohibit appointment of unqualified persons as CCO. However, the Commission does not believe that it is necessary to require a proficiency exam for CCOs at this time.

The Commission also agrees with Better Markets that there may be a potential conflict if a member of the legal department or the general counsel of a registrant also served as the registrant’s CCO. The Commission notes that the final rules for SDRs prohibited members of the legal department or the entity’s general counsel from serving as CCO.<sup>40</sup> On the other hand, the final rules for derivative clearing organizations did not include the same prohibition.<sup>41</sup> Given the diversity of FCMs and probable diversity of SDs and MSPs and cost considerations, the Commission is taking a flexible approach in these final rules and is not prohibiting a member of the legal department or general counsel from serving as CCO for an SD, MSP, or FCM. However, should a CCO be a member of the registrant’s legal department, the Commission expects the CCO and registrant to articulate clearly the segregation of that individual’s CCO and non-CCO responsibilities. All reports required under sections 4d(d) and 4s(k) of the CEA, as well as the rules promulgated pursuant thereto, are meant to be made available to the

Commission, and as such, they should not be subject to the attorney-client privilege, the work-product doctrine, or other similar protections.

#### 9. Duty To Establish Compliance Policies—§ 3.3(d)(1)

Proposed § 3.3(d)(1) required the CCO to establish the registrant’s compliance policies in consultation with the board of directors or senior officer.

Hess and Newedge each argued that the proposal concentrates too much of the compliance function on a single individual to the exclusion of other members of senior management and day-to-day business line supervisors. Hess argued that overemphasis on the independent role of the CCO and concentrating responsibility is less effective than integration. Instead, Hess recommended that the CCO should remain the monitor of the compliance monitors, which they could not be if they are responsible for compliance.

The Commission believes that section 4s(k) of the CEA requires that the CCO administer the compliance policies, but that it does not require the CCO to establish all of a registrant’s compliance policies. To alleviate some of the commenters’ concerns regarding concentration of the compliance function, the Commission is revising the proposed rule to track more closely the statutory language of section 4s(k).

#### 10. Duty To Resolve Conflicts of Interest—§ 3.3(d)(2)

Following section 4s(k)(2)(C) of the CEA, proposed § 3.3(d)(2) required the CCO, in consultation with the board or senior officer, to resolve any conflicts of interest that may arise.

NFA commented that resolution of conflicts of interest should rest with the board or the senior officer, in consultation with the CCO. FIA and SIFMA also commented that the CCO should not be deemed to be a business line supervisor and the rule should not fundamentally change the role of the CCO, which has customarily been an independent advisor to the business line supervisors that are ultimately responsible for compliance. FIA and SIFMA argued that when Congress used the term “resolve any conflicts of interest that may arise,” Congress did not mean resolve in the executive or managerial sense, requiring a CCO to examine the facts and determine the course of action. Instead, FIA and SIFMA recommended that the rule be revised to provide a definition of “resolving conflicts of interest” that reads: “designing a system of conflict identification, assessment and resolution, advising on conflict

avoidance or mitigation alternatives, and escalating inadequate management responses to conflicts to senior management. \* \* \*” Newedge commented that the CEO and business line supervisors are in a better position than the CCO to resolve conflicts. Newedge believes that any transfer of regulatory responsibility currently held by executive officers to the CCO could have the unintended effect of reducing the amount of time and level of concern such officers will spend on compliance matters.

Participants in the May Meeting with Commission staff stated that the phrase “resolve any conflicts of interest” would traditionally be interpreted as eliminating a conflict of interest, but that elimination is not always preferable. The participants commented that further interpretation is needed to permit conflicts of interest to be addressed, mitigated, or conditioned as well. Participants argued that the role of a compliance officer is to advise the business line of acceptable and unacceptable alternatives, and if the business line chooses an unacceptable alternative, then the compliance officer must escalate the problem until an acceptable alternative is selected. However, participants strongly believed that the compliance officer should not be the actual decision maker in the resolution.

Having considered these comments, the Commission is not removing the requirement that the CCO “resolve” conflicts of interest from the rule because the requirement is provided for in section 4s(k)(2)(C) of the CEA. However, the Commission confirms, as suggested by commenters, that the term “resolve” encompasses both elimination of the conflict of interest as well as mitigation of the conflict of interest, and that the CCO’s role in “resolving” conflicts of interest may involve actions other than making the final decision. The Commission notes that the SEC has taken a similar approach in the preamble of its equivalent CCO proposal.<sup>42</sup>

<sup>42</sup> See Business Conduct Standards for Security-Based Swap Dealers and Major Swap Participants, 76 FR 42396, 42436 (July 18, 2011) (stating “we would anticipate that the CCO’s role with respect to such resolution and mitigation of conflicts of interest would include the recommendation of one or more actions, as well as the appropriate escalation and reporting with respect to any issues related to the proposed resolution of potential or actual conflicts of interest, rather than decisions relating to the ultimate final resolution of such conflicts”).

<sup>40</sup> See Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR 54538, 54584 (Sept. 1, 2011).

<sup>41</sup> See 17 CFR 39.10; Derivatives Clearing Organization General Provisions and Core Principles, 76 FR 69334, 69434 (Nov. 8, 2011).

### 11. Duty To Review and Ensure Compliance—§ 3.3(d)(3)

Following the statutory text of section 4s(k)(2)(E) of the CEA, proposed § 3.3(d)(3) required the CCO to review and “ensure compliance” by the registrant with the registrant’s compliance policies and all applicable laws and regulations.

FIA and SIFMA argued that the term “ensure compliance” needs to be clarified, because the common usage of the word (i.e., to guarantee) goes well beyond any existing compliance model and creates a standard that is impossible to satisfy. FIA and SIFMA further argued that the requirement to remediate non-compliance issues, and the discussion of management’s response to remediation, acknowledges that instances of noncompliance are not wholly preventable by any person, and that it is management’s responsibility for implementing compliance policies. Instead, FIA and SIFMA recommended that the phrase should mean taking reasonable steps to adopt, review, test, and modify compliance policies, and pointed to the Commission’s RFED rule, which requires each RFED to designate a CCO that must certify that the RFED has in place policies and procedures “reasonably designed to achieve compliance with the Act, rules, regulations and orders thereunder.” FIA and SIFMA also recommended that the Commission add a provision in the definition of compliance policies and procedures to include “procedures for escalating inadequate management responses to apparent material violations of compliance policies and procedures to the appropriate level of senior management \* \* \* depending on the facts and circumstances of the issues being addressed.”

The Working Group argued that the requirement to “ensure compliance” should not be adopted literally from the statute, because it is an impossible task. The Working Group recommended that the rules be revised to avoid suggestions that an incident of noncompliance by a firm might constitute or evidence a failure by a CCO to meet its statutory or regulatory responsibilities.

NSCP argued that “ensure compliance” imposes a level of responsibility on a CCO that cannot be discharged and is inconsistent with the customary role of a compliance officer. Instead, NSCP recommended that the CCO “administer the system of compliance that is designed to ensure compliance with compliance policies and applicable law.” NSCP concedes that although the statutory language may be viewed as constraining, it offers

section 501 of the Gramm-Leach-Bliley Act as an example of constraining language modified by regulation. NSCP stated that section 501 of that act required financial institutions to adopt safeguards to “ensure the security and confidentiality of personal information,” but that banking regulators modified the standard to require adoption of safeguards “designed to ensure the security and confidentiality of personal information.” NSCP further argued that the business units within registrants either obey the law or violate it, and a CCO is limited to providing guidance, monitoring for compliance, and reporting on the business activities.

NFA commented that it should not be the duty of the CCO to ensure compliance by the FCM, SD, or MSP because it is an impracticable standard and imposes a duty to supervise a firm’s business activities. NFA argued that the rules improperly redefine a CCO’s duties, and registrants will have difficulty retaining CCOs who are willing to perform these duties. NFA believes that FINRA’s Rule 3130 sets forth the appropriate role of a CCO.

Participants in the May Meeting with Commission staff stated that the CCO’s responsibility to escalate (repeatedly if necessary) a problem that has not been resolved could serve as a possible meaning of the term “ensure compliance” when applied to the CCO position.

EI believes that a basic tenet of modern compliance is that compliance departments advise, monitor, assist, and escalate to a governing body if necessary. EI argued that the act of complying must be borne and executed by the business, and imposing responsibility on the CCO could abrogate responsibility of senior management and other employees.

Newedge believes that the CCO should be required only to review whether a registrant has established policies designed to achieve compliance and that the responsibility to enforce compliance should lie with the business line. Newedge believes the enormity of the obligations assigned to the CCO would result in inadequate means of ensuring compliance, defeating the plain purpose of the statute.

In response to the comments received regarding the role of the CCO in ensuring compliance, the Commission is modifying the proposed rule to provide that the CCO must take “reasonable steps to ensure compliance.” The Commission believes that this approach is responsive to commenters’ concerns, is consistent with the final rules for

SDRs<sup>43</sup> and DCOs,<sup>44</sup> and is broadly consistent with the SEC’s proposal for the duties of a CCO of a security-based swap dealer or a major security-based swap participant.<sup>45</sup>

In response to comments advocating a purely advisory role for the CCO, the Commission observes that the role of the CCO required under the CEA, as amended by the Dodd-Frank Act, goes beyond what has been represented by commenters as the customary and traditional role of a compliance officer. While the Commission does not believe, as some commenters have suggested, that the CCO’s duties under the CEA or § 3.3 requires that the CCO be granted ultimate supervisory authority by a registrant, it is the Commission’s expectation that the CCO will, at a minimum, be afforded supervisory authority over all staff acting in the direction of the CCO. Recent events have demonstrated the importance of the active compliance monitoring duties required of the CCO under the Dodd-Frank Act, as implemented through these regulations.

### 12. Duty To Prepare, Sign, and Certify Compliance Annual Report—§ 3.3(d)(6)

Proposed § 3.3(d)(6) required the CCO of an SD, MSP, or FCM to prepare, sign, and certify, under penalty of law, the annual report specified in section 4s(k)(3) of the CEA.

Rosenthal commented that FINRA’s approach to certification is preferable, i.e., that the CEO certifies that the firm has processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with securities laws, regulations, and FINRA rules, based on a report by the CCO. FIA, SIFMA, and Newedge each argued that section 4s(k)(3) of the CEA requires the CCO to sign the annual report, but does not require the CCO to certify the report. FIA, SIFMA, MFA, Newedge,

<sup>43</sup> See Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR at 54584 (stating that the duties of an SDR’s CCO include “[t]aking reasonable steps to ensure compliance with the [CEA] and Commission regulations”).

<sup>44</sup> See Derivatives Clearing Organization General Provisions and Core Principles, 76 FR at 69434 (stating that the duties of a DCO’s CCO include “[t]aking reasonable steps to ensure compliance with the [CEA] and Commission regulations”).

<sup>45</sup> See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 FR 42396, 42458–59 (July 18, 2011) (requiring the CCO of a security-based swap dealer or major security-based swap participant to “[e]stablish, maintain and review policies and procedures reasonably designed to ensure compliance with the Act and the rules and regulations thereunder”).

and NFA all recommended that the rule be revised to require the CEO to certify the report. Participants in the May Meeting with Commission staff stated that requiring the CEO, rather than the CCO, to make a certification as to whether policies are in place that are reasonably designed to ensure compliance appropriately shares responsibility between compliance and business management. FIA and SIFMA recommended that if the Commission requires the CCO to certify the annual report, then with respect to any Commission registrant that is also a BD, the Commission also should require the CEO to make the certification.

Rosenthal argued that requiring the CCO to certify under penalty of law will make the CCO liable for firm infractions and will give disgruntled customers a roadmap for frivolous lawsuits. Newedge also believes that the requirement to certify under penalty of law is not fair or practicable because whoever certifies will have to rely on many individuals to compile the report. On the other hand, Hess commented that the certification language strikes an appropriate balance such that strict liability is not imposed for inadvertent errors. NSCP commented that the certification that the report is accurate and complete should have a materiality qualifier added to it. Participants in the May Meeting with Commission staff requested clarification as to how the certification of the accuracy and completeness of the information in the annual report might be kept separate from matters of opinion expressed in the annual report. The participants urged the Commission to adopt a standard for the annual report certification that is reasonably attainable.

FIA and SIFMA requested that the Commission clarify that criminal liability for the certification will not apply (absent a knowing and willful materially false and misleading statement) because there is no indication that Congress ever thought CCOs should be subject to criminal liability. Similarly, NSCP requested that the Commission clarify whether “under penalty of law” means liability under 18 U.S.C. 1001 for a false statement to a Federal officer. FIA and SIFMA also felt that imposing criminal liability for annual report certifications would make it hard to fill the position of CCO.

EEI argued that although section 4s(k)(3) of the CEA requires the CCO to certify the report, any additional content requirements for the annual report beyond what section 4s(k)(3) requires will make the certification more difficult.

In response to these comments, with respect to certification by the CCO, the Commission is modifying the proposed rule to permit either the CCO or the CEO to make the required certification. Section 4s(k)(3)(A) of the CEA requires the CCO to sign the annual report and section 4s(k)(3)(B)(ii) requires that the annual report contain a certification that, under penalty of law, the compliance report is accurate and complete. Given the statutory provisions and under these circumstances, the Commission believes it is appropriate to afford SDs, MSPs, and FCMs the discretion to choose whether the CCO or CEO will make the certification.

The Commission disagrees with commenters that a mere certification that policies are in place that are reasonably designed to achieve compliance would satisfy the requirements of section 4s(k)(3) of the CEA. The Commission believes that the statute also requires a CCO to assess how compliance policies are implemented.

The Commission is of the view that limiting the certification with the qualifier “to the best of his or her knowledge and reasonable belief” addresses commenters’ concerns of overbroad liability because the rule would not impose liability for compliance matters that are beyond the certifying officer’s knowledge and reasonable belief at the time of certification. If the certifying officer has complied in good faith with policies and procedures reasonably designed to confirm the accuracy and completeness of the information in the annual report, both the registrant and certifying officer would have a basis for defending accusations of false, incomplete, or misleading statements or representations made in the annual report.

With respect to requests for clarification of the liability that may attach to the certification “under penalty of law,” the Commission notes that administrative, civil, and/or criminal liability could be imposed on the registrant or the certifying officer or both, either directly or vicariously. As explained in the NPRM, possible violations could include a claim of failure to supervise or false statements to the Commission, and the Commission could seek an injunction against future violations, civil monetary penalties, and/or any other appropriate relief. Additionally, criminal penalties may be sought by criminal authorities for willful violations of the CEA or Commission regulations, in appropriate cases.

The Commission is declining to add a materiality qualifier to the certification, as suggested by commenters. This approach is consistent with the statutory text, with the approach taken in final rules for SDRs<sup>46</sup> and DCOs,<sup>47</sup> and with proposed CCO rules for SEFs.<sup>48</sup>

### 13. Description and Review of Compliance in Annual Report—§ 3.3([e])(1) and (2)

The proposed regulation required the annual report to contain a description of the compliance by the registrant with respect to the CEA and regulations; a description of each of the registrant’s compliance policies; and a review of each applicable requirement under the CEA and regulations, and, with respect to each, identification of the policies that ensure compliance, an assessment as to the effectiveness of the policies, discussion of areas of improvement, and recommendations of potential or prospective changes or improvements to its compliance program and resources devoted to compliance.

NSCP, The Working Group, EEI, and Hess each argued that the level of detail contemplated by the rule would impose unnecessary burdens on the CCO with little offsetting benefits. NSCP argued that a better approach would be to follow the SEC requirements for annual reviews of compliance by registered investment advisers. NSCP stated that such reviews must reflect review of the adequacy of policies established and the effectiveness of their implementation (SEC Rule 206(4)–7(b)). NSCP believes the proposed rule is overbroad and discourages reporting of compliance issues to the CCO because if every issue, no matter how trivial, must be reported and recorded, there may be a chilling effect on open communication. NSCP believes that the key issue should be whether material issues were escalated and remedied. Newedge argued that thousands of Federal, SRO, and internal rules apply, so the report should contain a summation of compliance, with details only for areas of material noncompliance.

FIA and SIFMA argued that a one-size-fits-all approach to the annual report requirements is not appropriate because some registrants are not public reporting companies, some have customers while others only conduct

<sup>46</sup> See Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR at 54584.

<sup>47</sup> See Derivatives Clearing Organization General Provisions and Core Principals, 76 FR at 69435.

<sup>48</sup> See Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214, 1252 (Jan. 7, 2011).

proprietary trading, some deal with retail customers while others only deal with sophisticated counterparties, and some are small and local, while others are large, integrated institutions with thousands of employees worldwide.

FIA and SIFMA recommended that the Commission specify the material issues that should be discussed, so that there is no second guessing with respect to the adequacy of the report, and that the Commission clarify that compliance policies only include those relating to the CEA and Commission regulations. FIA, SIFMA, and NFA also argued that the report should identify the policies that are reasonably designed to result in compliance, not that ensure compliance. Hess recommended that the annual report contain only a summary of the registrant's compliance policies and procedures. CMC commented that the scope of activities included in the annual report should be limited to those directly triggering the requirement of a CCO. EEI argued that inclusion of descriptions of violations in the report to the Commission should not be decided by the CCO, but should be decided on a case-by-case basis by the registrant's governing body. NFA requested that a materiality qualifier be added to the requirement that registrants include a description of non-compliance.

Better Markets recommended that the board approve the annual report in its entirety or specify where and why it disagrees with any provision, and then CCOs should provide the report to the Commission either as approved or with statements of disagreement.

The Working Group recommended that the Commission develop a standard form of report and guidance as to how such report needs to be completed.

In response to the comments received, the Commission is modifying the proposed requirements for the annual report in § 3.3([e]) to (i) require the annual report to contain a description of the registrant's policies and procedures, rather than a description of the compliance of the registrant; (ii) require the annual report to identify the registrant's policies and procedures that "are reasonably designed" to ensure compliance, rather than those that ensure compliance; (iii) require a description of *material* non-compliance issues. The Commission agrees with commenters that certain information need be reported only if it is materially significant and that the requirement to "ensure compliance" can be interpreted to mean "safeguard" rather than "guarantee."

14. Certification of Compliance With Sections 619 and 716 of the Dodd-Frank Act in Annual Report—§ 3.3([e])(3)

The proposed regulation required registrants to include in the annual report a certification of compliance with sections 619 and 716 of the Dodd-Frank Act (the Volcker Rule and Derivatives Push-Out), and any rules adopted pursuant to these sections.

NFA recommended that the certification of compliance with sections 619 and 716 of Dodd-Frank be deleted, arguing that the Commission should wait for the implementing rulemakings for such sections before determining certification requirements.

FIA and SIFMA commented that the requirement to certify compliance with the Volcker Rule and Derivatives Push-Out provisions should be included as part of the rulemaking that will address the scope and requirements of those provisions, but not be prematurely included in the CCO rule.

In consideration of these comments, the Commission has determined not to finalize this provision.

15. Description of Compliance Resources in Annual Report—§ 3.3([e])(6)

Proposed § 3.3([e])(6) required the annual report to contain a description of the registrant's financial, managerial, operational, and staffing resources set aside for compliance with the CEA and regulations, including any deficiencies in such resources.

FIA and SIFMA argued that the CCO is not in a position to describe the financial, material, operational, and staffing resources set aside for compliance. FIA and SIFMA recommended that the CCO only be required to describe the resources of the compliance department and any recommendations that the CCO has made to senior management with regard to financial, managerial, operational, or staffing resources.

The Working Group argued that a description of deficiencies in resources dedicated to compliance would require a CCO to identify potential shortcomings and report them in a document likely to be available to the public, which could materially hinder the CCO's ability to function as an integral member of the management team.

Having considered these comments, the Commission is adopting the rule as proposed, but with the addition of a materiality standard with respect to the description of any deficiency. The Commission does not believe that the required description of resources

available for compliance would hinder the CCO's ability to fulfill his or her duties in coordination with others in the firm. The rule requires a description of compliance resources, but does not prescribe the form or manner of this description, which the Commission views as within the reasonable discretion of the registrant.

16. Delineation of Roles of the Board and Senior Officer in Addressing Conflicts of Interest in Annual Report—§ 3.3([e])(7)

The proposed regulations required the annual report to include a delineation of the roles and responsibilities of a registrant's board of directors or senior officer, relevant board committees, and staff in addressing any conflicts of interest, including any necessary coordination with, or notification of, other entities, including regulators.

FIA and SIFMA argued that the Sarbanes-Oxley Act already requires public companies to report the roles and responsibilities of its board, senior officers, and committees in resolving conflicts of interest, so the Commission should allow such reporting to satisfy this content requirement for the annual report. NFA also recommended that the reporting of any necessary coordination with, or notification of other entities, including regulators, should be deleted.

In response to FIA, SIFMA, and NFA's comments, the Commission is deleting § 3.3([e])(7) from the final rule. This provision is not essential to the Commission's evaluation of registrants' compliance programs, and if it is relevant to a material compliance matter, it will be provided to the Commission pursuant to § 3.3([e])(6). The Commission also notes that removing this provision will make the CCO requirements for FCMs, SDs, and MSPs more consistent with the CCO requirements for SDRs and DCOs, and those proposed for SEFs.

17. Recordkeeping—§ 3.3([g])

Proposed § 3.3([g]) required FCMs, SDs, and MSPs to maintain records of its compliance policies, materials provided to the board in connection with its review of the annual compliance report, and work papers that form the basis of the annual compliance report.

The Working Group argued that retaining all materials relating to the preparation of the report will cause the CCO to retain all materials for fear of an audit that second-guesses the CCO's materiality judgments, or the CCO will limit his or her inquiries to avoid making a determination of materiality. The Working Group recommended that

materials to be retained should be only those germane to the content of the compliance report.

Better Markets recommended adding a requirement that discussions between a CCO and traders or executives with oversight of traders involving compliance and trading practices and strategies be recorded by the CCO and retained in the CCO's records. Better Markets believes this requirement is necessary because the duties of the CCO could come into conflict with the interests of traders and managers.

The Commission is adopting the rule as proposed. In response to The Working Group's comment, the Commission believes the rule sufficiently qualifies the materials that must be retained by stating that the records must be "relevant" to the annual report. With regard to Better Markets' recommendation that CCOs record discussions with traders and executives regarding compliance and trading practices, the Commission believes that this material will be covered by the rules to the extent that the annual report requires the CCO to assess the effectiveness of the registrant's policies and procedures and describe any material non-compliance issues and the corresponding action taken. Consequently, any conflicts that arise between the CCO and the trading unit of an SD, MSP, or FCM in which the CCO believes that the requirements of the CEA and Commission regulations, including risk management obligations, are not being met, must be included in the annual report. Additionally, under § 3.3(g)(1)(iii), all records of that conflict as described in the annual report must be maintained. The Commission further notes that in such instances, it would be good practice for the CCO to make and maintain records of all discussions with traders and management.

### III. Effective Dates and Compliance Dates

In the Duties NPRM, Recordkeeping NPRM, and CCO NPRM, the Commission requested comment on the length of time necessary for registrants to come into compliance with the proposed rules.

#### A. Comments Regarding Compliance Dates

The Working Group recommended that the Commission not require compliance with proposed §§ 23.600 through 23.607 for at least two years, not require compliance with proposed §§ 23.200 through 23.205 for six to twelve months to provide adequate time to develop the necessary information technology systems and business

practices, and not require compliance with the CCO designation requirement of proposed § 3.3 for one year after registration. With respect to § 23.601, The Working Group also commented that if complex requirements are included in position limit rules, such as the requirement to convert customized bilateral transactions into futures-equivalents, substantially more time will be required for firms to design and implement procedures to monitor compliance with position limits. With respect to proposed § 3.3, The Working Group commented that entities should be able first to hire a CCO and then be permitted a reasonable period of time in which to write, test, and implement policies and procedures. With respect to all of the proposed rules, The Working Group recommended that the Commission provide an extended transition period for firms that have not been prudentially regulated by a financial regulator and might require substantial corporate restructuring.

FIA, ISDA, SIFMA, and the Financial Services Forum argued that if existing systems are not easily adaptable to §§ 23.200 through 23.205, the Commission must provide sufficient time for registrants to make the necessary changes in an orderly manner, but no specific time period was provided. FIA, ISDA, SIFMA, and the Financial Services Forum also recommended that compliance with proposed § 3.3 should not be required until after the regulatory requirements under section 4s of the CEA for which the CCO is responsible are finalized and become effective.

Cargill recommended that the Commission provide SDs with at least one year to come into compliance with proposed §§ 23.600 through 23.607 following the effective date of the rules. Cargill also stated that one year was a reasonable period to comply with proposed § 3.3.

MetLife recommended that the Commission allow one year from registration as an MSP to comply with the proposed §§ 23.600 through 23.607, because such compliance will require hiring required human capital resources, build out of necessary information technology, development of policies and procedures and internal vetting of a mandated risk management program. MetLife also stated that it would it would require one year after registration to recruit a CCO and develop a compliance program in compliance with proposed § 3.3.

NSCP stated that 18 months was necessary for registrants that do not currently have a CCO to comply with proposed § 3.3.

The Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd., and Sumitomo Mitsui Banking Corporation recommended that the effective date of the rules be deferred until December 31, 2012.

The Commission received no comments related to the length of time necessary for registrants to come into compliance with the rules proposed in the SD/MSP Conflicts NPRM and FCM/IB Conflicts NPRM.

#### B. Compliance Dates

Having considered the comments received, the Commission is adopting the effective and compliance dates as set forth below.

##### 1. Reporting, Recordkeeping and Daily Trading Records of SDs and MSPs—§§ 23.200–23.205

The effective date of §§ 23.200 through 23.205 will be the date that is 60 days after publication of the final rules in the **Federal Register**.

SDs and MSPs that are currently regulated by a U.S. prudential regulator or are registrants of the SEC must comply with §§ 23.200, 23.201, 23.202, 23.203, 23.204, and 23.205 by the date that is the later of 90 days after publication of these final rules in the **Federal Register** or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10. SDs and MSPs that are not currently regulated by a U.S. prudential regulator and are not registrants of the SEC must comply with §§ 23.200, 23.201, 23.202, 23.203, 23.204, and 23.205 by the date that is the later of 180 days after publication of these final rules in the **Federal Register** or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10.

##### 2. Duties of SDs and MSPs—§§ 23.600 Through 23.607

The effective date of §§ 23.600 through 23.607 will be the date that is 60 days after publication of the final rules in the **Federal Register**.

With respect to § 23.600 (Risk Management Program), SDs and MSPs that are currently regulated by a U.S. prudential regulator or are registrants of the SEC must comply with § 23.600 by the date that is the later of 90 days after publication of this final rule in the **Federal Register** or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10. SDs and MSPs that are not currently regulated by a U.S. prudential regulator and are not registrants of the SEC must comply with § 23.600 by the date that is the later of 180 days after publication of this final rule in the **Federal Register** or the date

on which SDs and MSPs are required to apply for registration pursuant to § 3.10.

With respect to § 23.603 (Business Continuity and Disaster Recovery), SDs and MSPs that are currently regulated by a U.S. prudential regulator or are registrants of the SEC must comply with § 23.603 by the date that is the later of 180 days after publication of this final rule in the **Federal Register** or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10. SDs and MSPs that are not currently regulated by a U.S. prudential regulator and are not registrants of the SEC must comply with § 23.603 by the date that is the later of 270 days after publication of this final rule in the **Federal Register** or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10.

With respect to § 23.601 (Monitoring of Position Limits), § 23.602 (Diligent Supervision), § 23.605 (Conflicts of Interest Policies and Procedures), § 23.606 (General Information: Availability for Disclosure and Inspection), and § 23.607 (Antitrust Considerations), SDs and MSPs must comply with §§ 23.601, 23.602, 23.605, 23.606, and 23.607 by the later of the effective date of these rules or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10.

### 3. Conflicts of Interest Policies and Procedures by FCMs and IBs—§ 1.71

The effective date of § 1.71 will be the date that is 60 days after publication of the final rule in the **Federal Register**.

FCMs and IBs that are registered with the Commission as of the effective date of this rule must comply with § 1.71 by such effective date except that such FCMs need not comply with § 1.71(d) until the later of the effective date or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10. FCMs and IBs that are not registered with the Commission as of the effective date of this rule must comply with § 1.71 upon registration with the Commission, except that such FCMs need not comply with § 1.71(d) until the later of their registration or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10.

### 4. Chief Compliance Officer of FCMs, SDs, and MSPs—§ 3.3

The effective date of § 3.3 and the amendments to § 3.1 will be the date that is 60 days after publication of the final rule in the **Federal Register**.

With respect to § 3.3 (Chief Compliance Officer), SDs and MSPs that are currently regulated by a U.S. prudential regulator or are registrants of

the SEC, must comply with § 3.3 by the date that is the later of 180 days after publication of this final rule in the **Federal Register** or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10. SDs and MSPs that are not currently regulated by a U.S. prudential regulator and are not registrants of the SEC must comply with § 3.3 by the date that is the later of 360 days after publication of this final rule in the **Federal Register** or the date on which SDs and MSPs are required to apply for registration pursuant to § 3.10. FCMs that are (1) registered with the Commission as of the effective date of the rule, and (2) currently regulated by a U.S. prudential regulator or are registrants of the SEC, must comply with § 3.3 by the date that is 180 days after publication of this final rule in the **Federal Register**. FCMs that are (1) registered with the Commission as of the effective date of the rule, and (2) not currently regulated by a U.S. prudential regulator and are not registrants of the SEC must comply with § 3.3 by the date that is 360 days after publication of this final rule in the **Federal Register**. FCMs that are not registered with the Commission as of the effective date of this rule must comply with § 3.3 upon registration with the Commission.

## IV. Cost Benefit Considerations

### A. Introduction

The swaps markets, which have grown exponentially in recent years, are now an integral part of the nation's financial system. As the financial crisis of 2008 demonstrated, inadequate understanding, oversight, and management of swaps can contribute to systemic risk.<sup>49</sup> The internal business conduct standards that the Commission is promulgating for SDs and MSPs in this rulemaking are an important element of the “improve[d] financial

<sup>49</sup> As the U.S. Senate Committee on Banking, Housing, and Urban Affairs explained in reporting what became the Dodd-Frank Act, while a “downturn in the national housing market” was the 2008 financial crisis’ “first trigger:”

\* \* \* the use of unregulated derivatives products based on [faulty mortgage loans was among the elements that] only served to spread and magnify the risk. The system operated on the wholesale misunderstanding of, or complete disregard for the risks inherent in the underlying assets and the complex instruments they were backing \* \* \* Technology, plus globalization, plus finance has created something quite new, often called “financial technology.” Its emergence is a bit like the discovery of fire—productive and transforming when used with care, but enormously destructive when mishandled’ \* \* \* Gaps in the regulatory structure allowed these risks and products to flourish outside the view of those responsible for overseeing the financial system.

S. Rep. No. 111–176, at 43 (2010) (quoting former Comptroller of the Currency, Eugene Ludwig; citations omitted).

architecture” that Congress intended in enacting the Dodd-Frank Act.<sup>50</sup> For, as entities that, respectively, engage in swap dealing activities<sup>51</sup> and “whose outstanding swaps create substantive counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets,”<sup>52</sup> the standards that SDs and MSPs follow (or fail to follow) in transacting their swaps may have repercussions for financial system stability more broadly. Effective systemic risk management for swaps begins with effective internal risk management protocols of individual SDs and MSPs.

Title VII of the Dodd-Frank Act mandates the Commission to establish risk management requirements for SDs and MSPs. Specifically, Section 731 adds new section 4s of the CEA that, among other things:

- Establishes reporting, recordkeeping, and daily trading records requirements for SDs and MSPs.<sup>53</sup>

- Defines and imposes duties on SDs and MSPs with regard to: (1) Risk management procedures,<sup>54</sup> (2) monitoring of trading to prevent violations of applicable position limits,<sup>55</sup> (3) diligent supervision,<sup>56</sup> (4) disclosure and the ability of regulators to obtain general information,<sup>57</sup> and (5) antitrust considerations.<sup>58</sup>

- Establishes conflicts-of-interest requirements for SDs and MSPs to establish information partitions between research and trading and between trading and clearing.<sup>59</sup>

- Requires each SD and MSP to designate a chief compliance officer, set out qualifications and duties of the chief compliance officer, and require that the chief compliance officer prepare, sign, and furnish to the Commission an annual report containing an assessment of the registrant’s compliance activities.<sup>60</sup>

Additionally, Dodd-Frank Act section 732 amends section 4d of the CEA to add conflict of interest requirements for

<sup>50</sup> *Id.* at 228. Stated another way, they are an aspect of that legislation’s “comprehensive regulation and rules” to achieve a “strengthened infrastructure for the financial system \* \* \* intended to make the system more resilient and resistant to the adverse effects of financial instability.” *Id.* at 228–29.

<sup>51</sup> CEA section 1(a)(49)(A).

<sup>52</sup> CEA section 1(a)(33)(A)(ii).

<sup>53</sup> CEA section 4s(f)&(g).

<sup>54</sup> CEA section 4s(j)(2).

<sup>55</sup> CEA section 4s(j)(1).

<sup>56</sup> CEA section 4s(h)(1).

<sup>57</sup> CEA section 4s(j)(3).

<sup>58</sup> CEA section 4s(j)(6).

<sup>59</sup> CEA section 4s(j)(5).

<sup>60</sup> CEA section 4s(k).

FCMs and IBs,<sup>61</sup> and a chief compliance officer requirement for FCMs.<sup>62</sup> This rulemaking implements these provisions of sections 4s and 4d of the CEA.

Section 15(a)<sup>63</sup> of the CEA requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing an order. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of the following five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. To the extent that these new regulations reflect the statutory requirements of the Dodd-Frank Act, they will not create costs and benefits beyond those resulting from Congress's statutory mandates in the Dodd-Frank Act.<sup>64</sup> However, to the extent that the new regulations reflect the Commission's own determinations regarding implementation of the Dodd-Frank Act's provisions, such Commission determinations may result in other costs and benefits. It is these other costs and benefits resulting from the Commission's own determinations pursuant to and in accordance with the Dodd-Frank Act that the Commission considers with respect to the section 15(a) factors.

The Commission is obligated to estimate the burden of and provide supporting statements for any collections of information it seeks to establish under considerations contained in the PRA, 44 U.S.C. 3501 et seq., and to seek approval of those requirements from the OMB. To the extent costs of the rulemaking are associated with collections of information, the estimated burden and support for such collections of information, as well as the consideration of comments thereto, are discussed in the PRA section of this rulemaking and the information collection requests filed with OMB as

<sup>61</sup> CEA section 4d(c).

<sup>62</sup> CEA section 4d(d).

<sup>63</sup> 7 U.S.C. 19(a).

<sup>64</sup> Certain commenters, such as The Working Group and the FHLBs, posit that there is no benefit to be derived from internal business conduct standards as mandated by Congress and that the mandated provisions do not generate sufficient benefits relative to costs or contribute to the purposes (e.g., mitigating systemic risk and enhancing transparency) of the Dodd-Frank Act. As such, these commenters' concerns fall outside the Commission's regulatory discretion to implement sections 4s and 4d of the CEA and fail to raise issues subject to consider under section 15(a).

required by that statute. The Commission has also considered these costs, which it incorporates herein by reference, in its CEA section 15(a) analysis.

In each of the NPRMs encompassed within this final rulemaking, the Commission asked for public comment on the costs and benefits of the proposed regulations, and specifically invited commenters to submit "any data or other information \* \* \* quantifying or qualifying" the costs and benefits of the proposal.<sup>65</sup> The Commission also separately requested comments on the overall costs and benefits of the proposed rules implementing the Dodd-Frank Act.<sup>66</sup> The Commission received approximately 51 comments addressing the cost and benefit considerations of the proposed rules, but few commenters presented to the Commission quantitative data pertinent to any of the proposed rulemakings, and no commenter stated whether such data is ascertainable with a degree of certainty that could inform Commission deliberations. After conducting a review of applicable academic literature, the Commission is not aware of any research reports or studies that are directly relevant to its considerations of costs and benefits of these final rules.

The Commission considered the comments on the costs and benefits of the proposed rules and, in particular, reasonable alternatives suggested by commenters. As detailed in the discussions of each rulemaking above, the Commission is adopting alternatives or modifications to the proposed rules where, in the Commission's judgment, the alternative or modification accomplishes the same regulatory objective in a less burdensome manner. Indeed, the Commission has sought to reduce the burden on market participants to the extent doing so satisfies the statute's requirements and does not undermine important benefits that the Commission believes the statute was intended to promote. In addition to benefits, the costs of the regulations and the steps the Commission has taken to mitigate them are discussed below.

Notwithstanding the paucity of available quantitative information, the Commission has endeavored to estimate quantifiable costs and benefits of the final rules when possible. Where estimation or quantification is not feasible, the Commission provides a qualitative assessment of the relevant

<sup>65</sup> See SD/MSP Conflicts NPRM, 75 FR at 71395; FCM/IB Conflicts NPRM, 75 FR at 70157; Duties NPRM, 75 FR at 71404; Recordkeeping NPRM, 75 FR at 76673; and CCO NPRM, 75 FR at 70886.

<sup>66</sup> *Id.*

costs and benefits. In the following discussion, the Commission: (i) Addresses comments regarding the effects of these final rules in terms of their material costs and benefits; (ii) considers the material cost and benefit implications of these final rules in comparison to baseline costs imposed by the statutory requirements and discusses cost mitigation undertaken in modifying the rules as proposed; and (iii) considers the material costs and benefits of the final rules in light of the five broad areas of market and public concern pursuant to section 15(a) of the CEA. After discussing some general considerations applicable to all rulemaking areas covered by this release and comments regarding rule scope, the cost-benefit considerations are divided among the following rulemaking areas: recordkeeping; duties and risk management; conflicts-of-interest policies and procedures; and designation of a CCO.

#### B. General Considerations

This rulemaking generated an extensive record, which is discussed at length throughout this notice as it relates to the substantive provisions in the final rules. A number of commenters stated that they would incur significant, though largely unquantified, costs because of the proposed rules. Others identified benefits attributable to the proposed rules or more stringent requirements. The Commission carefully considered these comments and the alternatives proposed in them.<sup>67</sup>

In response to the Commission's invitation for comments on the overall costs and benefits of the proposed rules,<sup>68</sup> Better Markets stated that the Commission's cost-benefit analyses in the notices of proposed rulemaking may have understated the benefits of the proposed rules.<sup>69</sup> Better Markets argued

<sup>67</sup> These comments also have been addressed in other sections of this release. This section's consideration of costs and benefits reviews and assesses them to the more narrow extent that they raise relative cost/benefit issues. A complete policy analysis of, and response to, these comments can be found in section II of this release.

<sup>68</sup> See SD/MSP Conflicts NPRM, 75 FR at 71395; FCM/IB Conflicts NPRM, 75 FR at 70157; Duties NPRM, 75 FR at 71404; Recordkeeping NPRM, 75 FR at 76673; and CCO NPRM, 75 FR at 70886.

<sup>69</sup> See Letter from Better Markets dated June 3, 2011 (comment file for 75 FR 71397 (Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants)). On the other hand, certain commenters, such as The Working Group and the FHLBs, posit that there is no benefit to be derived from internal business conduct standards as mandated by Congress and that the mandated provisions do not generate sufficient benefits relative to costs or contribute to the purposes (e.g., mitigating systemic risk and enhancing transparency) of the Dodd-Frank Act.

that adequate assessment of the costs and benefits of any single proposed rule or element of such a rule would be difficult or impossible without considering the integrated regulatory system of the Dodd-Frank Act as a whole. According to Better Markets:

It is undeniable that the Proposed Rules are intended and designed to work as a system. Costing-out individual components of the Proposed Rules inevitably double counts costs which are applicable to multiple individual rules. It also prevents the consideration of the full range of benefits that arise from the system as a whole that provides for greater stability, reduces systemic risk and protects taxpayers and the public treasury from future bailouts.

Better Markets also stated that an accurate cost benefit assessment must include the avoided risk of a new financial crisis and opined that one measure of this is the still accumulating cost of the 2008 financial crisis.<sup>70</sup> The Commission agrees with Better Markets that the proposed rules should operate in a coordinated manner to improve and protect financial markets; notwithstanding this, the Commission must (and has) conducted a cost-benefit analysis with respect to this specific rulemaking.

Recognizing that there will be costs incurred to comply with the regulations, the Commission believes there are significant benefits to be gained from these requirements, including but not limited to, increased risk management and enhanced transparency. While the Commission notes that the costs and benefits stemming from these regulations, in large part, are attributable to the baseline statutory mandate, each subsection herein further details the costs and benefits of the numerous discrete provisions of the rules in order to inform market participants more fully of the costs and benefits anticipated by the Commission.

As a general matter across these rules, the Commission sought to ease the burden for market participants through tailored phasing in of compliance requirements. In each of the Duties NPRM, Recordkeeping NPRM, and CCO NPRM, the Commission requested comment on the length of time necessary for registrants to come into compliance with the proposed rules. These comments are enumerated in section III.A., and the Commission considered those comments in adopting compliance dates for each rule as set

forth in section III.B. above. The approach recommended by commenters and accepted by the Commission recognizes and generally differentiates between registrants that have been previously regulated by the SEC or a prudential regulator and those that have not been previously regulated. The Commission has elected to provide additional time for compliance, where appropriate, for those that have not been previously regulated. In many instances, the Commission is providing more time for all market participants beyond the statutorily prescribed minimum of 60 days.

#### *C. Comments Regarding the Scope of the Proposed Rules*

Several commenters questioned the scope of the proposed rules and implicitly, if not expressly, whether the breadth as proposed was appropriate in light of the costs that would result to certain registrants. Comments illustrative of the concerns are discussed below.

The FHLBs articulated several reasons<sup>71</sup> for exempting them from the proposed internal business conduct standard rules. First, they maintain that subjecting FHLBs to internal business conduct standards could cause them to cease offering swaps transactions to their risk-hedging members, depriving their members of a competitive swap transaction counterparty and potentially increasing members' hedging costs. Second, they maintain that many of the requirements duplicate those imposed by their prudential regulator, the Federal Housing Finance Agency (FHFA), thus there is no incremental benefit attributable to the additional costs of complying with the proposed rules.<sup>72</sup>

The Commission finds the FHLB's position unpersuasive. First, the concern that FHLBs would cease transacting swaps is undermined by the FHLB's position that the proposed rules in large part duplicate the requirements of its prudential regulator; if internal business conduct standards would likely curb the FHLBs' swaps activity, presumably that would have occurred already. Second, the Commission construes the FHLB's position to be inconsistent with the statutory intent of sections 4s(f), (g), (j), and (k)—i.e.,

consistent Commission oversight of SDs and MSPs, regardless of whether they are also subject to regulation by a prudential regulator. For, in the one area that Congress intended the Commission to defer to prudential regulation with respect to SDs and MSPs—capital and margin requirements—it provided so expressly.<sup>73</sup> There is no such express language requiring prudential regulation deference in sections 4s(f), (g), (j), and (k). This gives rise to a negative inference that, with respect to them, Congress intended the Commission to establish uniform requirements for SDs and MSPs, notwithstanding any overlapping prudential regulation. In addition, to the extent that, as the FHLBs assert, FHFA rules are substantively similar with the proposed rules, compliance with the proposed rules should not present substantial additional compliance costs.

The Working Group suggested that the proposed rules would impose substantial costs with no corresponding increase in risk management and compliance effectiveness. The Commission disagrees. It believes that its final internal business conduct standards will enhance risk management by requiring, among other things: (1) SDs and MSPs to have a complete understanding of the various risks that the entity faces; and (2) entities to monitor their traders for compliance with trading policies established by the SD or MSP. These final rules also require that SDs and MSPs have sound recordkeeping policies in place, which will ensure that swap transactions are fully memorialized. Sound risk management and internal controls on an individual firm level is the basis of systemic risk mitigation.

Other commenters (MetLife, MFA, BlackRock, and AMG) argued that the Dodd-Frank Act does not require the Commission to apply the same rules to MSPs as those applied to SDs, and that MSPs should not be subject to the same regulations as SDs because MSPs do not engage in market-making activities. These commenters contend that the costs of compliance would be too high for MSPs. The Commission believes that the statutory baseline under sections 4s(f), (g), (j), and (k) of the CEA is identical treatment of SDs and MSPs. The statutory provisions of sections 4s(f), (g), (j), and (k) of the CEA do not distinguish between the requirements applied to SDs and those applied to MSPs. Additionally, in response to claims that the costs will be too high for MSPs, the Commission notes that if an

<sup>70</sup> The comment letter cited Andrew G. Haldane, Executive Director for Financial Stability of the Bank of England, who estimated the worldwide cost of the crisis in terms of lost output at between \$60 trillion and \$200 trillion, depending primarily on the long term persistence of the effects.

<sup>71</sup> In addition to the two reasons discussed, the FHLBs also expressed that, unlike external business conduct standards, the internal business conduct standards as mandated by Congress in the Dodd-Frank Act do not generate benefits to justify their costs. As noted above, this concern falls beyond the Commission's implementation discretion.

<sup>72</sup> SIFMA made a similar argument with respect to all SDs and MSPs that are subject to regulation by a prudential regulator.

<sup>73</sup> See CEA section 4s(e).

MSP does not engage in certain activities, the regulations pertaining to those activities are not applicable. Therefore, in these cases, the Commission believes MSPs would be relieved of any burden such regulations present.

Finally, Cargill recommended that the Commission make clear that the Commission's regulations only apply to the swap dealing business of an SD that is a division of a larger company, and not to the other, non-swaps-related business activities of the company.<sup>74</sup> The Commission has accepted the alternative proposed by Cargill by including a new definition of "swaps activities" in the final regulations and by limiting the scope of several requirements to fit this definition. Adopting this alternative approach should allow entities to understand their duties and requirements under the final regulations more clearly and reduce costs by limiting the scope of the rules' applicability.

#### *D. Recordkeeping, Reporting, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants*

As added by section 731 of the Dodd-Frank Act, sections 4s(f) and 4s(g) of the CEA establish reporting and recordkeeping requirements and daily trading records requirements for SDs and MSPs. Section 4s(f)(1) requires SDs and MSPs to "make such reports as are required by the Commission by rule or regulation regarding the transactions and positions and financial condition of the registered swap dealer or major swap participant." In the Recordkeeping NPRM, the Commission proposed regulations, pursuant to sections 4s(f)(1)(B)(i) and (ii) of the CEA, prescribing the books and records requirements for "all activities related to the business of swap dealers or major swap participants," regardless of whether or not the entity has a prudential regulator, as required by statute. In addition, the Commission proposed regulations in the Recordkeeping NPRM pursuant to section 4s(g)(1) of the CEA, requiring that SDs and MSPs "maintain daily trading records of the swaps of the registered swap dealer and major swap participant and all related records (including related cash and forward transactions) and recorded communications, including electronic mail, instant messages, and recordings of telephone calls." The Commission

notes that section 4s(g)(3) requires that daily trading records for each swap transaction be identifiable by counterparty, and section 4s(g)(4) specifies that SDs and MSPs maintain a "complete audit trail for conducting comprehensive and accurate trade reconstructions."

The Commission received 14 comment letters on the Recordkeeping NPRM. The Commission considered each in formulating the final rules, including any alternatives proposed and cost or benefit concerns expressed. Of the 14 comments received, five addressed issues relevant to the costs and benefits of the proposed rules, but no letters provided any quantitative data to support their claims. The comment letters focused on 9 areas of the rule that are most relevant to the Commission's consideration of costs and benefits. Each of these areas is discussed below. A more detailed discussion can be found in section II.B–E. above.

##### 1. Additional Types of Records

In the Recordkeeping NPRM, the Commission requested comments regarding whether additional types of records other than those specified in the proposed rules under § 23.201 should be required to be kept by SDs and MSPs. The Commission also requested comment regarding whether drafts of documents should be kept. Having considered the comments received,<sup>75</sup> the Commission is not requiring any additional types of records in the final rule. Although the Commission agrees that drafts may provide information regarding the development of transactions, the Commission does not believe that the marginal incremental value of such information is sufficient to require draft retention. The Commission also notes that pertinent pre-execution trade information that may appear in drafts is already subject to retention under the daily trading records rule.

##### 2. Reliance on SDRs for Recordkeeping Requirements

The proposed regulations did not address whether an SD or MSP could fulfill the recordkeeping requirements by reporting a swap to a swap data repository (SDR), but ISDA & SIFMA requested that the Commission consider the extent to which SDs and MSPs may rely upon SDRs to retain records beyond the time periods that registrants currently retain such records. ISDA &

SIFMA did not elaborate on the current retention periods for swaps records, nor did they explain how this approach would work in the absence of established SDRs for all types of swaps. The Commission considered this alternative to its recordkeeping rules, but determined that it is premature at this time to permit SDs and MSPs to rely solely on SDRs to meet their recordkeeping obligations under the rules. Additionally, the Commission believes that SDs and MSPs must maintain complete records of their swaps for the purposes of risk management. The data that is required to be reported to an SDR may not be sufficient for these purposes. At present, SDRs are new entities under the Dodd-Frank Act with no track record of operation; and, for particular swaps asset classes, SDRs have yet to be established. As SDRs evolve, the proposed alternative may prove appropriate, but the Commission believes that putative cost-savings benefits attributable to SDR record retention in lieu of individual firm record retention are too speculative presently to justify modification of the proposed rules.

##### 3. Records in a Single Electronic File, Searchable by Transaction and Counterparty

Proposed § 23.201(a)(1) required SDs and MSPs to keep transaction records in a form identifiable and searchable by transaction and by counterparty. Proposed §§ 23.202(a) and 23.202(b) also required SDs and MSPs to keep daily trading records for each swap and any related cash or forward transaction as a separate electronic file identifiable and searchable by transaction and counterparty. Commenters had several concerns with the costs of complying with this requirement.<sup>76</sup> In particular, commenters objected to the burden of maintaining the records required for each transaction in a separate electronic file and with maintaining the records in a manner searchable by transaction and counterparty. No commenter quantified the exact cost of these requirements, but the Commission recognizes that SDs and MSPs would incur costs to comply with both requirements. The Commission retained the requirement that trading records be searchable by transaction and

<sup>74</sup> Presumably, Cargill believes that limiting application of Commission regulations to a specific division, rather than the entirety of a larger company, will result in cost savings, although it does not directly advance this argument.

<sup>75</sup> The Working Group commented that the current proposal is sufficient. Chris Barnard, however, recommended that drafts of documents should also be kept, arguing that the decision process leading up to a final document can be very informative.

<sup>76</sup> ISDA & SIFMA argued that SDs and MSPs routinely store data across a number of systems, and that aggregating transaction data from all systems into a single electronic file would require a large investment across market participants and would require a substantial implementation period. The Working Group also argued that tying relevant records to each individual transaction in a manner that is identifiable and searchable by transaction would create a heavy technical burden.

counterparty because it interprets this to be the statutory minimum imposed by section 4s(g)(3) of the CEA, i.e., that registrants “maintain daily trading records for each counterparty in a manner and form that is identifiable with each swap transaction.” However, the Commission is modifying the proposed rules to remove the provision in § 23.202(a) and § 23.202(b) that requires each transaction record to be maintained as a separate electronic file. The Commission believes that this modification trims the rule’s requirements to the baseline required by statute, reducing the burden to the maximum extent possible.

#### 4. Form of Maintaining Business Records

As proposed, § 23.201(b) required SDs and MSPs to keep full, complete, and systematic business records, including records related to corporate governance, financial records, complaints, and marketing and sales materials. The Working Group recommended that, to minimize burden, the Commission permit these records to be retained as they currently are in the normal course of business. Responding to this concern, the Commission confirms that the rule does not require SDs and MSPs to keep the required business records in a single comprehensive file so long as such records can be readily accessed and provided to the Commission upon request. This confirmation as requested by The Working Group will minimize the burden on SDs and MSPs with regard to establishing new recordkeeping policies.

#### 5. Records of Complaints Received by MSPs

Proposed § 23.201(b) required SDs and MSPs to retain a record of complaints received, certain identifying information about the complainant, and a record of the disposition of the complaint. Without quantifying any cost, MFA commented that, because MSPs do not have customers nor make markets in swaps, it is unwarranted to subject them to the burden of retaining a complaint record. The Commission finds MFA’s position unpersuasive and is adopting the rule as proposed. The Commission has no basis to find that the burden of maintaining a complaint record will impose significant cost on MSPs. Moreover, the Commission believes that the relevant consideration is not whether MSPs have customers or whether they make markets, but the fact that they have substantial swaps positions and the potential significance of their swaps activities that defines them as MSPs. Given this, the

Commission believes a record of complaints, particularly if it establishes a pattern, could be of important regulatory value.

#### 6. Recording of Pre-Execution Trade Information, Including Voice Recordings

Proposed § 23.202(a)(1) required SDs and MSPs to make and keep records of pre-execution trade information, including records of all oral and written communications concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a swap, however communicated. As explained above, the Commission has eliminated the requirement that pre-execution trade information be maintained in a separate electronic file for each transaction. Otherwise the Commission is adopting the rule as proposed despite commenters concerns as to the cost of the required recording<sup>77</sup> because it believes the information specified in the rule is the minimum necessary to maintain an audit trail as statutorily required by section 4s(g)(4) of the CEA.

#### 7. Timestamp for Quotations Using Universal Coordinated Time (UTC)

Proposed § 23.202 required SDs and MSPs to use Universal Coordinated Time to record the time of each quotation provided to, or received from, a counterparty prior to execution; the time of swap and related cash and forward transaction execution; and the time of swap confirmation. The rule’s use of UTC reflects an approach consistent with the Commission’s final rules for real-time public reporting,<sup>78</sup> and the swap data reporting rule.<sup>79</sup> By requiring the use of UTC in § 23.202, the Commission is ensuring that the requirements of Part 23, Part 43, and Part 45 remain consistent to the extent possible. The Commission sees important benefits deriving from required UTC consistency in reporting and recordkeeping: avoiding the need to convert timestamps created in many different time zones is essential for timely and efficient automated processing of large amounts of market and pricing data by the Commission and

<sup>77</sup> ATA commented that the current telephone recording systems in use by SDs and MSPs may not meet all of the proposed rule’s requirements, and that implementing telephone recording systems that are compliant with the requirements would impose a significant additional cost. Notably, ATA did not propose any alternative ways that the Commission might achieve the statutory requirement of the CEA in a less burdensome manner.

<sup>78</sup> See Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182, 1251 (Jan. 9, 2012).

<sup>79</sup> See Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136, 2212 (Jan. 13, 2012).

others. Based on its belief that rapid automated processing is critical to the success of its regulatory mission, the Commission disagrees with the comments of ISDA & SIFMA in their joint letter that the value of this benefit is “minimal” relative to the cost of moving to UTC, which cost they did not quantify. Moreover, the Commission believes that UTC works in complimentary tandem with Part 43 and Part 45 measures that promote straight-through-processing.<sup>80</sup>

#### 8. Daily Trading Records for Cash and Forward Transactions Related to a Swap

Proposed § 23.202(b) required SDs and MSPs to keep daily trading records, similar to those SDs and MSPs are required to keep for swaps, for related cash and forward transactions.<sup>81</sup> The Commission is adopting the rule as proposed because section 4s(g)(1) of the CEA requires registrants to “maintain daily trading records of their swaps \* \* \* and related records (including related cash and forward transactions) . \* \* \*” No commenter objected to the proposed definition of “related cash and forward transactions,” although commenters argued that hedging and risk mitigation activities referred to in the proposed daily trading records rule typically are not executed with respect to specific trades and that it would not be possible to link cash and forward transactions to a specific swap.<sup>82</sup> The Working Group also argued that compliance with proposed § 23.202(b) would impose expensive and burdensome requirements on millions of physical transactions that are undertaken by commercial energy firms that are also parties to swap transactions. No commenter proposed, and the Commission has not identified, an alternative to achieve the statutory requirement in a less burdensome manner, however. Thus, the

<sup>80</sup> Straight-through processing was considered a “critical risk mitigate” in a 2005 report released by an industry group chaired by the then-chairman of Goldman Sachs and composed of representatives from Citigroup, JP Morgan Chase, and Morgan Stanley, among other prominent financial institutions. See Counterparty Risk Management Policy Group II, *Toward Greater Financial Stability: A Private Sector Perspective*, July 27, 2005, p. 84. Publicly available at [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-docs/2005-07-25%20Counterparty%20Risk%20Management%20Policy%20Group-%20Toward%20Greater%20Financial%20Stability.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2005-07-25%20Counterparty%20Risk%20Management%20Policy%20Group-%20Toward%20Greater%20Financial%20Stability.pdf).

<sup>81</sup> See definition under proposed § 23.200, “a purchase or sale for immediate or deferred physical shipment or delivery of an asset related to a swap where the swap and the related cash or forward transaction are used to hedge, mitigate the risk of, or offset one another.”

<sup>82</sup> ISDA & SIFMA and The Working Group made this point.

Commission is adopting the rule as proposed.

#### 9. Record Retention Period

Proposed § 23.203(b)(2) required SDs and MSPs to retain records of any swap or related cash or forward transaction until the termination or maturity of the transaction and for a period of five years after such date. The Commission notes that proposed revisions to Commission regulation § 1.31 require retention of swap transaction records for a period of five years following the termination, expiration, or maturity of a swap,<sup>83</sup> and that § 23.203 is consistent with retention requirements under the final swap data reporting rule.<sup>84</sup> However, to mitigate costs in response to commenters' concerns<sup>85</sup> regarding retention of pre-execution trade information, the Commission is revising the rule to reduce the voice recording retention period to one year. The Commission considered a six-month retention period for voice recordings, as recommended by ISDA & SIFMA, but determined that for swaps, particularly long tenor swaps, a longer period is necessary in order to give trade discrepancies an opportunity to surface. In addition, the Commission believes that a one-year retention period is necessary to make the audit trail most useful for the Commission's enforcement purposes. The Commission believes the benefit of available voice recordings to clear up latent trade discrepancies and aide in enforcement actions justifies the incremental cost of an additional six-month retention period.

#### Costs

Sections 4s(f) and (g) of the CEA require SDs and MSPs to adopt and implement certain reporting and recordkeeping requirements. The costs and benefits that necessarily result from these basic statutory requirements are considered to be the "baseline" against

which the costs and benefits of the Commission's final rules are compared or measured. The "baseline" level of costs includes the costs that result from the following activities required by the statute:

- Keeping books and records of all activities related to the business of the SD or MSP in such form and manner and for such period as may be prescribed by the Commission;
- Maintaining daily trading records of swaps and related cash or forward transactions and recorded communications, including electronic mail, instant messages, and recordings of telephone calls, and including such information as the Commission shall require;
- Maintaining daily trading records for each counterparty in a manner and form that is identifiable with each swap;
- Maintaining a complete audit trail for conducting comprehensive and accurate trade reconstructions.

Compliance with the statutory baseline alone would result in costs for SDs and MSPs. For example, the requirement to maintain recorded communications would include the cost of a telephonic recording system. Similarly, compliance with the statutory provisions would require data storage and retrieval systems.

Congress mandated that the Commission adopt rules to implement each of the statutory provisions. With regard to its implementation decisions, the Commission has determined the following to be costs to SDs and MSPs to comply with the final regulations regarding recordkeeping obligations under Part 23:

- Compiling transaction, position, and business records;
- Compiling records of data reported to an SDR;
- Compiling records of real-time reporting data;
- Compiling daily trading records for swaps of pre-trade information, including all oral and written communications concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a swap, however communicated; execution trade information, including the name of the counterparty, the terms of each swap, the date and time of execution; and post-execution trade information;
- Compiling daily trading records for related cash and forward transactions of pre-trade information, including all oral and written communications concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a related cash or forward transaction, however

communicated; execution trade information, including the name of the counterparty, the terms of each swap, the date and time of execution; and post-execution trade information;

- Data storage, in physical and/or digital format, in most cases for the term of a swap plus five years;
- Telephonic recording system (to record voice calls related to transactions); and
- Software and/or hardware updates to existing systems to capture and maintain the required records and to convert to Coordinated Universal Time.

With regard to the reporting requirements, the Commission has determined that compliance with the requirements relating to reporting swap data to an SDR and the real-time public reporting of swap transaction data will constitute compliance with such reporting requirements in section 4s(f). The reporting rules set forth in this release consist of cross-references to the reporting requirements in the rules relating to the reporting of swaps to an SDR and the real-time public reporting of swap transaction data. Accordingly, the Commission has considered the costs and benefits of reporting swap data to an SDR and real-time public reporting in those final rulemakings; therefore, those costs and benefits are not addressed in this rulemaking.<sup>86</sup>

As discussed, in adhering to its mandate from Congress, where possible the Commission also has attempted to alleviate the burdens on affected entities. In this regard, the Commission sought to minimize recordkeeping costs by eliminating the requirement that daily trading records of swaps and related cash and forward transactions be maintained as a separate electronic file.

Based on the available data, the Commission has been unable to reliably quantify the cost of compliance with the recordkeeping rules.<sup>87</sup> Although the rules were adapted from existing recordkeeping regulations from a variety of sources including the Commission's regulations and those of the SEC, such regulations have evolved over time and reliable quantitative data is generally not available regarding the costs of compliance with such requirements. A 1998 adopting release for the SEC's rules for OTC derivatives dealers

<sup>83</sup> See Adaptation of Commission Regulations to Accommodate Swaps, 76 FR 33066, 33088 (June 7, 2011).

<sup>84</sup> See Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136, 2212 (Jan. 13, 2012).

<sup>85</sup> See MFA (stating that the vast majority of its members do not keep records of transactions for five years and compliance with rule as proposed would be burdensome and costly); The Working Group (long-term electronic storage of significant amounts of pre-execution communication will prove costly over five-year period); ISDA (supporting a voice recording obligation aligned to the six-month minimum required by the UK Financial Services Authority); SIFMA (same). Chris Barnard, conversely, recommended that records should be required to be kept indefinitely rather than the general five years under the proposal. Mr. Barnard argued that documents can be scanned after five years, so there is no practical reason for limiting the retention period and the information would be useful for future analytical purposes.

<sup>86</sup> See Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 13, 2012); and Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182 (Jan. 9, 2012).

<sup>87</sup> To better inform this assessment, the Commission has conducted a review of applicable academic literature, but found no research reports or studies that are directly relevant to its considerations of costs and benefits of these final rules.

(including recordkeeping rules) cited commenters estimates in a range from \$75,000 to \$500,000 per year. Although dated, these SEC estimates provide a measure from which to very roughly attempt to gauge compliance costs.<sup>88</sup> Moreover, because financial entities that will likely be required to register as SDs are currently subject to prudential regulation or other form of regulatory oversight, the Commission believes they will already have some form of recordkeeping policies and procedures in place.

In contrast, the Commission anticipates that entities that are not subject to prudential regulation may incur greater costs to develop the infrastructure to comply with these recordkeeping requirements. In this respect, one commenter presented a report prepared by National Economic Research Associates, Inc. (NERA) stating that (1) compliance by certain entities with the proposed requirement that SDs and MSPs retain instant messages and tie them to transaction identifiers would entail average initial retention costs of \$464,000 and average incremental ongoing annual costs of \$228,000; (2) that the retention of phone calls would entail an average initial investment of \$649,000 with additional annual costs of \$382,000; and (3) that the requirement to time stamp transactions and use unique identifiers for transactions would entail average initial setup costs of \$2,800,000 and average annual costs of \$302,000.<sup>89</sup> The Commission notes that the required use of unique identifiers is the subject of another rulemaking not adopted in this release.

Certain of the costs associated with these recordkeeping rules result from collections of information subject to the Paperwork Reduction Act. Costs attributable to collections of information subject to the PRA are discussed further in section V.B.1. below. The Commission has also considered these costs, which it incorporates by reference herein, in its section 15(a) analysis.

<sup>88</sup> See OTC Derivatives Dealers, 63 FR 59362, 59391 (Nov. 3, 1998).

<sup>89</sup> NERA, Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition Prepared for the Working Group of Commercial Energy Firms, December 20, 2011. In this late-filed comment supplement, NERA concludes that cost-benefit considerations compel excluding entities "engaged in production, physical distribution or marketing of natural gas, power, or oil that also engage in active trading of energy derivatives"—termed "nonfinancial energy companies" in the report—from regulation as SDs, including these recordkeeping and reporting rules.

## Benefits

The Commission believes these recordkeeping requirements will contribute to important, though unquantifiable, benefits intended by the Dodd-Frank Act. More specifically, complete, rigorous transactional recordkeeping promotes both external and internal risk management by providing an audit trail of past transactions. A strong audit trail, in turn generates a number of benefits, including the following:

- It facilitates a firm's ability to recognize and manage its risk, thereby enhancing the risk management of the market as a whole.
- It acts as a disincentive to engage in unduly risky or injurious conduct in that the conduct will be traceable.
- In the event such conduct does occur, it provides a mechanism for policing such conduct, both internally as part of a firm's compliance efforts and externally by regulators.
- It provides a basis for efficiently resolving transactional disputes.
- And, it supports SDR reporting in that it provides a backstop to confirm the accuracy of reported information.

## Section 15(a) Determination

### 1. Protection of Market Participants and the Public

The Commission believes that, by generating the benefits identified above, these rules provide important protections to swap market participants and the public. The recordkeeping requirements: (1) Promote the ability of SDs and MSPs to manage their risks through accurate and timely recordkeeping; (2) create disincentives for conduct, such as rogue trading, that could be injurious to the firm (as well as the market generally) by requiring a comprehensive audit trail; (3) support internal compliance efforts by requiring that complaints and other pertinent documents be retained; and (4) facilitate resolution of trade disputes. Public protection also is enhanced in that effective comprehensive, internal risk management improves risk management for the market as a whole. Moreover, the rules serve as an important link in the risk reduction chain envisioned by Congress in enacting the Dodd-Frank Act. Working in concert with other Dodd-Frank Act requirements, these rules further the goal of avoiding market disruptions and the resulting financial losses to market participants and the general public.

The Commission believes that any incremental costs of the final rules over those necessitated by the statutory baseline of sections 4s(f) and (g) of the

CEA do not hinder the goal of effective protection of market participants and the public. Because some basic level of recordkeeping is fundamental to any financial undertaking, the Commission assumes that all likely SDs and MSPs currently keep records of some sort for their own internal control purposes. Therefore, the incremental costs of complying with the specific requirements of the Commission's final rules are unlikely to lead SDs or MSPs to withdraw from the market or cause SDs and MSPs to make investments in updating recordkeeping systems that would otherwise be directed to activities that increase protection of market participants or the public.

### 2. Efficiency, Competitiveness, and Financial Integrity of Markets<sup>90</sup>

Accurate recordkeeping is foundational to sound risk management and the financial integrity of SDs and MSPs, which impacts the financial integrity of markets. As illustrated by the collapse of firms during the 2008 financial crisis, poor recordkeeping can substantially impair resolution of customer claims.<sup>91</sup> Additionally, the recordkeeping rules will enhance the financial integrity of the markets by ensuring that swap transactions, especially those that are bilaterally executed and require the exchange of margin, are documented and recorded in a prompt and accurate manner. Market efficiency and competitiveness is benefited by accurate and timely recordkeeping and the creation of a complete audit trail to the extent that those requirements facilitate Commission's enforcement actions against market manipulation and other market abuses.

On the other hand, compliance with the rules is likely to require investment in recordkeeping, storage, and other back office systems; investment costs that otherwise could be used to enhance the efficiency and competitiveness of front office trading operations. For example, the telephonic recording systems that are required for recording oral communications may introduce new costs for SDs and MSPs that those

<sup>90</sup> Although by its terms CEA section 15(a)(2)(B) applies to futures markets only, the Commission finds this factor useful in analyzing regulations pertaining to swaps markets as well.

<sup>91</sup> See *In re Lehman Brothers Holdings Inc.*, 08–13555, and *Giddens v. Barclays Capital Inc.*, 09–01732, U.S. Bankruptcy Court, Southern District of New York; see also *Lehman Derivatives Records a "Mess," Barclays Executive Says*, available at <http://www.bloomberg.com/news/2010-08-30/lehman-derivatives-records-a-mess-barclays-executive-says.html> (reporting on testimony provided in previously cited Lehman bankruptcy proceeding).

entities would prefer to avoid in favor of enhancing trading operations.

### 3. Price Discovery

The Commission has identified no likely material impact on price discovery from the costs and benefits of these recordkeeping rules.

### 4. Sound Risk Management

The Commission believes that proper recordkeeping—though likely to require initial investment in recordkeeping and other back office systems—is essential to risk management because it facilitates an entity's awareness of its transactions, positions, trading activity, internal operations, and any complaints made against it, among other things. Such awareness supports sound internal risk management policies and procedures by ensuring that decision-makers within SDs and MSPs are fully informed about the entity's activities and can take steps to mitigate and address significant risks faced by the firm. When individual market participants engage in sound risk management practices, the entire market benefits. Accordingly, the Commission believes that these final rules, notwithstanding potential costs identified above, will promote the public interest in sound risk management.

### 5. Other Public Interest Considerations

The Commission has not identified any other public interest considerations that could be impacted by these recordkeeping and reporting obligations for SDs and MSPs.

#### *E. Duties and Risk Management Requirements of Swap Dealers and Major Swap Participants*

As part of an overall business conduct regime for SDs and MSPs, section 4s(j) of the CEA, as added by section 731 of the Dodd-Frank Act, sets forth certain duties for SDs and MSPs. In its Duties NPRM, the Commission proposed six regulations to implement section 4s(j), specifically addressing risk management, monitoring of positions limits, diligent supervision, business continuity and disaster recovery, the availability of general information, and antitrust considerations. The Commission's proposed conflicts-of-interest policies and procedures were the subject of the separate SD/MSP Conflicts NPRM.

As described in detail in the preamble, the Commission in preparing these final rules sought and incorporated comment from the public. The Commission received 20 comment letters on the Duties NPRM, and considered each in formulating the final

rules. Of the 20, eight comments addressed issues relevant to the costs and benefits of the proposed rules, but only two provided any quantitative data to support their claims. The comments focused on seven areas of the rules that are most relevant to the Commission's consideration of costs and benefits. Each of these areas is discussed below. A more detailed discussion of the Commission's policy decisions can be found in sections II.F–L. above.

#### 1. Scope of Risk Management Program

The proposed regulations required SDs and MSPs to establish, document, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the business of the SD or MSP. The Working Group, MetLife, and the Office of the Comptroller of the Currency, argued in favor of limiting § 23.600 to the risks associated with swaps activities, and not other business lines in which an entity may engage.<sup>92</sup> The Commission agrees with the commenters that its regulatory purpose is the management of the risk associated with SDs' and MSPs' swaps activities, not risks from their non-swaps activities, and is modifying the rule as they proposed. That is, the Commission is including a new definition of "swaps activities" in the final regulations and thus limiting the scope of several requirements. Clearly delimiting the activities of registrants subject to the rule in this way reduces the compliance burden of § 23.600.

The Commission, however, declines to adopt The Working Group's recommendation that the rule be limited further with respect to affiliates and consolidated entity risk management.<sup>93</sup> The Commission believes that considering the risks posed by affiliates is part of "robust and professional" risk management as required by section 4s(j), and provides a benefit to the registrant, its counterparties, and the swap market in the form of increased security and

<sup>92</sup> Although not expressly stated by these commenters, the Commission presumes that burden concerns motivate their limitation requests, at least in part.

<sup>93</sup> More specifically, The Working Group recommended that the rule be revised to require the risk management program to take into account only *swaps-related* risks posed by affiliates and take an integrated approach to risk management at the consolidated entity level only to the extent the SD or MSP deems necessary to enable effective risk and compliance oversight. Presumably, The Working Group recommended these alternatives out of an unexpressed concern for increased costs necessitated by monitoring and managing other risks posed by affiliates or being required to take an integrated approach to risk management; it did not quantify these however.

stability of the registrant. In the Commission's view, it is not unreasonably burdensome to require management of risk posed by affiliates—whether in the form of inter-affiliate transactions or otherwise—given their potential to be of the same kind and magnitude as risks posed by other swap counterparties. Likewise, the benefit of increased security and stability results from integrating the registrant's risk management program with risk management at the consolidated entity level, if applicable, where a top level company may be in the best position to evaluate risk due to its organization-wide view. Again, in light of this benefit, the Commission does not believe integration of an SD's or MSP's Risk Management Program into overall risk management at the consolidated entity level would be unduly burdensome.

#### 2. Risks Covered by the Risk Management Program

The proposed regulation required a registrant's risk management program to include certain enumerated elements: Identification of risks and risk tolerance limits; periodic risk exposure reports; a new product policy; policies and procedures to monitor and manage market risk, credit risk, liquidity risk, foreign currency risk, legal risk, and operational risk; use of central counterparties; compliance with margin and capital requirements; monitoring of compliance with risk management program; and approval of trading policies and monitoring of traders.

In response to comments received, the Commission is modifying the rule in several respects as discussed specifically below. The Commission believes that each of these changes will reduce the compliance burden on SDs and MSPs. More generally, the Commission believes the rules allow registrants to manage their costs by relying upon existing compliance or risk management capabilities to a large extent.<sup>94</sup> In this respect, the rules generally only require "policies and procedures" to monitor and manage the enumerated risks, but do not prescribe the content of such policies and procedures or require any specific control systems.

*Risk Tolerance Limits:* With respect to risk tolerance limit exceptions, the

<sup>94</sup> Comments of The Working Group, SIFMA, EEI, and MetLife, each of whom suggested that proposed § 23.600 be flexible enough to allow firms to adapt their existing compliance and risk management measures, and not cause firms to add entirely new compliance or risk management infrastructure.

Commission agrees with commenters<sup>95</sup> that requiring approval by risk management personnel would be more costly without materially enhancing benefits than allowing SDs and MSPs the flexibility to structure their approval process in accordance with written policies and procedures. Accordingly, the Commission has modified the rule to reflect this approach.

*New Product Policy Requirement:* Concerning the new product policy requirement, the Commission notes that the rule was adapted from existing regulatory guidance in this area,<sup>96</sup> and thus believes some SDs and MSPs already have such a policy in place; for them, the requirement would not impose any new burden. The Commission rejects the more limited alternative approach recommended by the Working Group—i.e., that before offering a new product an SD or MSP need only conduct due diligence that is commensurate with the risks associated with a new product, and receive approval from appropriate risk management and business unit personnel within the firm. While The Working Group's recommended approach may be less costly for some unspecified number of registrants that to date have not implemented a new product policy in line with the proposed rule and existing regulatory guidance, the Commission believes that the benefits to SDs, MSPs, and financial markets of greater scrutiny for new products, which may entail degrees of risk that are not initially evident, are sufficient to adopt the rule substantially as proposed. However, the Commission believes that SIFMA's recommended alternative—allowing approval of new products on a contingent or preliminary limited-time basis at a non-material risk level for the registrant to gain product experience and develop appropriate risk management processes for the product—better addresses the unforeseen risk potential. Accordingly, the Commission considers SIFMA's proposed alternative preferable on cost/benefit grounds to the rule as proposed and has modified the rule in line with it.

<sup>95</sup> With respect to exceptions to risk tolerance limits, SIFMA recommended that trading supervisors, rather than risk management personnel, should have the authority to approve risk tolerance limit exceptions because the quarterly risk exposure reports provided to a registrant's senior management and governing body are an adequate check on decision-making by trading supervisors. Presumably, SIFMA believes trading supervisor approval presents less costs than risk management unit approval.

<sup>96</sup> See OCC's Comptroller's Handbook, Risk Management of Financial Derivatives at 7 (Jan. 1997); Federal Reserve Board's Trading and Capital Markets Activities Manual.

*Reconciliation of Profits and Losses to the General Ledger:* The Commission has responded to commenters that objected to the burden of daily reconciliation by modifying the rule to require periodic, rather than daily, reconciliation. The Commission believes this modification, increases the flexibility available to registrants to design cost-effective procedures best suited to their own circumstances.

*Assessing Liquidity of Non-Cash Collateral:* With respect to assessing liquidity of non-cash collateral, the Commission agrees with commenters that testing by simulated disposition presented an unnecessary cost to SDs and MSPs<sup>97</sup> and has adjusted the final rule to provide flexibility for registrants to design procedures to fit their own circumstances.

*Foreign Currency Risk:* With respect to foreign currency risk, rather than mandating daily measurement, The Working Group recommended relaxing the rule to allow firms discretion with respect to how frequently capital exposed to fluctuations in the value of foreign currency needs to be measured. The Commission is rejecting The Working Group's recommendation because daily measurement is necessary for effective prudent risk management because the foreign currency markets are fluid, quick moving, and potentially volatile. Given the wide availability of foreign currency pricing information at a low cost, the Commission does not believe that the cost of daily measurement is unduly burdensome in light of the benefit of consistent management of foreign currency risk.

*Monitoring of Trading Requirements:* Concerning the monitoring of trading requirements, the Commission agrees with commenters that the proposed rule's requirement that traders be monitored to prevent the incurrence of "undue risk" is vague and thus potentially burdensome to implement. To add clarity, the Commission is revising the rule to require monitoring of trading to prevent the incurrence of "unauthorized risk."<sup>98</sup>

The Commission also agrees with The Working Group's recommendation that

<sup>97</sup> SIFMA recommended that the Commission not require testing of liquidation procedures by simulated disposition, but only require policies and procedures for identifying acceptable collateral and establishing appropriate haircuts, taking into account reasonably anticipatable adverse price movements, arguing that simulated disposition could be costly during periods of market stress.

<sup>98</sup> The Working Group and SIFMA requested that the Commission remove the requirement that firms monitor traders to prevent traders from "incurring undue risk" because the meaning of the phrase is ambiguous and presumably more costly to monitor under such standard.

the proposed rule be modified to add a materiality standard for reporting of trade discrepancies to management. Accordingly, the Commission is modifying the rule to require that only trade discrepancies that are not immaterial, clerical errors be brought to the immediate attention of management of the business trading unit.

*Use of Brokers:* The Commission agrees with commenters recommending against tasking the risk management unit with reviewing brokers' statements, monitoring commissions or initiating broker payments; allowing these functions to be handled by operations or other control units, and presumably lowering the cost of compliance. The Commission has narrowed the rule to require risk management units to periodically audit brokers' statements and payments only. The Commission believes that this modification retains the benefits of the rule (independent oversight of the use of brokers), while lowering the cost of compliance by not requiring modifications to current operations.

### 3. Risk Exposure Reports

Proposed § 23.600(c)(2)(ii) required SDs and MSPs to provide their senior management and governing body with quarterly Risk Exposure Reports detailing the registrant's risk exposure and any recommendations for changes to the risk management program. Copies of these reports were required to be furnished to the Commission within five business days of providing them to senior management. The Working Group and Cargill suggested as an alternative that SDs' and MSPs' periodic Risk Exposure Reports be required only annually and submitted to the Commission only upon request. They argued that quarterly reports will be costly, distract risk management personnel from their primary responsibilities, and tax Commission resources to review reports that frequently. The Commission is declining to modify the rule as suggested because, as recent events have shown, it is important that financial firm management have frequent information about the risk exposures faced. This affords prompt corrective action important to maintain financial stability. The potential costs of instability in the financial markets have been exhibited in a number of recent failures of major financial institutions, such as Long Term Capital Management, Bear Stearns, Lehman Brothers, and others. The Commission believes that any incremental additional burden of providing Risk Exposure Reports on a quarterly rather than annual basis is not

significant and is warranted by the benefit of Commission oversight and early risk detection capability.

#### 4. Frequency of Risk Management Program Testing

Proposed § 23.600(e) required SDs and MSPs to review and test their risk management programs quarterly using internal or external auditors independent of the business trading unit. As explained in more detail below, commenters objected to the costs of quarterly risk management program testing required by the rule. The Commission is modifying proposed § 23.600(e) to require only annual testing and audit of an SD's or MSP's risk management program, having been persuaded by the comments of The Working Group, Cargill, and MetLife, each of which recommended that both the frequency and the scope of audits of the risk management program be left to the discretion of the registrant so long as such audits are effective and are conducted at least annually. The Working Group and Cargill argued that this regime would provide the desired results without the unnecessary cost and administrative burden imposed by the proposed rules. The Commission agrees that the regulatory purpose of periodic testing will be met by annual testing. In order to further lessen the burden on SDs and MSPs, the Commission has determined not to specify testing procedures at this time, but to leave the design and implementation of testing procedures to the reasonable judgment of each registrant based on their own circumstances.

#### 5. Monitoring of Position Limits

Proposed § 23.601 required SDs and MSPs to establish policies and procedures to monitor, detect, and prevent violations of applicable position limits established by the Commission, a designated contract market (DCM), or a swap execution facility (SEF), and to monitor for and prevent improper reliance upon any exemptions or exclusions from such position limits.

One commenter presented a report prepared by NERA stating that compliance with proposed § 23.601 for certain entities would entail average incremental start-up costs of \$245,000 and average incremental ongoing annual costs of \$228,000.<sup>99</sup> The Commission

observes that the incremental average costs provided by NERA do not differentiate between the costs of compliance with proposed § 23.601 and the costs of compliance with section 4s(j)(1) of the CEA, which requires each SD and MSP to "monitor its trading in swaps to prevent violations of applicable position limits." Accordingly, the Commission believes that the cost estimates presented by NERA exceed the incremental costs attributable to Commission rulemaking. The NERA report, however, provides insufficient information to allow the Commission to assess the magnitude of the excess.

As discussed in more detail below, the Commission has also quantified certain costs of a monitoring regime based on the assumption that a firm could choose to implement a particular monitoring regime from a wide range of compliance systems, based on the specific, individual needs of the firm. Several other commenters requested that the rule be modified to lessen the cost burden on registrants.<sup>100</sup> The Commission is reducing the burden on SDs and MSPs by modifying the rule as follows: (1) Require policies and procedures *reasonably* designed to monitor for and prevent violations of applicable position limits; (2) require only notification to relevant personnel of changes to applicable position limits (rather than training); (3) except on-exchange violations of position limits from the Commission reporting requirement; (4) require testing of

distribution or marketing of natural gas, power, or oil that also engage in active trading of energy derivatives"—termed "nonfinancial energy companies" in the report—from regulation as swap dealers, including § 23.601.

<sup>100</sup> SIFMA recommended that testing of Position Limit Procedures be required only annually and not be required to be done all at the same time. The Working Group recommended that testing only be required on a semi-annual basis, and MetLife requested that the Commission permit the frequency of testing to be determined by an MSP based on the extent of its swap activities. MetLife also recommended that there be a clear exemption from testing requirements for MSPs that do not trade in swaps for which position limits have been established. BGA recommended that the Commission clarify that as long as an SD or MSP provides training on the position limits and establishes and enforces policies for monitoring, detecting, and curing violations, they will have met the obligation to "prevent violations." SIFMA recommended that the Commission revise § 23.601(c) to provide that a change in position limit levels will not trigger "training," but only require effective notification. The Working Group and MetLife recommended that the Commission require alerting the governing body only when a violation is material. The Working Group argued that the reporting of on-exchange violations of position limits to the Commission is already done by DCMs and will likely be the responsibility of SEFs as well, so SDs and MSPs should not be required to report on-exchange violations.

position limit procedures only if the registrant has transactions for which position limits have been established; and (5) require testing of position limit procedures quarterly (rather than monthly).

With respect to quarterly reporting of compliance with position limits to the chief compliance officer, senior management, and governing body under proposed § 23.601(g), The Working Group recommended that the proposed rule should be revised to require only annual reports to the entity's senior management and governing body, but did not quantify the cost burden of quarterly reporting. The Commission recognizes that generating such reports will entail costs in the form of preparing and transmitting the reports as required by the rule, but is unable to quantify the cost because the reports will vary greatly depending on the trading volume of individual SDs and MSPs in products for which position limits have been established. As discussed above with respect to Risk Exposure Reports, the Commission believes that the benefit of such reporting will be timely notification to decision makers within the SD and MSP of the entity's record of compliance with applicable position limits, thus providing a timely opportunity to adjust or revise Position Limit Procedures to prevent future violations, if necessary, and avoiding the costs to the public of excessive speculation.

#### 6. Diligent Supervision

Proposed § 23.602 required SDs and MSPs to: (1) Establish a system to supervise all activities relating to its business performed by its partners, members, officers, employees, and agents; (2) have that system be reasonably designed to achieve compliance with the CEA and Commission regulations; (3) have that system designate a person with authority to carry out the supervisory responsibilities of the SD or MSP; and (4) have all such supervisors meet qualification standards that the Commission finds necessary or appropriate.

The benefits of diligent supervision result from increased compliance with the regulatory standards of the CEA and the rules of the Commission. The standards that SDs and MSPs follow (or fail to follow) in transacting their swaps may have repercussions for financial system stability more broadly. Effective systemic risk management for swaps depends upon effective internal risk management protocols of individual SDs and MSPs and effective internal risk management in turn depends not

<sup>99</sup> NERA Economic Consulting, Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition Prepared for the Working Group of Commercial Energy Firms, December 20, 2011. In this late-filed comment supplement, NERA argues that cost-benefit considerations compel excluding entities "engaged in production, physical

just on appropriate policies and procedures, but on diligent supervision by the registrant to ensure that such policies and procedures are actually followed.

No commenters provided quantitative data on the cost of complying with the diligent supervision rule, but several commenters requested changes to the rule to lessen the compliance costs of SDs and MSPs.

The Working Group recommended that the Commission not require designation of a single individual with responsibility for supervision. The Commission considered whether permitting SDs and MSPs to designate more than a single individual for supervisory responsibilities would lessen the benefits of the rule and determined that it would not.

Accordingly, the Commission is modifying the rule to require SDs and MSPs to designate "at least one person" (rather than "a person") with authority to carry out supervisory responsibilities.

The Working Group also recommended that SDs and MSPs be given discretion to determine supervisor qualifications, presumably because such a standard would entail fewer compliance costs than the standard proposed (i.e., "training, experience, competence, and such other qualification standards as the Commission finds necessary or appropriate"). The Commission considered whether the benefits of the rule could be maintained with this change, and determined they could not. Accordingly, the Commission is declining to modify the rule on this point because it believes that full accountability for compliance with the CEA and Commission regulations is best served by requiring designation of individuals with objective qualifications.

#### 7. Business Continuity and Disaster Recovery

Proposed § 23.603 required SDs and MSPs to establish a business continuity and disaster recovery plan that includes procedures for and the maintenance of back-up facilities, systems, infrastructure, personnel, and other resources to achieve the timely recovery of data and documentation and to resume operations generally within the next business day. The proposed regulations also required SDs and MSPs to have their business continuity and disaster recovery plan tested annually by qualified, independent internal audit personnel or a qualified third party audit service. The Commission believes that all SDs and MSPs may be critically important to the proper functioning of

the swaps market. SDs are critical participants in the swaps market and MSPs may have counterparty exposures that could have serious adverse effects on the financial stability of the United States. Therefore, the Commission believes the benefit of the rule is that it ensures, to the extent practicable, that system failures or natural disaster will not stop the proper functioning of the swaps market for more than the one business day.

With respect to costs, the Commission again believes that it is not possible to reasonably quantify the industry-wide costs of a business continuity and disaster recovery program for SDs and MSPs because such costs necessarily flow from the size of the SD or MSP and the scope of activities in which it engages. One commenter stated that most SDs have the technology and network infrastructure in place to achieve a next day recovery time objective, reducing the incremental costs of compliance for these registrants. But the commenter also believes that some MSPs may have to develop and implement a plan from scratch. The commenter estimates that it would take up to 200 personnel days for MSPs to comply with this requirement. Thus, at eight hours a day and \$100 per hour,<sup>101</sup> the upper end of personnel costs related to implementation for an MSP would be \$160,000. In response, the Commission is lengthening the time for compliance to one year from the publication date of the final rule in the **Federal Register** for registrants that have not been previously regulated by a U.S. prudential regulator and are not SEC registrants. No other commenter provided cost estimates of compliance with the rule. Nevertheless, several commenters requested changes to the rule to reduce the cost of compliance.<sup>102</sup>

To further reduce the compliance burden, the Commission is additionally modifying the rule as follows: (1) Requiring procedures for alternative staffing (rather than back-up personnel); (2) requiring annual testing (rather than auditing); and (3) requiring auditing only once every three years. The Commission believes that these changes

<sup>101</sup> See section V.B. below for a discussion of the Commission's use of this hourly wage rate.

<sup>102</sup> The Working Group argued that the Commission should not require next business day recovery for non-systemically important SDs or MSPs, but should only require recovery "reasonably promptly." The Working Group also argued that the Commission should not require staffing of back-up facilities to avoid the burden of requiring two persons for the same job, and recommended that the Commission should not require annual testing of the business continuity and disaster recovery plan by independent auditors because independent audits would be too costly.

will lower compliance costs without reducing benefits.

Finally, SIFMA recommended that the Commission clarify that an SD's or MSP's business continuity and disaster recovery plan may be part of a consolidated plan established for the various entities in a holding company group. The Commission confirmed this could be the case.

#### Costs

Section 4s(j) of the CEA imposes certain duties and risk management requirements on SDs and MSPs. The costs and benefits that necessarily result from these basic statutory requirements are considered to be the "baseline" against which the costs and benefits of the Commission's final rules are compared or measured. The "baseline" level of costs includes the costs that result from the following activities required by the statute:

- Monitoring of trading in swaps to prevent violations of applicable position limits;
- Establishing robust and professional risk management systems;
- Disclosing to the Commission and applicable prudential regulators general information related to swaps and establishing internal systems and procedures to provide such information;
- Foregoing any process or action that results in any unreasonable restraint of trade, or impose any material anticompetitive burden on trading and clearing.

Compliance with the statutory baseline alone would result in costs for SDs and MSPs. For example, the requirement to monitor trading in swaps to prevent violations of applicable position limits would include the cost of designing and implementing monitoring procedures. Similarly, compliance with the statutory provisions would require establishment of robust and professional risk management policies and procedures.

Congress mandated that the Commission adopt rules to implement each of the statutory provisions. With regard to its implementation decisions, the Commission has determined the following to be costs to SDs and MSPs to comply with the final regulations regarding duties and risk management:

- Compiling and reporting certain risk assessment reports;
- Establishing, implementing, testing, and reviewing risk management policies and procedures;
- Auditing of policies and procedures;
- Ensuring the monitoring of traders and of applicable position limits;

- Implementing diligent supervision policies and procedures; and
- Implementing, testing, and reviewing business continuity and disaster recovery policies and procedures.

In adhering to its mandate from Congress, where possible the Commission has attempted to alleviate the burdens on affected entities. The Commission has modified the definition of “governing body” to provide additional flexibility and potentially eliminate the need for some registrants to change their current internal governance structures, thereby reducing compliance costs. The Commission has clarified that the requirements for a risk management program are confined to “swaps activities” of registrants, rather than the “day-to-day business” of the registrant, thereby avoiding the potential burden associated with an SD’s or MSP’s need to extend the program to any non-swaps business lines. In addition, risk management policies and procedures are required to be provided to the Commission only upon request, rather than upon any material change, reducing the reporting burden on registrants.

Risk management unit personnel are permitted to fulfill other duties. This should provide cost-lowering flexibility and potentially eliminate the need for some registrants to change current practices dramatically. The Commission also will permit limited preliminary approval for new products for testing purposes, reducing the necessary time and burden of new product analysis. Pricing models may be validated by internal personnel, eliminating the burden of hiring an external auditor to validate potentially valuable proprietary information. The requirement to reconcile profits and losses to the general ledger on a daily basis has been removed. Entities may perform an assessment of collateral liquidation procedures, instead of performing a potentially time-intensive and expensive test.

The proposed quarterly testing of risk management programs and position limit procedures has been reduced to annual testing to reduce costs. The proposed monthly testing of position limit procedures has been reduced to quarterly testing. To reduce the burden on senior management, only material trade discrepancies are required to be brought to senior management. The proposed employee training on position limits change has been modified to a notice requirement. Position limit violations that occur “on-exchange” are no longer required to be reported to the Commission by registrants, as the

exchange will notify the Commission. Finally, business continuity and disaster recovery plans are required to be audited triennially (not annually, as proposed).

With respect to quantifying the cost of compliance with the final rules, one commenter stated that the cost of implementing a comprehensive risk management program will be substantial. The commenter analogizes the cost to the cost of implementing a compliance program and cites FERC administrative proceedings that required implementation of compliance programs at a cost of \$1,000,000 to \$2,000,000. The same commenter also estimates that a required audit of the risk management program would cost \$24,000 per audit (\$96,000 annually). Another commenter stated that implementation of a business continuity and disaster recovery program could take up to 200 personnel days. At eight hours a day and \$100 per hour,<sup>103</sup> implementation personnel costs alone could thus cost a registrant \$160,000. The Commission believes these estimates may be on the high end of the range of potential costs, given that some likely SDs are subject to prudential regulation or other form of regulatory oversight currently and will already have some form of risk management and business continuity program in place.<sup>104</sup> By contrast, costs are expected to be higher for those entities not currently regulated or not currently implementing risk management policies and procedures. In this respect, one commenter presented a report prepared by NERA estimating that compliance with the proposed rules for some entities in this category would entail annual incremental costs of \$224,000.<sup>105</sup>

<sup>103</sup> See section V.B. below for a discussion of the Commission’s use of this wage rate.

<sup>104</sup> The Commission notes that in 2006 the UK FSA conducted a cost benefit analysis when promulgating requirements related to ensuring effective risk controls, including requirements for implementing effective policies and procedures to identify, manage, monitor, and report current and possible risks. The UK FSA was adopting rules that replaced existing guidance and concluded from survey results that the incremental aggregate cost of compliance for approximately 2000–2500 firms was £10.5 to 14 million in one-off costs (\$16.4 to 21.9 million at the current exchange rate, or \$8,200 to \$10,950 per firm) and £7 to 9.2 million in ongoing costs (\$10.9 to 14.4 million at the current exchange rate, or \$5,450 to \$7,200 per firm). See FSA Consultation Paper 06/9, Organisational Systems and Controls: Common Platform for Firms, Annex 2 (May 2006).

<sup>105</sup> NERA, Cost-Benefit Analysis of the CFTC’s Proposed Swap Dealer Definition Prepared for the Working Group of Commercial Energy Firms, December 20, 2011. In the late-filed comment supplement, NERA estimates these costs for entities “engaged in production, physical distribution or marketing of natural gas, power, or oil that also engage in active trading of energy derivatives”—

The Commission also has estimated potential costs to implement a tracking and monitoring system for position limits; the Commission anticipates that a firm could choose to implement a monitoring regime from a wide range of potential compliance systems, based on the specific, individual needs of the firm.<sup>106</sup> For example, a firm may elect to use an automatic software system, which may include high initial costs but lower long-term operational and labor costs. Conversely, a firm may decide to use a less capital-intensive system that requires more human labor to monitor positions. Thus, taking this range into account, the Commission anticipates, on average, labor costs per entity ranging from 40 to 1,000 annual labor hours, \$5,000 to \$100,000 in total annualized capital/start-up costs, and \$1,000 to \$20,000 in annual operating and maintenance costs.<sup>107</sup> The Commission contrasts this estimate with that provided by one commenter stating that compliance with proposed § 23.601 by non-financial energy companies would entail average incremental start-up costs of \$245,000 and average incremental ongoing annual costs of \$228,000.<sup>108</sup>

Other than as indicated with respect to monitoring for position limits, the limited cost data provided by commenters discussed above, and costs resulting from collections of information subject to the Paperwork Reduction Act (incorporated by reference herein), the Commission has little or no reliable quantitative data from which to reasonably estimate the costs of compliance with the duties and risk-management rules.<sup>109</sup> The

termed “nonfinancial energy companies” in the report. The figure cited includes costs to maintain a risk management program, quarterly audits of the program, and annual audits of swap trading relationship documentation, the last of which is required under a separate rulemaking proposal not being adopted in this release.

<sup>106</sup> See Position Limits for Futures and Swaps, 76 FR 71626, 71667 (Nov. 18, 2011).

<sup>107</sup> These costs would likely be lower for firms with positions far below the speculative limit, as those firms may not need comprehensive, real-time analysis of their swaps positions for position limit compliance to observe whether they are at or near the limit. Costs may be higher for firms with very large or very complex positions, as those firms may need comprehensive, real-time analysis for compliance purposes. Due to the variation in both number of positions held and degree of sophistication in existing risk management systems, it is not feasible for the Commission to provide a greater degree of specificity as to the particularized costs for SDs and MSPs.

<sup>108</sup> NERA, Cost-Benefit Analysis of the CFTC’s Proposed Swap Dealer Definition Prepared for the Working Group of Commercial Energy Firms, December 20, 2011. See also text accompanying note 103 for a discussion of these figures.

<sup>109</sup> Although the rules were adapted from existing risk management guidance from a variety of sources

Commission's review of applicable academic literature yielded no research reports or studies directly relevant to its considerations of costs of the final rules. Moreover, because it largely refrained from establishing prescriptive requirements under § 23.600—requiring certain policies and procedures while leaving their design and formulation to the discretion of each individual registrant—the Commission believes that many of the costs associated with the rules will be highly specific to each entity, and thus difficult to quantify for an individual firm or on an aggregated basis. Certain of the costs associated with these rules addressing duties and risk management requirements of SDs and MSPs result from collections of information subject to the Paperwork Reduction Act. Costs attributable to collections of information subject to the PRA are discussed further in section V.B.2. below. The Commission has also considered these costs, which it incorporates by reference herein, in its section 15(a) analysis.

#### Benefits

The Commission believes that the central, driving role of SDs and MSPs in swaps markets—markets that can be systemically critical as recent events have shown—requires that SDs and MSPs give due regard to, and properly manage, the risks they incur as part of their day-to-day businesses. The impact of an SD or MSP default may be greater than the impact to the entity alone, and of potentially profound significance to the financial system broadly. Given this, the Commission believes these regulations prescribing internal risk management requirements better assure the protection of market participants and the public.

In promulgating the regulations governing the duties of SDs and MSPs, the Commission has created a framework that requires proper internal oversight but also ensures that these participants retain the flexibility to comply in the manner best suited for their individual needs. While the Commission recognizes that the costs incurred by participants to comply with these regulations may be significant, the Commission also believes that the strength of critical market participants like SDs and MSPs is a vital component in the strength of the financial system as a whole. By requiring entities to monitor the risks arising from their operations actively and rigorously, the Commission

including the Federal Reserve and the OCC, such guidance has been built up incrementally over a period of time and the overall costs of compliance with such guidance has not been quantified.

believes that an entity's default risk will decrease substantially. Should an emergency situation—such as a natural disaster—occur, the largest derivatives market participants will have systems in place to resume full operation within one business day, mitigating the effects of a major crisis for the financial system as a whole. The Commission also recognizes that, given the systemic importance of these entities, ensuring proper risk management within SDs and MSPs helps to protect the public against major market disruptions and financial losses.

In addition, the registrants will benefit from the required oversight of their internal operations. The required monitoring is designed to protect an entity from “rogue” or unauthorized trading. Further, the required monitoring of applicable position limits protects the entity from an unforeseen violation that could lead to, among other things, an enforcement action from an exchange or the Commission. Moreover, the regulations require identification and monitoring of several different kinds of risk, allowing entities to realize and correct potential issues before problems (and associated costs) escalate. Finally, the stability of any entity rests on its ability to manage the risks inherent in its business; by requiring stringent internal oversight, the Commission believes these regulations will aid in the growth and competitiveness of SDs and MSPs by ensuring the stability that flows from the most basic forms of risk management.

#### Section 15(a) Determination

##### 1. Protection of Market Participants and the Public

The Commission believes that requiring prudent risk management policies and procedures lessens the risk of market disruptions and financial losses that could greatly impact not only a particular SD or MSP, but also other market participants and the public at large. The Commission also believes that requiring entities to assess and monitor their level of risk, as well as the adequacy of their own risk management policies and procedures, helps to: (i) Protect the entity from undue impacts from unanticipated market events, (ii) ensure swift recovery after a disaster or other emergency, and (iii) promotes the stability of the entity. The business practices of SDs and MSPs are of critical importance to the integrity and stability of the derivatives markets; this makes proper oversight and risk mitigation essential to the well-being of the financial system.

The Commission does not believe that the costs associated with these rules will have a detrimental effect on the protection of market participants or the public. It is possible that the costs associated with these rules will require that SDs and MSPs modify their business decisions in order to allocate more resources to risk management, monitoring traders, business continuity, and diligent supervision of personnel.

##### 2. Efficiency, Competitiveness, and Financial Integrity of Markets<sup>110</sup>

The Commission believes that effective internal risk management and oversight helps protect the financial integrity of individual SDs and MSPs. Their financial integrity, in turn, promotes the financial integrity of derivatives markets by helping to foster confidence in the stability of the financial system. Further, the regulations are designed to ensure that SDs and MSPs can sustain their market operations and meet their financial obligations to market participants, further protecting the financial integrity of derivatives markets. Additionally, the Commission believes that these regulations, as carefully tailored to minimize costs beyond those required by the statute, will enhance the efficiency and competitiveness of markets to the extent that SDs and MSPs have sound risk management programs and proper monitoring of traders. Monitoring traders to ensure that they do not engage in manipulative or other disruptive market behaviors is crucial to the efficiency of markets.

##### 3. Price Discovery

The Commission has identified no likely material impact on price discovery from the costs and benefits of these duties and risk management rules.

##### 4. Sound Risk Management

The regulations go to the heart of sound risk management for key market participants and for the swaps market generally. The rules require SDs and MSPs to establish policies and procedures for: (i) Monitoring and managing traders and all risks associated with their swaps activities, including market, credit, liquidity, foreign currency, legal, and operational risk; (ii) business continuity planning, and (iii) diligent supervision. Such policies and procedures will ensure that the largest derivatives market

<sup>110</sup> Although by its terms section 15(a)(2)(B) of the CEA applies to futures markets only, the Commission finds this factor useful in analyzing regulations pertaining to swaps markets as well. The Commission has identified no impact to futures markets.

participants understand the risks associated with their swaps activities, take steps to mitigate those risks when appropriate, and are prepared for managing crisis situations. In essence, these rules create risk management benefits by working to prevent SDs and MSPs from having to default on their financial obligations, potentially threatening overall financial stability in the process.

The costs associated with these rules will likely require that SDs and MSPs allocate more resources to risk management, monitoring traders, business continuity, and diligent supervision of personnel. The Commission does not foresee that the allocation of these additional resources will have a detrimental effect on sound risk management.

#### 5. Other Public Interest Considerations

The Commission has not identified any other public interest considerations that could be impacted by these duties and risk management requirements for SDs and MSPs.

#### *F. Conflicts-of-Interest Policies and Procedures for SDs, MSPs, FCMs, and IBs*

Section 4s(j) of the CEA, as added by section 731 of the Dodd-Frank Act, sets forth certain duties for SDs and MSPs, including the duty to implement conflict-of-interest systems and procedures. Specifically, section 4s(j)(5) mandates that SDs and MSPs implement conflict-of-interest systems and procedures that establish safeguards to ensure that research activities and the provision of clearing services are separated by appropriate informational partitions from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision. Section 4s(j)(5) further requires that such systems and procedures “address such other issues as the Commission determines to be appropriate.” The proposed regulations, as set forth in the SD/MSP Conflicts NPRM, addressed the statutory mandate of section 4s(j)(5).

Similarly, section 732 of the Dodd-Frank Act amended section 4d of the CEA by creating a new subsection (c), which mandates that the Commission “require that futures commission merchants and introducing brokers implement conflict-of-interest systems and procedures.” New section 4d(c) mandates that such systems and procedures establish firewalls between research and trading or clearing. New section 4d(c) further requires that such systems and procedures “address such

other issues as the Commission determines to be appropriate.” The proposed regulations, as set forth in the FCM/IB Conflicts NPRM, addressed the statutory mandate of section 4d(c).

As described in detail in the preamble, the Commission, in preparing these final rules, sought and incorporated comment from the public. In the SD/MSP Conflicts NPRM and the FCM/IB Conflicts NPRM, the Commission requested comment on the Commission’s consideration of costs and benefits and invited commenters to provide data quantifying the costs and benefits of the proposed regulations.<sup>111</sup> The Commission received 29 comment letters to the SD/MSP Conflicts NPRM and 26 comment letters to the FCM/IB Conflicts NPRM. Many commenters provided comments addressing identical provisions or issues in both proposed rules. The Commission considered each in formulating the final rules, including any alternatives and cost concerns. Of the comment letters received, 21 letters addressed issues relevant to the costs and benefits of the proposed rules, but no letters provided any quantitative data to support their claims.

With regard to the conflicts provisions, the comment letters focused on 16 areas of the rule that are most relevant to the Commission’s consideration of costs and benefits. Each of these areas is discussed below. A more detailed discussion can be found in section II.M. above.

#### 1. Compliance Oversight by SROs

The Commission declines the recommendation of commenters<sup>112</sup> to delegate conflicts of interest oversight to an SRO because sections 4d(c) and 4s(j)(5) of the CEA direct the Commission exclusively to promulgate such rules. In this regard, the CEA differs from section 15D of the Securities Exchange Act of 1934, which mandates that conflict-of-interest rules be adopted either by the SEC or by an SRO. Therefore, the cost savings that the commenters asserted would result from

<sup>111</sup> See SD/MSP Conflicts NPRM, 75 FR at 71395 and FCM/IB Conflicts NPRM, 75 FR at 70157.

<sup>112</sup> FIA, ISDA, SIFMA, and JP Morgan suggested that the Commission instruct an appropriate SRO to write detailed compliance requirements within a framework set forth by the Commission because SROs would be in a better position than the Commission to address the likely need for future amendments to the rule. The Commission presumes that the commenters believe that this alternative arrangement would streamline compliance requirements resulting in cost savings. The Commission notes, however, that the comments of Michael Greenberger and UNITE HERE supported monitoring and enforcement of the implementation of conflict-of-interest policies and procedures by the Commission, as opposed to SROs.

the delegation of oversight and rulemaking authority to an SRO are in fact not an option that the Commission may consider under the statutory framework provided by the Congress.

#### 2. Non-Research Personnel

EEI argued that the Commission should limit the definition of non-research personnel<sup>113</sup> to only those persons involved with trading, pricing, or clearing activities because implementing the restrictions on communications between research analysts and all non-research personnel as the proposed rule more broadly defined the term will be burdensome. Sections 4d(c) and 4s(j)(5) of the CEA require informational partitions between research analysts and persons involved in pricing, trading, or clearing activities. The Commission recognizes that extending the requirement for informational partitions above the statutory minimum to all non-research personnel may cause registrants to experience some incremental cost increase, though EEI did not provide any quantification. Notwithstanding this, however, the Commission is adopting the definition as proposed because it believes doing so closes a significant window that could be exploited to evade the statutory purpose—i.e., to ensure that research reports published by registrants are free from bias. The Commission believes that informational partitions only between research analysts and persons involved in pricing, trading, or clearing activities are unlikely to ensure that research reports are free from bias because other personnel may have similar motives for influencing the content of research reports, or may be subject to the influence of pricing, trading, or clearing personnel and thus present an avenue of indirect influence on research personnel. The Commission observes that the definition and use of the term “non-research personnel” was adapted from NASD rule 2711, which also prohibits all non-research personnel from reviewing or approving a securities research report prior to publication.<sup>114</sup> Thus, despite some potential

<sup>113</sup> The proposed rule defined the term “non-research personnel” as “any employee of the business trading unit or clearing unit, or any other employee of the [SD] or [MSP] who is not directly responsible for, or otherwise involved with, research concerning a derivative, other than legal or compliance personnel.”

<sup>114</sup> See NASD rule 2711(b)(2) (stating “no employee of the investment banking department or any other employee of the member who is not directly responsible for investment research (‘non-research personnel’), other than legal or compliance personnel, may review or approve a research report of the member before its publication”).

incremental cost to registrants, the Commission believes that ensuring unbiased registrant research reports accords with statutory intent and justifies the increased burden.

### 3. Public appearances by research personnel

The proposed rules defined the term “public appearance” as “any participation in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons \* \* \*.” FIA, ISDA, and SIFMA argued that the definition of public appearance should articulate that the term “person” includes both a customer that is a natural person and one that is an entity. The Commission presumes these commenters to be concerned that requiring public-appearance disclosures when the 15-person threshold is crossed due to attendance by multiple representatives of one entity increases the disclosure burden with no attendant increase in benefit. The Commission agrees and is modifying the rule accordingly.

### 4. Research department

FIA, ISDA, and SIFMA, in a joint comment, objected that the imposition of the rule’s restrictions to research departments<sup>115</sup> of global affiliates would create logistical difficulties and expense for multinational firms; this impact was not quantified by the commenters. FIA, ISDA, and SIFMA suggested that the Commission limit the rules to requiring disclosure “on third party research reports.” The Commission believes that the rule helps ensure that the research reports produced by or on behalf of an SD, MSP, FCM, or IB, on which consumers may rely in making investment or risk management decisions, are not biased in favor of the financial interest of the SD, MSP, FCM, or IB—a benefit. This, in turn, promotes consumer confidence in such reports—another benefit. Therefore, because it believes that the alternative suggested by FIA, ISDA, and SIFMA would be unacceptably porous and invite evasion by registrants that move their research function to an affiliate, the Commission is adopting the rule as proposed. The Commission believes that ensuring that the intended benefits of the rule are not depleted through evasion justifies any incremental cost of extending the rule to

<sup>115</sup> The proposed rules defined the term “research department” as “any department or division that is principally responsible for preparing the substance of a research report relating to any derivative \* \* \* including a department or division contained in an affiliate \* \* \*.”

affiliates of registrants. In addition, the Commission believes that the increased costs are not as significant as posited by the commenters. A registrant need not examine the research functions of all of its affiliates under these rules; rather, the rules only require that a registrant apply the informational partitions of the rules to those research groups doing research on behalf of an SD, MSP, FCM, or IB.

### 5. Research Report

As proposed, the definition of the term “research report” expressly excluded four categories of communications from coverage. After considering the comments received, the Commission is expanding the list of exclusions as recommended to include “commentaries on economic, political or market conditions” and “statistical summaries of multiple companies’ financial data, including listings of current ratings.” As modified, the Commission believes the rule strikes a reasonable balance between the need to identify research reports on which an investor or risk manager may rely in making a decision to enter into a swap or other derivative that may also be subject to potential bias in favor of the financial interest of an SD, MSP, FCM, or IB, and those research reports on which an investor or risk manager may rely, but that are not likely to be subject to such bias. The benefits of the rule as modified are that the rules foster less biased research reports without burdening registrants with unnecessary restrictions on those research reports that, by their nature, are not likely to be subject to bias. To maintain these benefits, the Commission declines to broaden the definitional exclusion as suggested by commenters<sup>116</sup> to communications the Commission believes could represent the core focus of a research department—e.g., asset

<sup>116</sup> FIA, ISDA, and SIFMA argued for the expansion of the exclusions that the Commission has accepted. FIA/ISDA/SIFMA further argued that communications produced by a business trading unit labeled as a “trading/sales desk product” and as “non-research” should be excluded from the definitions of research report. In a separate comment, JP Morgan expressed a general agreement with the points raised in the FIA/ISDA/SIFMA letter. EEI argued that the Commission should exclude from the definition any communication between an SD or MSP, and its regulator, concerning hedging activity because firms with small trading operations should be permitted to publish occasional research reports to justify trading decisions, without being subject to the proposed rules. NFA also argued that the definition in proposed § 1.71(a)(9) was too broad and suggested that the definition be limited in a number of ways similar to NASD Rule 2711. Newedge also argued that the definition was too broad and suggested a more narrow definition of research report.

classes, economic variables commonly referenced in derivatives, and on-the-run swap rates—and thus be susceptible to bias.

### 6. Conflicts of Interest Adequately Addressed by Existing Commission and NFA Rules; FCM *de minimis* Exception

NFA commented that existing NFA rules address issues raised in proposed § 1.71, and that the rule could have unintended consequences. K&L Gates LLP (on behalf of Peregrine Financial Group Inc.), ADM Investor Services Inc., John Stewart & Associates Inc., and Stewart-Peterson Group Inc. each agreed with NFA that existing rules of NFA and the Commission are sufficient, and thus the additional compliance costs imposed by the rules are not justified.

The Commission believes that sections 4d(c) and 4s(j)(5) of the CEA require registrants to institute safeguards beyond what has been previously required in the rules of the Commission and NFA, and, accordingly, is adopting the rule substantially as proposed. For example, the statutory provisions require “structural and institutional safeguards” to ensure that research and trading functions are “separated by appropriate informational partitions,” a requirement not imposed by existing NFA or Commission rules. Thus, to the extent institution of these additional safeguards incur added costs, these are attributable to the statutory requirements imposed by Congress. Moreover, by providing specificity under the rules with respect to the conflict-of-interest requirement and by maintaining consistency with NASD Rule 2711, the Commission believes that the rule will minimize disruption to the market and minimize the additional compliance costs required by the CEA because the rules rely on well-established standards.

### 7. FCM *de minimis* Exception

Newedge commented that FCMs engaging in minimal proprietary trading should not be subject to the burdens of the rule relating to research analysts because such a firm does not present a risk of conflicts of interest. Again, the Commission notes that sections 4d(c) and 4s(j)(5) of the CEA require registrants to institute “structural and institutional safeguards” to ensure that research and trading functions are “separated by appropriate informational partitions,” and that neither of these sections makes an allowance for a *de minimis* amount of trading or research. Thus, the Commission cannot adopt the alternative approach suggested by Newedge because the imposition of a *de minimis* exception to the conflicts rule

is inconsistent with the statutory directive that Congress set forth. Moreover, the Commission does not believe that the limited nature of a firm's proprietary trading negates the issues intended to be addressed through the statutory mandate because a firm engaged in trading solely on behalf of customers can increase its commissions by encouraging an increase in trading activity through research reports.

#### 8. Small IB Exception

In the FCM/IB Conflicts NPRM, the Commission invited comment on how the proposed rules should apply to FCMs and IBs, considering the varying size and scope of the operations of such firms. A number of commenters requested relief for small IBs on grounds that the burden to them would be high and could discourage them from providing research to the detriment of customers seeking to hedge commercial risk.<sup>117</sup> Given the mandate of section 4d(c) of the CEA to establish "appropriate informational partitions" within all FCMs and IBs, the Commission is not able to exempt small firms from the statutory requirements.

The Commission, however, recognizes that an IB's size is a significant factor in determining the "appropriateness" of the informational partitions required by section 4d(c). Thus, in light of the burden to small IBs and the attendant loss of research benefits for consumers that could result, the Commission has modified § 1.71(b) to set forth a separate policies and procedures requirement for small IBs designed to provide them greater flexibility in determining the appropriate informational partitions required under their own circumstances.<sup>118</sup>

<sup>117</sup> NFA, National Introducing Brokers Association, ADM Investor Services Inc., John Stewart & Associates Inc., and Stewart-Peterson Group Inc. each argued that implementing the proposed rules would be prohibitively costly, burdensome, and unnecessary for small IBs, particularly for IBs dealing with agricultural commodities where the IB may have only a few employees engaged in both research and trading for customers, and would force an unspecified number of small IBs out of business. Chris Barnard noted that small IBs lack the capacity to carry the proportionately heavier regulatory burden set forth in the proposed rule, and as such, some regulatory mitigation would be beneficial based on number of staff or revenues. Multiple commenters also commented on the limited market price impact of research reports created or distributed by small IBs.

<sup>118</sup> The threshold to qualify for this small IB alternative is \$5 million or less in aggregate gross revenues generated over the preceding 3 years from activities as an IB. This approach is similar to that taken in NASD Rule 2711 and was raised as a possible alternative in the preamble of the proposed rule.

#### 9. Restriction on Non-Research Personnel From "Influencing the Content" of Research Reports

The proposed rules provided that non-research personnel shall not influence the content of a research report. In response to commenters' concerns that the proposed standard was unnecessarily broad and would tend to chill all communications, including those beneficial to research integrity, between research and non-research personnel, the Commission is modifying the rules in line with suggested alternatives to provide instead that non-research personnel shall not direct the views and opinions expressed in a research report.<sup>119</sup> The Commission believes that accepting this change will reduce the compliance burden of registrants because it directs compliance efforts toward ensuring that the views and opinions expressed in research reports are those of the research analyst, rather than attempting to prohibit all influence.<sup>120</sup>

#### 10. Restriction on Research Analyst Supervision by Business Trading Unit or Clearing Unit

The proposed rules prohibited (1) supervision or control of a research analyst by any employee of the registrant's business trading unit or clearing unit, and (2) influence or control over the evaluation or compensation of a research analyst by personnel engaged in pricing, trading, or clearing activities. The intent of the rules is to foster research free of bias that may result from research analysts' expectation of increased compensation for producing research reports favorable to the financial interests of personnel in the business trading unit or clearing unit—a benefit.

FIA, ISDA, and SIFMA recommended—presumably on the basis that requiring a separate reporting line adds to the compliance burden—that the restriction only apply to direct supervision of research analysts, and not to others further up the management chain. No commenter provided

<sup>119</sup> FIA, ISDA, SIFMA, and JP Morgan argued that the proposed prohibition on "influencing the content" should be eliminated because it would impair ordinary communications between research and non-research personnel. As an alternative, FIA/ISDA/SIFMA suggested that non-research personnel should be prohibited only from "directing the views and opinions expressed in research reports." Better Markets argued that the rules should be expanded to include any decision not to publish a report or to refrain from including relevant information.

<sup>120</sup> The Commission further modified the rules in response to commenters to provide that non-research personnel shall not direct a research analyst's decision to publish a research report. The Commission believes this is a burden-neutral modification to provide clarification, however.

quantitative information with respect to the costs of such burden. The Commission believes that it has resolved the concerns of commenters through (1) changes to the definitions of "business trading unit" and "clearing unit" discussed in section II.M above, and (2) using those definitions to designate personnel who may not have influence or control over the evaluation or compensation of a research analyst. As modified, the definitions reach only those performing certain functions in the unit and those supervising the performance of those functions. The Commission believes the threat to research analyst independence that would result from permitting supervision by any member of the business trading unit or clearing unit, as defined in the final rules, justifies adopting the rule as proposed.

#### 11. Requirement That Legal/Compliance Personnel Supervise Communication Between Research and Non-Research Personnel

The proposed rules permitted non-research personnel to review a research report before its publication for limited purposes, such as verifying factual accuracy. Such review: (1) May only be conducted through authorized legal or compliance personnel, and (2) must be properly documented. In this respect, the rules maintain consistency with NASD Rule 2711 and the Commission believes that such consistency will minimize compliance costs because the rules rely on well-established standards. In addition, the Commission notes that the benefit of this provision is that it maintains the independence of the views and opinions expressed in research reports while improving the accuracy of such reports. The rules accomplish these benefits by balancing the need for some review of research reports by non-research personnel, while ensuring the review is limited in scope by requiring the presence of legal or compliance personnel.

EEI recommended that the Commission exempt communications that are factual in nature from oversight by legal and compliance personnel, arguing that such oversight unnecessarily burdens legal/compliance personnel. EEI did not further qualify or quantify the costs implicated by the proposed exemption. Upon consideration of the alternative's cost/benefit ramifications, the Commission determined to adopt the rule as proposed. The Commission finds the suggested alternative unacceptable for several reasons. First, the Commission does not believe that registrants will be able to distinguish easily

communications that are “factual in nature” from those that are not, likely resulting in more uncertainty and needed review by legal and compliance personnel, not less. In addition, the Commission believes that allowing for communications that are merely “factual in nature” opens an avenue for evasion that could undermine the rules’ intended benefits.

#### 12. Restrictions on Research Analyst Communications

The proposed rules provided that a research analysts’ written or oral communication relating to any derivative must not omit any material fact or qualification that would cause the communication to be misleading to a reasonable person. The requirement, as proposed, applied to external communications to a current or prospective counterparty as well as internal communications to any employee of the registrant. The Commission intends the rules to promote research report integrity—i.e., help ensure that reports are both unbiased in favor of a registrant’s financial interests and factually accurate in material respects. The Commission anticipates that the cost attendant to achieve the accuracy component of this intended benefit is any increased time a registrant spends ensuring that research analysts’ reports are free of material misleading inaccuracies.

FIA, ISDA, SIFMA, and JP Morgan commented that the proposed rule would materially burden an affected firm’s operations because it applies to internal communications as well as external communications. Upon consideration of the potentially significant cost of including internal communications relative to the limited gain in intended benefits, the Commission is modifying the rules to exclude communications with employees of the registrant from the requirement.

#### 13. Restriction on Influence of Business Trading Unit and Clearing Unit on Research Analyst Compensation

Proposed §§ 23.605(c)(3) and 1.71(c)(3) precludes (1) a registrant from considering a research analyst’s contribution to the trading or clearing business as a factor in his or her compensation review or approval, and (2) a review or approval role for business trading or clearing unit personnel with respect to a research analyst’s compensation. As articulated above, the Commission believes that the benefit of unbiased research flows directly from a research analyst’s independence, which is compromised if

the analyst’s compensation is subject to business trading or clearing unit influence.

The Commission recognizes that the rule, to some incremental extent, may add to compliance costs, although no commenter specifically articulated or quantified this impact. After considering the comments received,<sup>121</sup> the Commission has determined to revise the proposed rule to relieve the compliance burden by permitting communications to research department management relating to client or customer feedback, ratings, and other indicators of a research analyst’s performance. The Commission does not believe that this relaxation will negatively impact research independence. The Commission declines to further modify the rule, however, based on its belief that maintaining a firewall around research analyst compensation decisions is crucial to implementing effective conflict-of-interest policies and procedures and ensuring the benefits of unbiased research reports. The Commission also confirms that the rule does not prohibit compensation decisions from being subject to non-discriminatory and non-prejudicial firm-wide compensation guidelines.

#### 14. Disclosure of Conflicts by Research Analysts in Research Reports and Public Appearances; Disclosure of Conflicts in Third-Party Research Reports

Proposed §§ 23.605(c)(5)(i) and 1.71(c)(5)(i) required certain disclosures in registrants’ research reports and at research analysts’ public appearances. Specifically, it required disclosure of whether the analyst that prepared the report or makes the appearance maintains, from time to time, a financial interest in the types of derivatives that the analyst follows, the general nature of such interest, and any other material conflicts of interest of which the research analyst has knowledge. Additionally, as proposed, §§ 23.605(c)(5)(iv) and 1.71(c)(5)(iv) required that, if a registrant distributes or makes available third-party research

reports, each report be accompanied by certain disclosures pertinent to conflicts of interest. The required disclosures benefit consumers of research reports produced by SDs, MSPs, FCMs, and IBs because they alert the consumers of such reports to interests that may influence the content of such reports, allowing the consumer to make an independent judgment as to their value.

Several commenters recommended changes that could lessen the incremental (though unquantified) compliance costs of the rule by curtailing the required disclosures.<sup>122</sup> The Commission has considered these comments and has determined that the benefits of the rule will be maintained without subjecting registrants to the burden of determining and disclosing financial interests that are maintained “from time to time.” Thus, the Commission is modifying the language of §§ 23.605(c)(5) and 1.71(c)(5) to remove the phrase “from time to time,” such that a research analyst need only disclose whether she maintains a relevant financial interest at the time of publication of the report or the time of a public appearance. However, the Commission is not adopting a *de minimis* exception, due to the difficulty of deciding when a financial interest is *de minimis* in this context. A *de minimis* exception would require a registrant to determine the threshold point at which a financial interest poses a threat of conflicts of interest—a nebulous standard; such determination is likely to increase the costs of compliance of the rule over the cost that would be incurred to simply disclose all financial interests.

Commenters also raised concerns regarding the burden of required disclosures when distributing research reports produced by a third-party.<sup>123</sup> The Commission considered the burden of disclosure in this context in light of maintaining the benefit of disclosure of information necessary for consumers to judge the content of research reports. The Commission has determined not to modify the rule in regard to third-party research disclosures. It believes that

<sup>121</sup> FIA, ISDA, SIFMA, and JP Morgan contended that research management should be able to solicit input from business trading and clearing unit personnel concerning the performance of research personnel. FIA/ISDA/SIFMA, as well as Newedge, further argued that research management decisions should be subject to firm-wide compensation guidelines. By contrast, Michael Greenberger argued that research management should be prohibited from soliciting any input of business trading and clearing units concerning a research analyst’s compensation or performance evaluation, even if the influence is indirect or if research management maintains the ability to make all final decisions on such determinations. Better Markets commented that the provision should be broadened.

<sup>122</sup> FIA, ISDA, and SIFMA argued that §§ 23.605(c)(5)(i) and 1.71(c)(5)(i) should be limited to disclosing whether a research analyst maintains a relevant financial interest at the time of publication of the report/time of public appearance, rather than “from time to time” as provided in the rule. EEI suggested that the Commission modify the proposed rule to provide a *de minimis* exception to the disclosure requirements, such that a research analyst should be required only to identify relevant financial interests.

<sup>123</sup> FIA, ISDA, SIFMA, JP Morgan, and EEI argued that the required disclosures with respect to third-party research reports are unnecessary because third-parties are, by definition, independent.

third-party research reports distributed by a registrant may be interpreted as carrying the endorsement of the registrant and thus may present conflicts-of-interest issues in the same way as research reports originating with the registrant's own research analysts; accordingly, the same level of disclosure is appropriate.

Finally, commenters also contended that the phrase "any other actual, material conflict of interest of the research analyst" is vague and would be burdensome to implement, requiring coordination among various business units and the creation of special databases in order to comply with the rule. The Commission believes that the cost concerns of commenters are misplaced in this regard. The rules require disclosure of "any other actual, material conflicts of interest of the research analyst or [SD, MSP, FCM, or IB] of which the research analyst *has knowledge* at the time of publication of the research report or at the time of the public appearance" (emphasis added). Thus, the disclosure requirement is limited to conflicts of which the research analyst has knowledge, and the SD, MSP, FCM, or IB need not construct the databases suggested by commenters in order to comply with the rule.

#### 15. Separation of Clearing Unit From Business Trading Unit

As proposed, § 23.605(d) and § 1.71(d) prohibited interference by an SD or MSP with the decisions of clearing members, including FCMs, regarding the provision of clearing services and activities. The proposed rules also required informational partitions between business trading units and clearing member personnel. In addition, the proposals prohibited any employee of a business trading unit from supervising or controlling any employee of a clearing member. The Commission believes the benefits of the rules are that, to the extent practicable, the rules protect fair and open access to clearing by ensuring that decisions to accept clearing customers are not motivated solely by considerations of trading profits.

Commenters raised a number of cost concerns related to operation of the rule, as follows:

- Sales personnel should be able to act for both the trading unit and the clearing unit to offer a full range of services to customers efficiently;<sup>124</sup>

<sup>124</sup> FIA/ISDA/SIFMA and JP Morgan argue that sales personnel should be permitted to act for both units. UBS Securities LLC also argued that the rule inhibits the ability of a financial services firm to operate its swap clearing business as a partnership with its trading business in order to serve clients.

- The rules will impair a registrant's ability to follow risk management best practices by requiring independent risk assessments in the trading unit and clearing unit for the same counterparty, rather than a consolidated risk assessment;<sup>125</sup>

- The rule should be limited to prohibiting a trading unit from obtaining information about the transactions or positions of customers of the clearing unit;<sup>126</sup>

No commenter provided any quantitative information regarding the expected costs of complying with the rules.

Having considered the costs of compliance as presented by commenters in light of the benefits of open access to clearing, the Commission has determined it appropriate to promulgate the rules largely as they were originally proposed. Despite the varying incremental costs of any needed corporate structure reorganization and instituting informational partitions, the Commission believes the separation of the FCM clearing unit from the interference or influence of an affiliated SD or MSP is crucial to promoting open access to clearing and securing the benefits to market participants and the stability of the financial system itself expected to follow from increased central clearing.<sup>127</sup> Open access to clearing will be essential for the expansion of client clearing needed for market participants to comply with the mandatory clearing of swaps as determined by the Commission under section 723 of the Dodd-Frank Act. Specifically, the Commission does not believe that the rule language should be changed to permit sales personnel to act for both the trading unit and the clearing unit. The risks associated with this approach, in terms of potential undue influence and interference with

Similarly, the FHLBs argued that the proposed rule overly restricts the ability of SDs and MSPs to run their trading and clearing operations and effectively serve the needs of their end-user counterparties.

<sup>125</sup> FIA/ISDA/SIFMA and the FHLBs argued that the proposed rules would impair an SD's/MSP's ability to follow risk management best practices. NFA commented that § 1.71(d) is too broad and may negatively impact a firm's ability to share information about customers to make credit and risk determinations.

<sup>126</sup> FIA/ISDA/SIFMA recommended that the Commission not adopt the proposed rules, but instead adopt a rule that prohibits an affiliated SD or MSP from obtaining information from an affiliated FCM's clearing personnel concerning transactions conducted by FCM clients with either their own clients or with independent SDs or MSPs.

<sup>127</sup> In September 2009, the G-20 Leaders agreed in Pittsburgh that "all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest."

clearing decisions, has been well-supported by commenters.<sup>128</sup>

However, in response to commenters' concerns about an FCM's ability to manage a default scenario without the benefit of the trading expertise in the business trading unit, the Commission is modifying proposed § 1.71(d)(2)(i) to permit the business trading unit of an affiliated SD or MSP to participate in the activities of an FCM during an event of default. Specifically, the business trading unit personnel would be permitted to participate in the activities of the FCM, as necessary, during any default management undertaken by a derivatives clearing organization and for the purposes of transferring, liquidating, or hedging any proprietary or customer positions as a result of an event of default.

#### 16. Undue Influence on Customers

As proposed, § 1.71(e) required that FCMs and IBs adopt and implement written policies and procedures that mandate the disclosure of any material incentives and any material conflicts of interest regarding the decision of a customer as to trade execution and/or clearing of a derivatives transaction. Proposed § 23.605(e) mandated that SDs and MSPs adopt policies and procedures requiring disclosure to counterparties of any material incentives and conflicts of interest regarding the decision of a counterparty: (1) Whether to execute a derivative on a swap execution facility or designated contract market; or (2) whether to clear a derivative through a derivatives clearing organization. The Commission believes that the rules benefit counterparties by ensuring that they are adequately informed of any material incentives or conflicts prior to the execution of a transaction, and benefit the market by promoting the efficient use of trading facilities and clearing for swap transactions.

Some commenters objected to the rule on the grounds that existing Commission regulations already impose risk disclosure requirements on FCMs and IBs. FIA, ISDA, SIFMA, and JP Morgan argued that the Commission could reduce the burden of the rules by

<sup>128</sup> MFA and Pierpont Securities Holdings LLC commented that they support the Commission's proposals. Swaps and Derivatives Market Association contended that that the restrictions correctly address key areas where conflicts arise, and that the independence of clearing members is essential to accomplish several policy goals of the Dodd-Frank Act. Michael Greenberger also expressed support for § 23.605(d), noting that attempts to tie clearing decisions to trade execution decisions would raise potential conflicts of interest, which could serve to block access to clearing and prevent competition among execution venues.

requiring SDs and MSPs to provide customers with an annual disclosure document describing potential conflicts that may exist among the firm, its affiliates, clients, and employees.

After considering costs of compliance with the rule in light of the benefits outlined above, and the underlying statutory requirements, the Commission has determined it appropriate to adopt the rules as originally proposed. The Commission believes that the disclosure of conflicts of interest in this context are materially different from the risk disclosures required of FCMs and IBs under existing Commission regulations and, therefore, existing regulations are inadequate to secure the benefits of the rule outlined above. In addition, the Commission notes that the rule does not prohibit an SD or MSP from providing its customers with an annual disclosure document, and the Commission confirms that such would be permitted assuming that such document is sufficient to meet the requirements of the rule.

#### Costs

Sections 4d(c) and 4s(j)(5) of the CEA require FCMs, IBs, SDs, and MSPs, to adopt and implement certain conflict of interest systems, procedures and safeguards, including research firewalls. The costs and benefits that necessarily result from these basic statutory requirements are considered to be the "baseline" against which the costs and benefits of the Commission's final rules are compared or measured. The "baseline" level of costs includes the costs that result from the following activities required by the statute:

- FCMs and IBs must establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in trading or clearing activities might potentially bias the judgment or supervision of the persons.

- SDs and MSPs must establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity or swap are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open

access and the business conduct standards described in the CEA.

- SDs and MSPs must establish structural and institutional safeguards to ensure that the activities of any person within the firm acting in a role of providing clearing activities or making determinations as to accepting clearing customers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open access and the business conduct standards described in the CEA.

Compliance with the statutory baseline alone would result in costs for FCMs, IBs, SDs, and MSPs. For example, the requirement to establish informational partitions would include the cost of identifying personnel involved in research or analysis of the price or market for any commodity or swap, identifying personnel involved in pricing, trading, or clearing activities, and designing and implementing communication policies and procedures.

Congress mandated that the Commission adopt rules to implement each of the statutory provisions. With regard to its implementation decisions, the Commission has determined the following to be potential costs to FCMs, IBs, SDs, and MSPs to comply with the final regulations regarding conflicts-of-interest policies and procedures:

- Identifying reports that qualify as research reports;
- Maintaining records of public appearances by research analysts; and
- Designing and implementing policies and procedures regarding:
  - Legal or compliance participation in communications between research analysts and non-research personnel regarding the content of research reports;
  - Oversight of research analyst communications regarding omissions of material facts or qualifications that would cause the communication to be misleading to a reasonable person;
  - Communication of any client or customer feedback on research analyst performance from the business trading unit or clearing unit to research department management;
  - Implementing the prohibition on promises of favorable research by research analysts;
  - Discovering, monitoring, and disclosing financial interests maintained by research analysts;
  - Implementing the prohibition on retaliation against research analysts;

- Implementing the prohibition of interference with or influence on decisions with regard to the provision of clearing services or activities; and
- Disclosing material incentives and conflicts-of-interest regarding exchange trading or clearing decisions by counterparties.

In adhering to its mandate from Congress, where possible the Commission has attempted to alleviate the burdens on affected entities. The Commission has narrowed the definitions of "business trading unit" and "clearing unit" to include fewer registrant personnel affected by the rules. The Commission has narrowed the definition of "public appearance" to include fewer appearances by research analysts that would require the disclosures mandated by the rules. The Commission has broadened the number of exclusions from the definition of "research report" such that there are fewer subject areas that would be covered by the rules. The Commission has provided a separate regulatory standard for small IBs that will lessen the compliance burden on such firms. The Commission also has narrowed the prohibition on non-research personnel involvement in producing content of research reports, and removed the need to police internal communications from research analysts for omissions of material facts or qualifications. The Commission has permitted trading and clearing units to provide client and customer feedback on research analyst performance to research department management and removed the need to determine and document financial interests of research analysts maintained "from time to time" for disclosure purposes. Finally, the Commission has permitted business trading unit personnel to participate in the activities of an FCM, as necessary, during any default management undertaken by a derivatives clearing organization and for the purposes of transferring, liquidating, or hedging any proprietary or customer positions as a result of an event of default.

Other than costs resulting from collections of information subject to the Paperwork Reduction Act, incorporated by reference herein, the Commission has no reliable quantitative data from which to reasonably estimate the costs of compliance with these conflict of interest rules.<sup>129</sup> No commenter provided any quantitative data on the costs of compliance with the rules as

<sup>129</sup> Although the rules were adapted from NASD rule 2711, that rule was promulgated by an SRO (now FINRA), which was not required to conduct a cost-benefit analysis of the rule prior to promulgation.

proposed. The Commission's review of applicable academic literature yielded no research reports or studies directly relevant to its considerations of costs of the final rules.

The Commission anticipates that many entities may currently have, pursuant to other regulation, the informational partitions required by the rules in place. The Commission notes that dually registered FCMs and BDs are more likely to have implemented such informational partitions under other regulatory regimes<sup>130</sup> than entities that are subject to such requirements for the first time. Costs, therefore, are expected to be higher for those entities not currently dually registered or not currently implementing conflicts of interest policies and procedures. Certain of the costs associated with these conflict of interest rules result from collections of information subject to the Paperwork Reduction Act. Costs attributable to collections of information subject to the PRA are discussed further in section V.B.3. below. The Commission has also considered these costs, which it incorporates by reference herein, in its section 15(a) analysis.

#### Benefits

The Commission believes that the proper informational partitions between research and trading and between clearing and trading, including restrictions on communications, supervision, and compensation oversight, help to ensure that research being released by SDs, MSPs, FCMs, and IBs and decisions related to trade execution and clearing are not tainted by inappropriate incentives. Because this research may be relied upon by a public that views such entities as experts in derivatives markets by virtue of their intimate knowledge of the

<sup>130</sup> In this respect, the Commission observes that 55% of current FCMs are also registered as BDs with the SEC, and thus may already have informational partitions between research and trading as required under the rules of FINRA. See letter from NFA, dated Jan. 18, 2011 (comment file for 75 FR 70881 (Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a FCM, SD, or MSP)). The Commission also notes that in 2003 the UK FSA conducted a cost benefit analysis when promulgating conflicts of interest rules and guidance with respect to investment research and issues of securities. The UK FSA concluded that because UK firms were required to comply with their existing statutory obligations including management of conflicts of interest when carrying out regulated activity, the "total compliance costs relating to [the FSA's] new proposed rule and supporting guidance on objective investment research will be of no more than minimal significance." See FSA Consultation Paper 205, Conflicts of Interest: Investment Research and Issues of Securities, Annex 1 (October 2003); FSA Consultation Paper 171, Conflicts of Interest: Investment Research and Issues of Securities, Annex 5 (February 2003).

products and markets, it is imperative that the information released therein is as accurate and free of conflicts of interest as possible. Similarly, because the importance of central clearing in derivatives markets necessitates free and open access to clearing, unrestrained by any potential conflicts of interest, it is imperative that access to clearing is not impeded by any inappropriate motivation. The rules adopted in this release require entities to establish appropriate policies and procedures to accomplish these benefits.

In addition, by ensuring that decisions on clearing activities remain separate from decisions relating to trade execution and other proprietary activities, the final regulations promote competitiveness in futures and swaps markets by ensuring open access to clearing. Central clearing is a pillar of derivatives reform initiatives, contributing heavily to the efficiency and safety of derivatives markets; barriers to clearing access may have an adverse effect on that efficiency and safety.

To the extent that a research report informs the financial investment in derivatives markets, protecting the integrity of that report aids in the protection of the financial integrity of markets.

Moreover, requiring registrants to disclose any potential conflicts of interest further affords the public the opportunity to make judgments regarding the information provided to them in the written reports and public appearances of research analysts. The Commission's mission to ensure fair and orderly markets relies in part on the transparency of certain market information, in order to provide potential investors the accurate information necessary to make informed decisions.

#### Section 15(a) Determination

##### 1. Protection of Market Participants and the Public

The Commission believes that, as a result of these rules, market participants and the public are better protected from the potential harm that may occur when financial research reports are not insulated from the bias of registrants' own financial interests. This bias holds strong potential to operate as an incentive for registrants to produce and distribute research reports tainted by misleading, unbalanced, and/or inaccurate information. Such tainted reports, in turn, may induce market participants to engage in a financial transaction that they otherwise would not. Thus, the Commission believes that

these regulations perform an important consumer protection function in the markets it regulates. While, in theory regulation could discourage some SDs, MSPs, FCMs, or IBs from making research reports public, the Commission believes the rules are carefully tailored to minimize costs beyond those required by the statute. The Commission also believes that SDs, MSPs, FCMs, and IBs likely will use research reports as a tool to differentiate themselves from competitors. In addition, the Commission believes that by insulating clearing services from pricing and trading bias, the regulations foster fair and open access to central clearing.

##### 2. Efficiency, Competitiveness, and Financial Integrity of Markets<sup>131</sup>

The final rules promote the efficiency, competitiveness, and financial integrity of futures and swaps markets<sup>132</sup> by prohibiting an entity's trading personnel from manipulating research reports or otherwise biasing the information contained in research reports to their own financial advantage. To the extent the research produced by registrants is used to inform financial strategies, the integrity of that research is beneficial to the financial integrity of derivatives markets. The final rules strive to ensure the integrity of research performed by Commission registrants. Sound research also promotes market efficiency insofar as the increased dissemination of reliable, unbiased market information is acted upon by market participants in their decision-making. As discussed above, the Commission does not believe that the costs of these regulations, as carefully tailored to minimize costs beyond those required by the statute, will materially decrease market efficiency by leading to less sharing of relevant market information, particularly in light of the competitive incentives to do so.

Because the final rules promote fair and open access to central clearing, they also promote the financial integrity of derivatives markets—both futures and swaps markets. Greater access to central clearing ensures that more market participants will have the option to mitigate the counterparty credit risk that they face when entering into derivatives transactions. Protecting market participants from discrimination in the provision of clearing services will foster

<sup>131</sup> Although by its terms CEA section 15(a)(2)(B) applies to futures markets only, the Commission finds this factor useful in analyzing regulations pertaining to swaps markets as well.

<sup>132</sup> Although by its terms CEA section 15(a)(2)(B) applies to futures markets only, the Commission finds this factor useful in analyzing regulations pertaining to swaps markets as well.

a competitive environment for the provision of clearing services and afford market participants greater choice in clearing members. While the Commission recognizes that some costs are attendant to the required firewall between trading and clearing, the Commission does not believe that these costs, as carefully tailored to minimize costs beyond those required by the statute, are sufficient to materially inhibit the provision of clearing services.

### 3. Price Discovery

To the extent that insulating research reports from registrant financial bias results in hedgers and investors making more accurately informed investment decisions, reported trade and transaction prices should better reflect the intrinsic value. This promotes the price discovery function of derivative markets. In contrast, where there is no check on the integrity of registrant research materials and market actors transact on the basis of misleading or inaccurate information, resulting prices may be distorted. Because the rules are carefully tailored to minimize costs, the Commission does not believe these rules will reduce liquidity to hinder price discovery.

### 4. Sound Risk Management

The final rules regarding informational partitions between clearing and trading will contribute to sound risk management because the separation of the FCM clearing unit from the interference or influence of an affiliated SD or MSP promotes open access to clearing. Open access to clearing will be essential for the expansion of client clearing needed for market participants to comply with the mandatory clearing of swaps as determined by the Commission under section 723 of the Dodd-Frank Act. The mandatory central clearing of swaps is one of the primary responses to the 2008 financial crisis, as central clearing is believed to promote sound risk management in the swap markets. While the Commission recognizes that some costs are attendant to the required firewall between trading and clearing, the Commission does not believe that these costs, as carefully tailored to minimize costs beyond those required by the statute, are sufficient to materially inhibit the provision of clearing services and the risk management benefit these services afford.

### 5. Other Public Interest Considerations

The Commission has not identified any other public interest considerations

impacted by these conflicts-of-interest rules.

#### *G. Designation of a Chief Compliance Officer, Required Compliance Policies, and Annual Report of an FCM, SD, or MSP*

The CCO NPRM proposed several rules addressing chief compliance officer (CCO) designation and certain CCO requirements:

- Proposed § 3.3(a) codified the statutory requirements that each FCM, SD, and MSP designate a CCO and prescribed certain qualifications for the position.<sup>133</sup>
- Proposed § 3.3(d) codified the CCO duties defined in section 4s(k)(2) for SDs and MSPs, and extended their application to FCMs.<sup>134</sup>
- Proposed § 3.3(e) <sup>135</sup> codified the requirements of section 4s(k)(3) of the CEA for SDs and MSPs—i.e., that the CCO annually prepare and sign a report containing descriptions of: (i) The registrant's compliance with the CEA and regulations promulgated under the CEA, and (ii) each policy and procedure of the CCO, including the code of ethics and conflicts-of-interest policies—and extended their application to FCMs pursuant section 4d(d) of the CEA.

Of the 25 comment letters the Commission received on the CCO NPRM, 17 raised issues relevant to the consideration of the proposed rules' material costs and benefits; two of these provided some quantitative data relevant to costs and benefits.

The comments relevant to costs and benefits can be classified with respect to the following 10 aspects, each of which is discussed below.<sup>136</sup>

#### 1. Decision To Extend Same Requirements to FCMs as SDs and MSPs

The Commission proposed uniform rules applicable to SDs, MSPs, and FCMs. After reviewing the comments received,<sup>137</sup> the Commission is adopting

<sup>133</sup> Section 4d(d) of the CEA requires that each FCM designate an individual to serve as its chief compliance officer (CCO). Likewise, section 4s(k) of the CEA requires that each SD and MSP designate an individual to serve as its CCO.

<sup>134</sup> Section 4d(d) of the CEA authorizes the Commission to promulgate rules concerning the duties of a CCO of an FCM.

<sup>135</sup> The proposed regulations mis-numbered the subsections of § 3.3 such that two subsections were designated as "(d)." To avoid confusion, this release re-designates such sections correctly in brackets.

<sup>136</sup> A more detailed discussion of the comments can be found in section II.N. above.

<sup>137</sup> Comments from Rosenthal, Newedge, and NFA advocated separate treatment for FCMs, given the Commission's separate statutory authority over them. A number of other commenters, including Better Markets, NSCP, and CII generally supported extension of the same duties to FCMs (provided that certain modifications were made to the proposed rules).

the same requirements for SDs, MSPs, and FCMs. The Commission recognizes commenters' concerns (though not substantiated with quantitative data) that subjecting FCMs to the same CCO requirements as applied to SDs and MSPs by section 4s(k) of the CEA (as codified in these rules) may increase costs for FCMs as compared to a less prescriptive approach. The Commission believes these costs may vary widely among FCMs, depending on the activities in which an FCM engages and the size and complexity of an FCM's operations.<sup>138</sup> Lacking quantitative information requested of commenters, the Commission has looked to public sources to estimate the boundaries of this range. In this regard, it finds the estimates contained in the SEC's 2003 published final compliance program rules for investment companies and investment advisers informative and, in lieu of FCM-specific information, a reasonable proxy for estimating an FCM compliance cost range.<sup>139</sup> The SEC estimated costs for developing a compliance program, depending on the manner chosen, ranging from \$1,000 to \$200,000.<sup>140</sup>

Notwithstanding these costs, the Commission believes the same considerations and benefits, discussed further below, that warrant these regulations for SDs and MSPs, warrant them for FCMs as well. As recent Congressional hearings in the wake of the MF Global bankruptcy have highlighted, an FCM's conduct holds potential to cause severe negative impact to market participants and the public.<sup>141</sup> In that the statutory

<sup>138</sup> In this respect, the Commission observes that 55% of current FCMs are also registered as BDs with the SEC, and thus will already have a CCO and significant compliance regimes as required under the rules of FINRA. See letter from NFA, dated Jan. 18, 2011 (comment file for 75 FR 70881 (Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a FCM, SD, or MSP)). FCMs that do not currently have a CCO or a compliance program may choose to develop a program in-house if their activities are limited and the regulatory requirements well-understood. Other FCMs may choose to purchase an off-the-shelf compliance manual and adjust it to correspond to their regulatory requirements. Still others may hire a third-party compliance firm, a law firm, or an accounting firm to draft a firm-specific manual. As of 2003, when the SEC published final compliance program rules for investment companies and investment advisers, the costs for these options ranged from \$1,000 to \$200,000. See Compliance Programs of Investment Companies and Investment Advisers, 68 FR 74714 (Dec. 24, 2003).

<sup>139</sup> See Compliance Programs of Investment Companies and Investment Advisers, 68 FR 74714 (Dec. 24, 2003).

<sup>140</sup> The SEC considered the same three alternative compliance avenues as noted above for FCMs. See *id.*

<sup>141</sup> See Press Release, Senate Committee on Agriculture, Nutrition & Forestry, Senator Pat

requirements of the CEA and Commission regulations under it seek to prevent harm to market participants and the public by FCMs, the Commission believes that requiring a robust CCO function within FCMs is an important benefit of these regulations. A CCO will serve as a focal point to better monitor and assure FCM legal compliance. Moreover, the Commission believes the role of FCMs likely will grow in importance as client clearing of swaps increases, fostering commensurate growth in the benefits of active compliance monitoring by CCOs of FCMs to the security and stability of swaps markets. The Commission also expects that consistent regulation of its registrants is likely to benefit the Commission's regulatory mission by increasing the efficiency of registrant oversight.

## 2. Harmonization With Other Regulatory Regimes

After reviewing comments,<sup>142</sup> the Commission is modifying its proposal to reduce the cost burden by harmonizing the CCO requirements for SDs, MSPs, and FCMs with the traditional compliance model as reflected in other regulatory regimes—including regimes established by FINRA for broker-dealers (BDs), the FHFA, and by the Commission for RFEDs—to the extent consistent with section 4s(k) of the CEA.<sup>143</sup> Specifically, the Commission

Roberts: We Need Answers on MF Global \* \* \* Futures Still Critical to Risk Management (Dec. 1, 2011), available at <http://www.ag.senate.gov/hearings/continuing-oversight-of-the-wall-street-reform-and-consumer-protection-act> (prepared remarks of Sen. Pat Roberts, ranking subcommittee member, at December 1, 2011 Senate Committee on Agriculture, Nutrition & Forestry).

<sup>142</sup> See e.g., NFA's comment letter and representatives of market participants in a May meeting with SEC and Commission staff (see <http://comments.cftc.gov/PublicComments/>) were concerned with differences between the Commission's proposed rules and FINRA's rules and recommended harmonization. The FHLBs commented that they are subject to FHFA regulation and requested that the Commission not impose duplicative regulations for them. Edison Electric Institute (EEI) urged the Commission to follow the Federal Energy Regulatory Commission's approach by setting forth principles of an effective compliance program while leaving the details to the registrant. FIA and SIFMA noted that the more traditional compliance model—RFEDs are required to designate a CCO and prepare an annual compliance certification under current Commission regulations (see 17 CFR 5.18(j))—would be consistent with the approach the Commission took with regard to RFEDs. FIA and SIFMA, along with Newedge and Rosenthal, argued that the Commission should harmonize its rules with those of FINRA and defer to NFA's experience in determining the proper role for the CCO.

<sup>143</sup> To the extent the other regulatory regimes prescribe CCO rules more general than those specifically required by section 4s(k), they do not conform to statutory requirements and are not implemented in the final rules. However, the

has modified the rule to (1) require that the CCO “administer” the compliance policies of the registrant (rather than establish compliance policies); (2) confirm, as suggested by commenters, that the CCO's role in “resolving” conflicts of interest may involve actions other than making the final decision; (3) provide that the CCO must take “reasonable steps to ensure compliance” (rather than simply “ensure compliance”); and (4) permit either the CCO or the CEO to make the required certification of the annual report.

## 3. Flexibility in Rule's Structure

In the CCO NPRM, the Commission requested comment on whether the structure of the proposed rules allows for sufficient flexibility, thereby permitting FCMs, SDs, and MSPs to control costs by tailoring their compliance programs to their individual circumstances. The comments received raised the following issues with cost-benefit implications:

- Allowing a CCO to perform other duties in addition to compliance duties;<sup>144</sup>
- Designation of multiple CCOs with defined areas of responsibility;<sup>145</sup>
- Allowing a single officer to be CCO for multiple affiliated entities;<sup>146</sup>
- Allowing CCOs of multiple affiliated entities to report to the board of a holding company that controls all affiliated entities;<sup>147</sup>
- Allowing CCOs to consult with other employees, outside consultants, lawyers, and accountants in fulfilling their duties;<sup>148</sup>
- Requiring a senior CCO to have responsibility for multiple affiliated

Commission believes the more specific requirements of section 4s(k) are supplemental—not contradictory—to the more general “policies, procedures, and testing” requirements of the rules of the other regulatory regimes.

<sup>144</sup> NFA and the FHLBs commented that the rules explicitly should permit the CCO to share any other executive role, such as CEO, to provide flexibility for smaller firms.

<sup>145</sup> NFA also argued that the rules should recognize that compliance expertise may reside with more than one individual, and thus the Commission should consider allowing an entity to designate multiple CCOs, so that each CCO's primary area of responsibility is defined, and each CCO should be required to perform duties and responsibilities with respect to their defined area.

<sup>146</sup> Newedge, Hess, and The Working Group argued that affiliated FCMs, SDs, and MSPs that are separate legal entities should be permitted to share the same CCO to increase compliance efficiency.

<sup>147</sup> The Working Group also argued and that the CCO of affiliated registrants should be allowed to report to a board of an affiliated entity that controls both entities.

<sup>148</sup> NFA also recommended that CCOs explicitly be permitted to consult with other employees, outside consultants, lawyers, and accountants.

entities, even if each has its own CCO; and<sup>149</sup>

- Requiring the CCO to be located remotely from the business trading unit.<sup>150</sup>

Having considered these comments, the Commission has taken steps to reduce the cost burden on registrants by expanding the flexibility allowed under the proposed rule. Specifically, the Commission agrees that firms, especially small firms, could reduce costs if a CCO were permitted to perform additional duties and therefore confirms that a CCO may share additional executive responsibilities and/or be an existing officer within the entity. In addition, the final rule would allow registrants to recognize cost savings by not prohibiting multiple legal entities from designating the same individual as CCO. The Commission also is not requiring the CCO to be remotely located from the business trading unit. Moreover, the Commission is modifying the rule to permit either the CCO or the CEO to make the certification required in the annual report, as requested by commenters. This change will reduce the compliance costs insofar as it may make it easier to recruit and retain qualified candidates for CCO. In response to NFA's concern about CCOs being able to rely on the expertise of others, presumably in part to reduce the cost of personally developing the requisite expertise, the Commission confirms that the qualifying language “to the best of his or her knowledge and reasonable belief” in the annual report certification required by the rule permits the CCO or CEO to rely on other experts for statements made in the annual report.

With respect to two of the above-noted issues, however, the statutory language does not afford the Commission flexibility to relax requirements. Specifically, section 4s(k) of the CEA requires the CCO to report to each registrant's board or senior officer, rather than to the board or senior officer of a consolidated corporate parent, so the Commission is unable to adjust the rule to permit the CCOs of multiple affiliated entities to report to the board of a holding company. Similarly, the statutory language of sections 4d(d) and 4s(k) of the CEA—requiring FCMs, SDs, and MSPs to “designate an *individual* to serve as chief compliance officer”—provides the

<sup>149</sup> Better Markets commented that a senior CCO should have overall responsibility of each affiliated and controlled entity, even if individual entities within the group have CCOs.

<sup>150</sup> Better Markets recommended that the rule require the CCO office to be located remotely from the trading floor.

Commission no latitude to permit designation of multiple CCOs with delineated areas of responsibility. The Commission notes that any costs of these requirements are directly attributable to the statutory requirements of Congress, and not to Commission action.

#### 4. Limited Scope of the Rule

Proposed § 3.3(a) required each SD, MSP, and FCM to designate an individual as a CCO and provide the CCO with the full responsibility and authority to develop and enforce, in consultation with the board or senior officer, appropriate policies and procedures to fulfill the duties set forth in the CEA and regulations. The proposed rule also required the CCO to establish policies and procedures required to be established by a registrant pursuant to the CEA and Commission regulations. The Commission believes that the benefits of the rule consist of consolidating oversight of compliance by FCMs, SDs, and MSPs in a single individual, thereby reducing the risk that compliance matters will be subject to inconsistent policies and procedures or that compliance matters will not receive the attention necessary to be effective.

Commenters<sup>151</sup> criticized the proposed rule for two reasons, each presumably based in part on the cost of expanding the traditional role of a CCO:

- A CCO should not be viewed as an enforcer of compliance policies; and
- A CCO should not be required to develop all compliance policies.

The Commission agrees with commenters that the rule could be modified to maintain the benefits identified above while imposing less burden on registrants. The Commission is therefore narrowing proposed § 3.3(a) by (i) removing the requirement that a CCO be provided with “full” responsibility and authority; (ii) removing the requirement that a CCO “enforce” policies and procedures; (iii) limiting the responsibilities of the CCO to (a) the “swaps activities” of SDs and MSPs and (b) FCMs’ derivatives activities included in the definition of FCM under section 1(a)(28) of the CEA; and (iv) clarifying that a CCO need only develop policies and procedures to fulfill the duties set forth in, and ensure

<sup>151</sup> Rosenthal commented that the Commission’s rules should be revised in a manner that reflects the view that the CCO is only an advisor to management and should not be viewed as an enforcer of policies within the FCM. EEI and Newedge argued that the proposed rules go beyond what is required by the CEA by inappropriately imposing upon the CCO full responsibility to develop and enforce all policies.

compliance with, the CEA and Commission regulations. The Commission believes that the rule as modified will achieve the benefits of consolidated compliance oversight without imposing costs on registrants that are unnecessary to achieve this goal.

#### 5. CCO Reporting Line

Proposed § 3.3(a)(1) required that the CCO report to the board of directors or the senior officer of a registrant, that the board or senior officer approve the compensation of the CCO, and that the board or senior officer meet with the CCO at least once a year to discuss the effectiveness of compliance policies and their administration by the CCO.

Proposed § 3.3(a)(2) also prohibited the board or senior officer of a registrant from delegating its authority over the CCO, including the authority to remove the CCO. The Commission believes that these aspects of the rule will ensure CCO independence from influence, interference, or retaliation from business trading unit personnel and freedom from conflicts of interest in performance of the CCO’s duties. The Commission believes CCO independence is crucial to achieving the benefits of the CCO role as envisioned under the statutory provisions of the CEA because an independent CCO is more likely to: (i) speak out on non-compliance issues and raise them with senior management and the board, and (iii) have stature within the firm to successfully institute a culture of compliance.

Commenters raised the following issues with respect to the above-described aspects of the proposed rule:

- The CCO should be permitted to report to the governing body or senior officer of a division, rather than to the board;<sup>152</sup>
- The CCO should be permitted to report to a board committee, rather than to the whole board;<sup>153</sup>
- The CCO should be permitted to report to the board of a holding company;<sup>154</sup>

<sup>152</sup> Cargill recommended that the definition of board of directors be expanded to include a governing body of a division, such as a management committee, and that the Commission add a definition of “senior officer” to include a senior officer of a division, because a division might be more familiar with the swaps activities of an SD.

<sup>153</sup> MetLife requested that the definition of board of directors include expert committees of the whole board.

<sup>154</sup> The Working Group argued that the CCO should be allowed to report to a board of an affiliated entity.

- The CCO should be permitted to report to an officer other than the senior officer;<sup>155</sup>

- CCO compensation and termination decisions should be reserved to the independent members of the board;<sup>156</sup>

- The CCO should be permitted to report to the full board at any time, without interference;<sup>157</sup> and

- The CCO should have the right to address the board prior to termination.<sup>158</sup>

Having considered the costs and benefits implications of these issues, the Commission is adopting the rule as proposed. Section 4s(k) of the CEA requires the CCO to “report directly” to the board or the senior officer of the SD or MSP. The Commission believes, therefore, that despite the costs imposed the statutory requirement that the CCO report directly to the board or senior officer does not permit a firm to have its CCO report to a board committee, the independent members of the board, the board of a holding company, or any officer other than the senior officer.

The Commission recognizes that adopting some commenters’ recommendations would increase the independence of the CCO. The Commission has declined to modify the rule to include such recommendations because it believes the benefits outlined above will be sufficiently assured by the rule as adopted herein and thus the additional burden of more stringent independence requirements is unnecessary at this time.

#### 6. Qualifications of the CCO

As proposed, § 3.3(b) required the CCO to have the background and skills appropriate for fulfilling the responsibilities of the position, and prohibited an individual who is statutorily disqualified under sections 8a(2) or 8a(3) of the CEA from serving. The Commission rationale for this is that a well-qualified CCO, without a history of disqualifying attributes, is

<sup>155</sup> EEI, FIA, SIFMA, NFA, and The Working Group argued that the CCO should be permitted to operate under the direction of corporate officers other than the senior officer, as long as independence and authority as a control function is maintained.

<sup>156</sup> Better Markets and Chris Barnard recommended that decisions to designate or terminate a CCO, as well as compensation decisions, be prescribed solely by independent members of the board, acting by majority vote.

<sup>157</sup> NWC recommended that (1) the term “senior officer” be defined as the CEO or chairman of the board, (2) the rule should permit the CCO to report to the full board at any time with no interference from a board committee or a CEO, and (3) that the rule should prohibit termination of the CCO unless the CCO is presented the opportunity to address the board.

<sup>158</sup> *Id.*

more likely to fulfill the duties of the position successfully and have the stature and experience to demand the respect necessary to instill a culture of compliance. The Commission believes that an effective CCO serves an important role in guarding against registrant failures and misfeasance, and the resulting losses to customers and other market participants.

Commenters criticized the above-described aspects of the proposed rule as follows, but no commenter provided any quantitative data to justify their arguments:

- It is unnecessary to include statutory disqualification as a qualification for the CCO;<sup>159</sup>
- “Background and skills appropriate for fulfilling the responsibilities of the position” is too vague a standard—qualifications should be left to the discretion of the firm;<sup>160</sup>
- The Commission should require CCOs to pass a specific compliance examination and be licensed;<sup>161</sup> and
- The Commission should prohibit members of a firm’s legal department from acting as CCO due to potential conflicts of interest.<sup>162</sup>

Based on the issues raised by commenters, the Commission presumes that commenters are concerned about the cost of locating, recruiting, and compensating a CCO that meets the necessary qualifications, or about the costs to the market if CCOs are not well-qualified and fail to fulfill their duties under the CEA and rule. The Commission estimates that a well-qualified CCO for an FCM, SD, or MSP is likely to be compensated at approximately \$216,000 per year.<sup>163</sup>

<sup>159</sup> NFA argued that the prohibition on individuals who are disqualified by statute is unnecessary because an SD, MSP, or FCM’s registration could be denied or revoked under section 8a(2)–(3) of the CEA if any principal of the registrant is subject to a statutory disqualification.

<sup>160</sup> Cargill commented that the requirement for a CCO to have “the background and skills appropriate” is a commendable aspirational goal but is too vague a standard for Federal law, and is best reserved as a business decision. The Working Group also commented that wide latitude for qualifications of a CCO is necessary.

<sup>161</sup> Newedge recommended that CCOs be required to pass a specific compliance examination and obtain a specific compliance license, as is the case in the securities world.

<sup>162</sup> Better Markets argued that a CCO should not be permitted to be an attorney that represents the SD, MSP, or FCM, or its board because the potential conflict would disqualify such an attorney.

<sup>163</sup> The Commission staff estimates concerning the wage rates are based on salary information for the securities industry compiled by SIFMA. The salary estimate was taken from SIFMA Report on Management & Professional Earnings in the Securities Industry 2010. Staff took an average of the last two years of salary estimates for Chief Compliance Officers, modified to account for inflation as well as overhead and other benefits,

Having considered the costs and benefits implications of these issues, the Commission is adopting the rule as proposed. Given the duties and responsibilities of the CCO as set forth in the CEA and the rule, the Commission believes that the cost to FCMs, SDs, and MSPs to hire a well-qualified person to act as CCO are appropriate given the critical role the CCO will play in ensuring registrants comply with the CEA and Commission regulations. Moreover, the Commission believes the qualifications required by the rule as proposed are sufficient to ensure the necessary level of CCO qualification without need to adopt the more restrictive CCO qualifications (e.g., an examination and licensing requirement and/or legal counsel bar) recommended by some commenters. To maintain flexibility in the rule for the wide variety of registrants that will be affected, the Commission also is not defining what the “background and skills appropriate for fulfilling the responsibilities of the position” would be, leaving this determination to the discretion of the registrant as appropriate to their unique circumstances.

#### 7. Role of the CCO

As proposed, § 3.3 established a number of duties for the CCO. Proposed § 3.3(d)(1) required the CCO to establish the registrant’s compliance policies in consultation with the board of directors or senior officer. Proposed § 3.3(d)(2) required the CCO, in consultation with the board or senior officer, to resolve any conflicts of interest that may arise. Proposed § 3.3(d)(3) required the CCO to review and “ensure compliance” by the registrant with the registrant’s compliance policies and all applicable laws and regulations.

Commenters criticized the above-described aspects of the proposed rule as follows:

- Responsibility for resolving conflicts of interest belongs more appropriately to the board or senior officer, not a CCO;<sup>164</sup>

then adjusted upward based on the additional responsibility demanded from SD, MSP, and FCM CCOs as required by the CEA (as noted by commenters).

<sup>164</sup> NFA commented that resolution of conflicts of interest should rest with the board or the senior officer, in consultation with the CCO. FIA and SIFMA argued that when Congress used the term “resolve any conflicts of interest that may arise,” Congress did not mean resolve in the executive or managerial sense. Newedge commented that the CEO and business line supervisors are in a better position than the CCO to resolve conflicts. Participants in the May Meeting with Commission staff stated that resolving a conflict would traditionally be interpreted as eliminating the conflict, but that elimination is not always

• Responsibility for ensuring compliance belongs more appropriately to the board or senior officer, not a CCO;<sup>165</sup>

- The transfer of regulatory responsibility from executive officers to the CCO may result in executive officers spending less time and attention to compliance matters;<sup>166</sup>
- Firms will have difficulty retaining a CCO who is willing to perform the duties set forth in the rule.<sup>167</sup>

Having considered the cost and benefit implications of these issues, the Commission presumes that commenters are concerned in part about the cost of expanding their compliance departments to fulfill duties currently or traditionally handled by other executive officers or departments. In response to this concern, the Commission is adopting the final rule as follows: (1) The Commission is revising proposed § 3.3(d)(1) to track more closely the statutory language of section 4s(k) and require that the CCO “administer” the compliance policies of the registrant; (2) the Commission is not removing the requirement that the CCO “resolve” conflicts of interest from the rule because the requirement is provided for in section 4s(k)(2)(C) of the CEA, but confirms, as suggested by commenters, that the CCO’s role in “resolving” conflicts of interest may involve actions other than making the final decision; and (3) the Commission is modifying proposed § 3.3(d)(3) to provide that the CCO must take “reasonable steps to ensure compliance.”

preferable and the compliance officer should not be the actual decision maker in the resolution.

<sup>165</sup> NSCP argued that “ensure compliance” imposes a level of responsibility on a CCO that cannot be discharged and is inconsistent with the customary role of a compliance officer. Hess argued that the proposal concentrates too much of the compliance function on a single individual and recommended that the CCO should remain the monitor of the compliance monitors. FIA, SIFMA, The Working Group, Newedge, and NFA each argued that requiring the CCO to ensure compliance goes beyond existing compliance models and creates a standard that is impossible to satisfy. FIA and SIFMA further argued that the requirement to remediate non-compliance issues acknowledges that instances of non-compliance are not wholly preventable by any person. FIA and SIFMA recommended that “ensure compliance” should mean taking reasonable steps to adopt, review, test, and modify compliance policies. EEI and participants in the May Meeting with Commission staff stated that ensuring compliance could mean that the CCO escalates a problem that has not been resolved.

<sup>166</sup> Newedge believes that any transfer of regulatory responsibility currently held by executive officers to the CCO could have the unintended effect of reducing the amount of time such officers spend on compliance matters.

<sup>167</sup> NFA also argued that the rules improperly redefine a CCO’s duties, and registrants will have difficulty retaining CCOs who are willing to perform these duties.

The foregoing changes align the rule to the duties of the CCO for SDs and MSPs as set forth in the CEA, and, thus, the costs of these requirements are directly attributable to the statutory requirements of Congress, and not to Commission action. The Commission's decision to extend the same requirements to CCOs for FCMs is explained in detail above.

#### 8. Certification of the Annual Report by the CCO "Under Penalty of Law"

Proposed § 3.3(d)(6) required the CCO of an SD, MSP, or FCM to prepare, sign, and certify, under penalty of law, the annual report specified in section 4s(k)(3) of the CEA.

Commenters criticized the above-described aspects of the proposed rule as follows:

- The CEO, not the CCO, should certify the annual report;<sup>168</sup>
- Requiring the CCO to certify the annual report under penalty of law will make it difficult for registrants to retain a CCO and, thus, should not be required;<sup>169</sup> and
- The required certification should be subject to a materiality qualifier.<sup>170</sup>

<sup>168</sup> Rosenthal commented that FINRA's approach to certification is preferable, i.e., the CEO certifies that the firm has processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with securities laws, regulations, and FINRA rules. FIA, SIFMA, and Newedge each argued that section 4s(k)(3) of the CEA requires the CCO to sign the annual report, but does not require the CCO to certify the report. FIA, SIFMA, MFA, Newedge, and NFA all recommended that the rule be revised to require the CEO to certify the report. Participants in the May Meeting with Commission staff stated that requiring the CEO to make the certification appropriately shares responsibility between compliance and business management. FIA and SIFMA recommended that, with respect to any Commission registrant that is also a BD, the Commission should require the CEO to make the certification.

<sup>169</sup> FIA and SIFMA felt that imposing criminal liability for annual report certifications would hinder the ability to fill the position of CCO. FIA and SIFMA requested that the Commission clarify that criminal liability for the certification will not apply (absent a knowing and willful materially false and misleading statement) because there is no indication that Congress ever thought CCOs should be subject to criminal liability. Similarly, NSCP requested that the Commission clarify whether "under penalty of law" means liability under 18 U.S.C. 1001 for a false statement to a Federal officer. Rosenthal argued that requiring the CCO to certify under penalty of law will make the CCO liable for firm infractions and will give disgruntled customers a roadmap for frivolous lawsuits. Newedge also believes that the requirement to certify under penalty of law is not fair or practicable because whoever certifies will have to rely on many individuals to compile the report. On the other hand, Hess commented that the certification language strikes an appropriate balance such that strict liability is not imposed for inadvertent errors.

<sup>170</sup> NSCP commented that the certification that the report is accurate and complete should have a materiality qualifier added to it. Participants in the

Having considered the cost-benefit implications of these issues and the arguments raised by commenters, the Commission is modifying the requirement that the CCO make the required certification of the annual report to allow the registrant the discretion to choose whether the CCO or the CEO makes the certification. As explained by commenters, this change will make it easier and less costly for registrants to recruit and retain candidates for the position of CCO.

However, consistent with the statutory text in section 4s(k)(3)(B)(ii) of the CEA, the Commission is also declining to add a materiality qualifier to the certification, as suggested by commenters. Moreover, not qualifying certification on materiality is consistent with the approach taken in final rules for SDRs<sup>171</sup> and DCOs,<sup>172</sup> and with proposed CCO rules for SEFs;<sup>173</sup> the Commission expects consistent regulation of its registrants and registered entities to benefit the Commission's regulatory mission by increasing the efficiency of oversight. The Commission believes that limiting the CCO's certification requirement with the qualifier "to the best of his or her knowledge and reasonable belief" sufficiently mitigates commenters' liability costs concerns because the rule would not impose liability for compliance matters that are beyond the certifying officer's knowledge and reasonable belief at the time of certification.

Having modified the rule as described above, and otherwise confined the rule to the requirements of the CEA, the Commission believes that the costs of these requirements are directly attributable to the statutory requirements of Congress, and not to Commission action. The Commission's decision to extend the same requirements to CCOs for FCMs is explained in detail above.

#### 9. Content of the Annual Report

The proposed regulation required the annual report to contain (1) a description of the compliance by the registrant with respect to the CEA and regulations; (2) a description of each of the registrant's compliance policies; (3) a review of each applicable

May Meeting with Commission staff urged the Commission to adopt a standard for the annual report certification that is reasonably attainable.

<sup>171</sup> See Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR at 54584.

<sup>172</sup> See Derivatives Clearing Organization General Provisions and Core Principles, 76 FR at 69435.

<sup>173</sup> See Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214, 1252 (Jan. 7, 2011).

requirement under the CEA and regulations, and, with respect to each, identification of the policies that ensure compliance, an assessment as to the effectiveness of the policies, discussion of areas of improvement, and recommendations of potential or prospective changes or improvements to its compliance program and resources devoted to compliance; (4) a description of the registrant's financial, managerial, operational, and staffing resources set aside for compliance with the CEA and regulations, including any deficiencies in such resources; (5) a delineation of the roles and responsibilities of a registrant's board of directors or senior officer, relevant board committees, and staff in addressing any conflicts of interest, including any necessary coordination with, or notification of, other entities, including regulators; and (6) a certification of compliance with sections 619 and 716 of the Dodd-Frank Act (the Volcker Rule and Derivatives Push-Out), and any rules adopted pursuant to these sections. The proposed rule also required FCMs, SDs, and MSPs to maintain records of its compliance policies, materials provided to the board in connection with its review of the annual compliance report, and work papers that form the basis of the annual compliance report.

The Commission believes the benefits of the annual report result from the focus on compliance with the CEA and Commission regulations. The annual requirement to compile in a single document the results of a registrant's compliance policies and procedures should serve as an efficient means to focus the registrant's board and senior management on areas requiring additional compliance resources or changes to business practices; it also will provide the Commission with a detailed overview of the state of compliance of the industry as a whole. This annual and ongoing compliance focus will result in increased industry compliance, thereby increasing market security and stability. A secure and stable market fosters increased market confidence and increased activity by investors and hedgers managing risk.

Commenters raised the following issues with respect to the above-described aspects of the proposed rule:

- Overbreadth concerns with the requirements for the content of the annual report;<sup>174</sup>

<sup>174</sup> NSCP, The Working Group, EEL, and Hess each argued that the level of detail contemplated by the rule would impose unnecessary burdens on the CCO with little offsetting benefits. NSCP argued that a better approach would be to follow the SEC requirements for annual reviews of compliance by registered investment advisers. NSCP believes the

- Concern that the annual report is not subject to board approval or a board addendum noting any disagreement with the report;<sup>175</sup>

- Concern that some requirements for the content of the annual report are inappropriate for a document that may be publicly available;<sup>176</sup> and

- Concern that, absent a materiality qualifier, the recordkeeping obligations will be unduly burdensome.<sup>177</sup>

proposed rule is overbroad and discourages reporting of compliance issues to the CCO. Newedge argued that thousands of Federal, SRO, and internal rules apply, so the report should contain a summation of compliance, with details only for areas of material noncompliance. FIA and SIFMA argued that a one-size-fits-all approach to the annual report requirements is not appropriate because registrants vary in size and focus. FIA, SIFMA, and The Working Group recommended that the Commission specify the material issues that should be discussed, or provide a standard form. FIA, SIFMA, and NFA also argued that the report should identify the policies that are reasonably designed to result in compliance, not that ensure compliance. Hess recommended that the annual report contain only a summary of the registrant's compliance policies and procedures. CMC commented that the scope of activities included in the annual report should be limited to those directly triggering the requirement of a CCO. EEI argued that inclusion of descriptions of violations in the report should be decided on a case-by-case basis by the registrant's governing body. NFA requested that a materiality qualifier be added to the requirement that registrants include a description of non-compliance. FIA and SIFMA argued that the CCO is not in a position to describe the financial, material, operational, and staffing resources set aside for compliance, rather the CCO only should be required to describe the resources of the compliance department and any recommendations that the CCO has made to senior management with regard to the same. FIA and SIFMA argued that the Sarbanes-Oxley Act already requires public companies to report the roles and responsibilities of its board, senior officers, and committees in resolving conflicts of interest, so the Commission should allow such reporting to satisfy this content requirement for the annual report. NFA also recommended that the reporting of any necessary coordination with, or notification of other entities, including regulators, should be deleted. NFA, FIA, and SIFMA recommended that the certification of compliance with sections 619 and 716 of the Dodd-Frank Act be deleted, arguing that the Commission should wait for the implementing rulemakings for such sections before determining certification requirements.

<sup>175</sup> Better Markets recommended that the board approve the annual report in its entirety or specify where and why it disagrees with any provision, and then CCOs should provide the report to the Commission either as approved or with statements of disagreement.

<sup>176</sup> The Working Group argued that a description of deficiencies in resources dedicated to compliance would require a CCO to identify potential shortcomings and report them in a document likely to be available to the public, which could materially hinder the CCO's ability to function as an integral member of the management team.

<sup>177</sup> The Working Group argued that retaining all materials relating to the preparation of the report will cause the CCO to retain all materials for fear of an audit that second-guesses the CCO's materiality judgments, or the CCO will limit his or her inquiries to avoid making a determination of materiality. The Working Group recommended that

In response to comments, the Commission has reduced the cost burden of the annual report by modifying the rule as follows: (1) Requiring a description of the registrant's policies and procedures, rather than a description of the compliance of the registrant; (2) requiring identification of the registrant's policies and procedures that "are reasonably designed" to ensure compliance, rather than those that ensure compliance; (3) including a required description of *material* non-compliance issues; (4) including a materiality standard with respect to the description of any deficiency in compliance resources; (5) deleting the proposed delineation of the roles and responsibilities of a registrant's board of directors or senior officer, relevant board committees, and staff in addressing any conflicts of interest; and (6) removing the requirement to certify compliance with sections 619 and 716. The Commission has not modified the recordkeeping requirement because it believes the rule sufficiently qualifies the materials that must be retained by stating that the records must be "relevant" to the annual report.

The Commission observes that section 4s(k) of the CEA requires the annual report and specifies that it contain a description of the compliance of the SD or MSP with respect to the CEA, and a description of each policy and procedure of the SD or MSP of the CCO (including the code of ethics and conflict-of-interest policies). To the extent that the rule also requires these descriptions, the Commission believes that the costs of these requirements are attributable to statutory requirements not subject to Commission discretion. The Commission's decision to extend the same requirements to CCOs for FCMs is explained in detail above. Therefore, the Commission believes the modified rule would impose modest costs, attributable to the narrow requirements of: (i) Listing any material changes to compliance policies and procedures; and (ii) describing the financial, managerial, operational, and staffing resources set aside for compliance, including any material deficiencies. The Commission believes the benefits of these requirements warrant the limited incremental costs to comply.

#### Costs

Section 4s(k) requires SDs and MSPs to designate a CCO and undertake certain other compliance measures. The

materials to be retained should be only those germane to the content of the compliance report.

costs and benefits that necessarily result from these basic statutory requirements are considered to be the "baseline" against which the costs and benefits of the Commission's final rules are compared or measured. The "baseline" level of costs includes the costs that result from the following activities required by the statute:

- Designating a CCO;
- Corporate governance changes to require the CCO to report directly to the board or senior officer;
- Reviewing the compliance of the SD and MSP with section 4s of the CEA;
- Requiring the CCO, in consultation with the board or the senior officer, to resolve any conflicts of interest;
- Administration of each policy and procedure required to be established under section 4s;
- Ensuring compliance with the CEA and Commission regulations relating to swaps;
- Establishing procedures for the handling, management response, remediation, retesting, and closing of non-compliance issues;
- Preparing and signing a compliance report containing a description of compliance and a description of each policy and procedure of the SD or MSP; and
- Furnishing the annual report to the Commission along with each appropriate financial report.

Similarly Section 4d(d) defines a statutory "baseline" against which the costs and benefits of the Commission's final rules are to be measured with respect to FCMs. That "baseline" cost level is defined by those costs that result from an FCM's CCO designation.

Compliance with the statutory baselines alone will result in costs for FCMs, SDs and MSPs. For example, designating a CCO that reports to the board or senior officer could include the cost of board action and the salary of the CCO. Similarly, preparing and signing a compliance report containing a description of compliance and each compliance policy and procedure entails the cost of the CCO's time.

Congress mandated that the Commission adopt rules to implement each of the statutory provisions. The following implementation decisions may cause affected entities to incur costs to comply with the final regulations regarding designation of a CCO, the duties of the CCO, and the annual report:

- Extending the statutory and rule requirements applicable to SDs and MSPs to FCMs;
- Providing the CCO with authority to develop, in consultation with the board

or senior officer, appropriate policies and procedures;

- Requiring the board or senior officer to appoint the CCO, approve the CCO's compensation, and meet with the CCO once a year;

- Requiring designation of a CCO with the background and skills appropriate for fulfilling the responsibilities of the position and that is not statutorily disqualified;

- Submission of a Form 8-R to the Commission for the CCO as a principal of the firm;

- Listing any material changes to compliance policies and procedures in the annual report; and

- Describing the financial, managerial, operational, and staffing resources set aside for compliance, including any material deficiencies, in the annual report.

As discussed, the Commission has attempted, wherever possible, to alleviate burdens for registrants while remaining consistent with the CEA. The Commission has taken steps to reduce the responsibilities of the CCO and lower staffing and corporate governance costs for the entity by permitting the CCO to perform other duties and act as the CCO for more than one entity. The Commission has removed the requirement that the CCO be provided with the authority to enforce compliance policies and procedures, limited the CCO's duties to those directly required by the CEA and Commission regulations relating only to the swaps activities of SDs and MSPs and the derivatives activities included in the definition of FCM under section 1(a)(28) of the CEA, and required the CCO be responsible for administering, not establishing, compliance policies. The Commission also is permitting either the CCO or the CEO to certify the annual report.

The Commission estimates a base salary for a Chief Compliance Officer in the financial services industry at approximately \$216,000 per year, as explained above. Because entities may designate a current employee as the CCO, some SDs, MSPs, or FCMs may not need to hire an additional member of staff. For example, entities currently regulated by prudential authorities already may have a CCO or another employee who could serve as a CCO; other entities may determine it is more cost-effective based on their current business models to designate a current employee as CCO, perhaps adjusting that individual's salary accordingly. Because of the wide variety of possibilities in determining the compensation of a CCO, the Commission finds it is impossible to

estimate a cost burden for the industry of the statutory requirement to designate a CCO.

One commenter presented a report prepared by NERA stating that designation of a CCO and preparation of an annual compliance report by certain entities would entail average incremental start-up costs of \$445,000 and average incremental ongoing annual costs of \$760,000.<sup>178</sup> The Commission observes that the incremental average costs provided by NERA do not differentiate between the costs of compliance with proposed § 3.3 and the costs of compliance with sections 4d(d) and 4s(k) of the CEA absent Commission rulemaking. Accordingly, the Commission believes that the cost estimates presented by NERA exceed the incremental costs attributable to Commission rulemaking. The NERA report, however, provides insufficient information to allow the Commission to assess the magnitude of the excess.

Other than as indicated below with respect to CCO compensation and costs resulting from collections of information subject to the Paperwork Reduction Act, incorporated by reference herein, the Commission has no reliable quantitative data from which to reasonably estimate the costs of compliance associated with the CCO's duties and the annual report required by the rules in this release. After conducting a review of applicable academic literature, the Commission is not aware of any research reports or studies that are directly relevant to its considerations of costs and benefits of the final rules. The Commission anticipates that many entities may currently have a CCO pursuant to other regulations. The Commission notes that dually registered FCMs and BDs are more likely to have a CCO<sup>179</sup> than entities that are subject to such requirement for the first time.<sup>180</sup> Costs,

<sup>178</sup> NERA, Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition Prepared for the Working Group of Commercial Energy Firms, December 20, 2011. In this late-filed comment supplement, NERA concludes that cost-benefit considerations compel excluding entities "engaged in production, physical distribution or marketing of natural gas, power, or oil that also engage in active trading of energy derivatives"—termed "nonfinancial energy companies" in the report—from regulation as swap dealers, including § 3.3.

<sup>179</sup> In this respect, the Commission observes that 55% of current FCMs are also registered as BDs with the SEC, and thus may already have a CCO as required under the rules of FINRA. See letter from NFA, dated Jan. 18, 2011 (comment file for 75 FR 70881 (Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a FCM, SD, or MSP)).

<sup>180</sup> The Commission notes that in 2006 the UK FSA conducted a cost benefit analysis when promulgating requirements related to ensuring effective compliance with the applicable regulatory framework, including a requirement that a

therefore, are expected to be higher for those entities not currently dually registered. Registrants that do not currently have a CCO or a compliance program may choose to develop a program in-house if their activities are limited and the regulatory requirements well-understood. Other registrants may choose to purchase an off-the-shelf compliance manual and adjust it to correspond to their regulatory requirements. Still others may hire a third-party compliance firm, a law firm, or an accounting firm to draft a firm-specific manual. As of 2003, when the SEC published final compliance program rules for investment companies and investment advisers, the costs for these options ranged from \$1,000 to \$200,000.<sup>181</sup>

Certain of the costs associated with these CCO, compliance policy, and annual report rules result from collections of information subject to the Paperwork Reduction Act. Costs attributable to collections of information subject to the PRA are discussed further in section V.B.3. below. The Commission has also considered these costs, which it incorporates by reference herein, in its section 15(a) analysis.

#### Benefits

The Commission believes that the CCO rules will protect market participants and the public by promoting compliance with the CEA and Commission regulations through (1) the designation and effective functioning of the CCO, and (2) the establishment of a framework for preparation of a meaningful annual review of an FCM's, SD's, and MSP's compliance program. As a qualified, impartial, accountable focal point, the CCO is an effective vehicle to ensure that vital market actors—SDs, MSPs, and FCMs—comply with the law and

compliance officer be appointed that reports to the governing body and has the necessary authority and responsibility for the compliance oversight function. The UK FSA was adopting rules that replaced existing guidance and concluded from survey results that the incremental aggregate cost of compliance for approximately 2000–2500 firms was £4.5 to 5.5 million in one-off costs (\$7.1 to 8.6 million at the current exchange rate, or \$3,550 to \$4,300 per firm) and £6.5 to 8.5 million in ongoing costs (\$10.1 to 13.3 million at the current exchange rate, or \$5,050 to \$6,650 per firm). See FSA Consultation Paper 06/9, Organisational Systems and Controls: Common Platform for Firms, Annex 2 (May 2006).

<sup>181</sup> See Compliance Programs of Investment Companies and Investment Advisers, 68 FR 74714 (Dec. 24, 2003). The Commission notes that significant differences in the activities and structures of investment advisors and SDs/MSPs/FCMs may create significant differences in the costs incurred by the respective entities; these SEC estimates provide at best an imperfect measure from which to very roughly attempt to gauge compliance costs for affected entities.

regulations, including those designed to contain systemic risk through appropriate risk management efforts. In this way, these rules foster financial integrity and responsible risk management practices to protect the public from the adverse consequences of FCM, SD, or MSP failure or misfeasance that an effective compliance program may help to prevent.

The annual compliance report will help FCMs, SDs, MSPs, and the Commission to assess whether the registrant has mechanisms in place to address adequately compliance problems that could lead to a failure of the registrant. It also will assist the Commission in determining whether the registrant remains in compliance with the CEA and the Commission's regulations, including the customer protection regime for segregation of customer funds, supervision of trading activities, and risk management. Such compliance will protect market participants and the public from market disruptions and financial losses resulting from the failure or misfeasance of a registrant.

#### Section 15(a) Determination

##### 1. Protection of Market Participants and the Public

The Commission believes that the compliance measures specified in these rules reinforce the CEA's protections for swap market participants, futures markets participants, and the public. Just as the CEA's regulation of futures and swaps transactions promotes the "national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities"<sup>182</sup> so do these rules by ensuring, through a CCO, that entities are in compliance with CEA regulations. Concentrating compliance responsibility in one individual with independent authority, rather than dispersing it throughout an organization (and thus potentially diminishing accountability), is one example of this. Compliance evaluation and preparation of an annual report are other examples. Thus, taken together, these requirements set out a compliance regime that endeavors to ensure protection for market participants and public that the CEA is intended to provide. Moreover, to the extent that provisions of the CEA diminish the potential for harmful market disruptions and attendant financial losses to market participants and the general public as

Congress intended in enacting the Dodd-Frank Act, these rules enhance that protection.

While the Commission recognizes there are costs associated with this rulemaking and the mandate from Congress it represents, the Commission believes that, as discussed above, it has included measures to afford firms flexibility in the designation of a CCO, as well as other made other burden-reducing changes to the proposed rules. It believes these measures minimize the costs attributable to implementation decisions within its statutory authority. The Commission does not believe that any such incremental costs undermine effective protection of market participants and the public, but rather will be a worthwhile investment toward enhancing that protection.

##### 2. Efficiency, Competitiveness, and Financial Integrity of Markets<sup>183</sup>

Secure and stable SDs, MSPs, and FCMs are critical components of the efficient, competitive, and financially sound functioning of derivatives markets—futures and swaps. The financial integrity of these markets, in particular, is achieved through layers of protection. Requirements for an effective FCM, SD, and MSP compliance program will add a new layer of protection to ensure that registrants remain compliant with the CEA and Commission regulations, and in particular those relating to risk management, diligent supervision, and system safeguards.

An effective CCO will provide benefits to FCMs, SDs, and MSPs and the markets they serve by implementing and overseeing compliance measures that enhance the safety and efficiency of registrants and reduce systemic risk. Reliable and financially sound FCMs, SDs, and MSPs are essential for the stability of the derivatives markets they serve, and for the greater public, which benefits from a sound financial system.

The Commission believes that to the extent there are any incremental costs associated with these rules attributable to the implementation decisions within its statutory authority, they are competitively neutral. They do not favor or disfavor any class of market participant over others. In other words, no entity should have a greater advantage over another based on these rules alone.

<sup>183</sup> Although by its terms CEA section 15(a)(2)(B) applies to futures markets only, the Commission finds this factor useful in analyzing regulations pertaining to swaps markets as well.

##### 3. Price Discovery

The Commission has identified no likely material impact on price discovery from the costs and benefits of these rules pertaining to CCO designation and related compliance requirements.

##### 4. Sound Risk Management

The Commission believes these rules promote sound risk management. The regulatory provisions that interpret or implement the statutory requirements for the CCO and annual report serve to reinforce and ensure the effectiveness of FCM, SD, and MSP compliance programs, including their risk management components. Compliance with § 23.600 (risk management program) and related regulations encompasses, among other things, policies and procedures for monitoring and managing of credit exposures to counterparties, market risk, liquidity risk, settlement risk, and other applicable risk exposures. Compliance with § 1.14 (risk assessment recordkeeping requirements for FCMs) and related regulations encompasses, among other things, policies and procedures for monitoring and managing of credit risk, market risk, and other applicable risk exposures. The CCO has responsibility to ensure that the FCM, SD, or MSP is compliant with these regulations. Costs attendant to satisfying CCO and annual report requirements in these rules represent an investment towards improved risk management, not a diminution from them.

##### 5. Other Public Interest Considerations

The Commission does not believe that the rule will have a material effect on public interest considerations other than those identified above.

#### H. Conclusion

Having considered the costs and benefits of the final rules in light of the factors enumerated in section 15(a)(2) of the CEA, the Commission is adopting the rules as set forth in this release.

#### V. Related Matters

##### A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA)<sup>184</sup> requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and if so, provide a regulatory flexibility analysis respecting the impact. The Commission has already established certain definitions of "small entities" to

<sup>184</sup> 5 U.S.C. 601 *et seq.*

<sup>182</sup> Section 3(a) of the CEA.

be used in evaluating the impact of its rules on such small entities in accordance with the RFA.<sup>185</sup> SDs and MSPs are new categories of registrant. Accordingly, the Commission noted in the proposals that it had not previously addressed the question of whether such persons were, in fact, small entities for purposes of the RFA.

In this regard, the Commission explained that it previously had determined that FCMs should not be considered to be small entities for purposes of the RFA, based, in part, upon FCMs' obligation to meet the minimum financial requirements established by the Commission to enhance the protection of customers' segregated funds and protect the financial condition of FCMs generally. Like FCMs, SDs will be subject to minimum capital and margin requirements, and are expected to comprise the largest global financial firms—and the Commission is required to exempt from designation as an SD entities that engage in a de minimis level of swaps dealing in connection with transactions with or on behalf of customers. Accordingly, for purposes of the RFA for the proposals and future rulemakings, the Commission proposed that SDs not be considered "small entities" for essentially the same reasons that it had previously determined FCMs not to be small entities.

The Commission further explained that it had also previously determined that large traders are not "small entities" for RFA purposes, with the Commission considering the size of a trader's position to be the only appropriate test for the purpose of large trader reporting. The Commission then noted that MSPs maintain substantial positions in swaps, creating substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. Accordingly, for purposes of the RFA for the proposals and future rulemakings, the Commission proposed that MSPs not be considered "small entities" for essentially the same reasons that it previously had determined large traders not to be small entities.

The Commission concluded its RFA analysis applicable to SDs and MSPs as follows: "The Commission is carrying out Congressional mandates by proposing these rules. The Commission is incorporating registration of SDs and MSPs into the existing registration structure applicable to other registrants.

In so doing, the Commission has attempted to accomplish registration of SDs and MSPs in the manner that is least disruptive to ongoing business and most efficient and expeditious, consistent with the public interest, and accordingly believes that these registration rules will not present a significant economic burden on any entity subject thereto."

The Commission did not receive any comments on its analysis of the application of the RFA to SDs and MSPs.

The final rules will also impact FCMs and IBs, each of which is addressed separately in the following paragraphs.

In its proposals, the Commission explained that it had previously established certain definitions of "small entities" to be used in evaluating the impact of the Commission's rules on such small entities in accordance with the RFA. In the Commission's "Policy Statement and Establishment of Definitions of 'Small Entities' for Purposes of the Regulatory Flexibility Act,"<sup>186</sup> the Commission concluded that registered FCMs should not be considered to be small entities for purposes of the RFA. The Commission's determination in this regard was based, in part, upon the obligation of registered FCMs to meet the capital requirements established by the Commission. Likewise, the Commission determined "that, for the basic purpose of protection of the financial integrity of futures trading, Commission regulations can make no size distinction among registered FCMs."<sup>187</sup> Thus, with respect to registered FCMs, the Commission believes that the proposed regulations will not have a significant economic impact on a substantial number of small entities.

The Commission previously has determined that, for purposes of the RFA, the Commission should "evaluate within the context of a particular rule proposal whether all or some [IBs] should be considered to be small entities and, if so, to analyze the economic impact on [IBs] of any such rule at that time. Specifically, the Commission recognizes that the [IB] definition, even as narrowed to exclude certain persons, undoubtedly encompasses many business enterprises of variable size."<sup>188</sup> At present, IBs are subject to various existing rules that govern and impose minimum requirements on their internal compliance operations, based on the nature of their business. The

Commission believes that the amendments will merely augment the existing compliance requirements of such persons to address potential conflicts of interest within such firms. To the extent that certain IBs may be considered to be small entities, the Commission believes that the final rules will not have a significant economic impact.

The Commission did not receive any comments on its analysis of the application of the RFA to FCMs and IBs.

Accordingly, pursuant to Section 605(b) of the RFA, 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies that these rules and rule amendments will not have a significant economic impact on a substantial number of small entities.

#### *B. Paperwork Reduction Act*

The Commission may not conduct or sponsor, and a registrant is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number. The Commission's adoption of §§ 23.200 through 23.205 (Reporting, Recordkeeping, and Daily Trading Records), 23.600 (Risk Management Program), 23.601 (Monitoring of Position Limits), 23.602 (Diligent Supervision), 23.603 (Business Continuity and Disaster Recovery), 23.605 (Conflicts of Interest Policies and Procedures for SDs and MSPs), 23.606 (General Information: Availability for Disclosure and Inspection), 23.607 (Antitrust Considerations), 3.3 (Chief Compliance Officer), and 1.71 (Conflicts of Interest Policies and Procedures for FCMs and IBs) impose new information collection requirements on registrants within the meaning of the Paperwork Reduction Act.<sup>189</sup>

Accordingly, the Commission requested and OMB assigned control numbers for the required collections of information. The Commission has submitted this notice of final rulemaking along with supporting documentation for OMB's review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for these collections of information are "Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, OMB control number 3038-0087," "Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, OMB control number 3038-0084," "Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap

<sup>186</sup> 47 FR 18618, Apr. 30, 1982.

<sup>187</sup> *Id.* at 18619.

<sup>188</sup> 48 FR 35248, 35276, Aug. 3, 1983.

<sup>189</sup> 44 U.S.C. 3501 *et seq.*

<sup>185</sup> 47 FR 18618 (Apr. 30, 1982).

Participants, OMB control number 3038–0079,” “Annual Report for Chief Compliance Officer of Registrants, OMB control number 3038–0080,” and “Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers, OMB control number 3038–0078.”<sup>190</sup> Many of the responses to this new collection of information are mandatory.

The Commission protects proprietary information according to the Freedom of Information Act and 17 CFR part 145, “Commission Records and Information.” In addition, Section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the Act, from making public “data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers.” The Commission also is required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

The regulations require each respondent to furnish certain information to the Commission and to maintain certain records.<sup>191</sup> The

<sup>190</sup> These collections include certain collections required under the Business Conduct Standards with Counterparties rulemaking, as stated in that rulemaking. See Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734 (Feb. 17, 2012).

<sup>191</sup> See 75 FR at 76674 (maintain transaction and position records of swaps, including daily trading records of swaps and related cash and forward transactions; business records; records of data and information reported to SDRs and for real time public reporting purposes).

See 75 FR at 71404 (establish a risk management program, including specific policies for compliance with position limits and to ensure business continuity and disaster recovery; policies to prevent unreasonable restraints of trade and anticompetitive burdens; establish systems to diligently supervise the activities relating to its business; and make certain information available for disclosure and inspection by the Commission).

See 75 FR at 71395 (adopt conflicts of interest policies and procedures; recordkeeping obligations related to implementation of policies and procedures designed to ensure compliance with Commission regulations; document certain communications between non-research and research personnel; record of the basis for determination of research personnel compensation; provision of certain disclosures to recipients of research reports).

See 76 FR at 70887 (prepare a Form 8–R designating a CCO; draft and maintain certain compliance policies and procedures; annually prepare and furnish to the Commission an annual report describing the registrant’s compliance policies and resources and compliance with the CEA and Commission regulations; amend previously furnished annual reports, if necessary; and maintain records related to compliance policies and annual reports).

See 75 FR at 70157 (adopt conflicts of interest policies and procedures; recordkeeping obligations related to implementation of policies and procedures designed to ensure compliance with

Commission invited the public and other Federal agencies to comment on any aspect of the information collection requirements discussed in the Recordkeeping NPRM, the Duties NPRM, the CCO NPRM, the SD/MSP Conflicts NPRM, and the FCM/IB Conflicts NPRM. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicited comments in order to: (i) Evaluate whether the proposed collections of information were necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission’s estimates of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

It is not currently known how many SDs and MSPs will become subject to these rules, and this will not be known to the Commission until the registration requirements for these entities become effective. In its rule proposals, the Commission took “a conservative approach” to calculating the burden hours of this information collection by estimating that as many as 300 SDs and MSPs would register.<sup>192</sup> Since publication of the proposals in late 2010, the Commission has met with industry participants and trade groups, discussed extensively the universe of potential registrants with NFA, and reviewed public information about SDs active in the market and certain trade groups. Over time, and as the Commission has gathered more information on the swaps market and its participants, the estimate of the number of SDs and MSPs has decreased. In its FY 2012 budget drafted in February 2011, the Commission estimated that 140 SDs might register with the Commission.<sup>193</sup> After recently receiving

Commission regulations; document certain communications between non-research and research personnel; record of the basis for determination of research personnel compensation; provision of certain disclosures to recipients of research reports).

<sup>192</sup> 75 FR at 76671, 75 FR at 71402, 75 FR at 71394, and 75 FR 70885.

<sup>193</sup> CFTC, President’s Budget and Performance Plan Fiscal Year 2010, p. 13–14 (Feb. 2011), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2012.pdf>. The estimated 140 SDs includes “[a]pproximately 80 global and regional banks currently known to offer swaps in the United States;” “[a]pproximately 40 non-bank swap dealers currently offering commodity and other swaps;”

additional specific information from NFA on the regulatory program it is developing for SDs and MSPs,<sup>194</sup> however, the Commission believes that approximately 125 SDs and MSPs, including only a handful of MSPs, will register. While the Commission originally estimated there might be approximately 300 SDs and MSPs, based on new estimates provided by NFA, the Commission now estimates that there will be a combined number of 125 SDs and MSPs that will be subject to new information collection requirements under these rules.<sup>195</sup>

For purposes of the PRA, the term “burden” means the “time, effort, or financial resources expended by persons to generate, maintain, or provide information to or for a Federal Agency.”

In each of the NPRMs the Commission estimated the cost burden of the proposed regulations based upon an average salary of \$100 per hour. In response to this estimate, The Working Group commented that, inclusive of benefit costs and allocated overhead, the per hour average salary estimate for compliance and risk management personnel should be significantly higher than \$120. FIA and SIFMA stated that some of the compliance policies required by the proposed regulations will be drafted by both in-house lawyers and outside counsel, so the blended hourly rate should be roughly \$400.

The Commission notes that its estimate of \$100 per hour was based on recent Bureau of Labor Statistics findings, including the mean hourly wage of an employee under occupation code 23–1011, “Lawyers,” that is employed by the “Securities and Commodity Contracts Intermediation and Brokerage Industry,” which is \$82.22. The mean hourly wage of an employee under occupation code 11–3031, “Financial Managers,” (which includes operations managers) in the same industry is \$74.41.<sup>196</sup> Taking these data, the Commission then increased its hourly wage estimate in recognition of the fact that some registrants may be large financial institutions whose employees’ salaries may exceed the mean wage. The Commission also observes that SIFMA’s “Report on

and “[a]pproximately 20 new potential market makers that wish to become swap dealers.” *Id.*

<sup>194</sup> Letter from Thomas W. Sexton, Senior Vice President and General Counsel, NFA to Gary Barnett, Director, Division of Swap Dealer and Intermediary Oversight, CFTC (Oct. 20, 2011) (NFA Cost Estimates Letter).

<sup>195</sup> NFA Letter (Oct. 20, 2011) (estimating that there will be 125 SDs and MSPs required to register with NFA).

<sup>196</sup> See <http://www.bls.gov/oes/2099/mayowe23.1011.htm> and <http://www.bls.gov/oes/current/oes113031.htm>.

Management & Professional Earnings in the Securities Industry—2010” estimates the average wage of a compliance attorney and a compliance staffer in the U.S. at only \$46.31 per hour.

The Commission recognizes that some registrants may hire outside counsel with expertise in the various regulatory areas covered by the regulations discussed herein. While the Commission is uncertain about the billing rates that registrants may pay for outside counsel, the Commission believes that such counsel may bill at a rate of several hundred dollars per hour. Outside counsel may be able to leverage its expertise to reduce substantially the number of hours needed to fulfill a requested assignment, but a registrant that uses outside counsel may incur higher costs than a registrant that does not use outside counsel. Any determination to use outside counsel is at the discretion of the registrant. Having considered the comments received and having reviewed the available data, the Commission has determined that \$100 per hour remains a reasonable estimate of the per hour average salary for purposes of its PRA analysis. The Commission also notes that this determination is consistent with the Commission’s estimate for the hourly wage for CCOs under the recently adopted DCO final rules.<sup>197</sup>

The Commission received comments related to the PRA for three of its notices of proposed rulemaking: Recordkeeping, Duties, and CCO. No comments were received with regard to the two Conflicts proposals.

#### 1. Recordkeeping NPRM

With respect to the voice recording requirements of the Recordkeeping NPRM, as explained in more detail above, ATA commented that telephone recording systems that are compliant with all of these requirements would impose a significant additional cost to dealers. The Working Group commented that the long-term electronic storage of significant amounts of pre-execution communications will prove costly over the proposed five-year period. The Working Group also commented that requiring records of physical positions linked with related swap transactions would impose very expensive and burdensome requirements on millions of physical transactions that are undertaken by commercial energy firms that are also parties to swap transactions.

With respect to the record retention requirements in the Recordkeeping NPRM, MFA commented that maintaining records of transactions for 5 years following the termination, expiration, or maturity of the transactions would constitute an additional administrative burden and entail substantial additional cost. ISDA & SIFMA also believe that recordkeeping of all oral and written communications that may lead to execution of a swap for the life of a swap plus five years could impose a heavy cost burden to implement and maintain, for only a small incremental benefit and would be more supportive of a voice recording obligation to retain recordings for a minimum period of six months. The Commission notes that it is modifying the retention period for voice recordings to one year, which should minimize the burden on SDs and MSPs.

Notably, none of these commenters suggested specific revised calculations with regard to the Commission’s burden estimate. Accordingly, the only change that the Commission is making to its estimation of burdens associated with its Recordkeeping rules is the change to reflect the new estimate of the number of SDs and MSPs. The Commission now estimates the burden to be 2096 hours, at an annual cost of \$209,600 [2096 × \$100 per hour] for each SD and MSP, and the aggregate hour burden cost for all registrants is 262,000 burden hours and \$26,200,000 [262,000 × \$100 per hour].

In addition to the per hour burden discussed above, the Commission anticipated that SDs and MSPs may incur certain start-up costs in connection with the proposed recordkeeping obligations. Such costs would include the expenditures related to developing and installing new technology or reprogramming or updating existing recordkeeping technology and systems to enable the SD or MSP to collect, capture, process, maintain, and re-produce any newly required records. Based on comments received regarding system installation or upgrades that may be needed to meet the requirements of the rules, the Commission is doubling its estimate of programming burden hours associated with technology improvements to be 320 hours, rather than 160 hours.

The Commission received no comments with respect to its programming wage estimate of \$60 per hour. Accordingly, the Commission has revised only the estimate of the start-up burden associated with the required technological improvements with respect to the number of burden hours. The Commission estimates that the

start-up burden would be \$19,200 [\$60 × 320 hours] per affected registrant or \$2,400,000 in the aggregate for all registrants.

#### 2. Duties NPRM

The burden associated with regulations proposed in the Duties NPRM will result from the development of the required policies and procedures, satisfaction of various reporting obligations, and the documentation of required testing.

The Working Group commented that the Commission’s average personnel cost estimate of \$20,450 per effected entity significantly understates the cost of compliance with the proposed rules for commercial firms that are deemed SDs or MSPs. Specifically, the Working Group stated that a commercial energy firm will require at least five new fulltime employees at 1,800 hours per year, not the 204.5 hours per year estimated by the Commission; and the Commission’s analysis does not consider any necessary information technology expenditures or third-party costs.

The Working Group also commented that quarterly documentation of risk management testing should be 200 personnel-hours per quarter at a cost of \$96,000 per year for each registrant, rather than 1 personnel-hour per quarter at a cost of \$400 per year as estimated by the Commission.

With respect to the reporting requirements proposed in the Duties NPRM, The Working Group argued that Risk Exposure Reports should be provided to senior management and governing body annually, not quarterly because quarterly reporting would be too costly and burdensome.

With respect to the documentation of testing requirements proposed in the Duties NPRM, The Working Group recommended that both the frequency and the scope of audits of the risk management program be left to the discretion of registrants in order to lessen the cost and administrative burden imposed by the proposed rules. Cargill recommended that testing of the risk management program be required annually rather than quarterly. Cargill stated that a quarterly requirement is excessive and unduly expensive. MetLife stated that monthly testing of position limit monitoring procedures and quarterly testing of the risk management program may be excessive, costly, and overly burdensome for some MSPs and that the frequency of testing should be determined by the MSP based on the extent of its swap activities.

In the Duties NPRM, the burden per registrant was estimated to be 204.5

<sup>197</sup> See Derivatives Clearing Organization General Provisions and Core Principals, 76 FR at 69428.

hours per year, at an annual cost of \$20,450. Based on comments received, as discussed above, the Commission is changing the required risk management testing from quarterly to annually. The Commission also is accepting The Working Group's contention that it will take more than 160 hours annually to draft, file, and update the Risk Management Program materials, including the entity's position limit procedures and its business continuity and disaster recovery plan. While the Commission does not agree with the estimate that the new rules will require at least five new fulltime employees at 1,800 hours per year, the Commission accepts that on average it will take 900 hours to comply with the information collection required by these provisions. The Commission also agrees with The Working Group's revised estimation of 200 hours for documentation of risk management testing and is increasing its estimate from four hours. Finally, the Commission is increasing its estimate of the burden hours associated with quarterly documentation of position limit compliance from two hours to 10 hours to account for the required testing. Accordingly, the Commission has revised its overall burden estimate to be 1148.5 hours per year per registrant, at an annual cost of \$114,850. The aggregate cost for all registrants (with a revised estimate of 125 SDs and MSPs) is 143,562.5 burden hours and \$14,356,250 [143,562.5 × \$100 per hour].

### 3. SD/MSP Conflicts NPRM and FCM/IB Conflicts NPRM

The Commission received no comments related to its estimates of the information collection burden with respect to either the SD/MSP Conflicts NPRM or the FCM/IB Conflicts NPRM. Accordingly, the only change that the Commission is making to its estimation of burdens associated with its Conflicts rules is the change to reflect the new estimate of the number of SDs and MSPs. The Commission estimates the overall burden to be 44.5 hours per year per SD and MSP, at an annual cost of \$4,450 [44.5 × \$100 per hour], and the aggregate cost for all SDs and MSPs (with a revised estimate of 125 SDs and MSPs) is 5562.5 burden hours and \$556,250 [5562.5 × \$100 per hour]. There are currently 159 registered FCMs and 1,645 registered IBs that will be required to comply with the proposed conflicts of interest provisions (or a total of 1,804 registrants). The Commission estimates the burden to be 44.5 hours, at an annual cost of \$4,450 for each FCM and IB, and the aggregate cost for all FCMs and IBs is 80,278 burden hours

and \$8,027,800 [80,278 burden hours × \$100 per hour].

### 4. CCO NPRM

With respect to the annual compliance report requirement in the CCO NPRM, NSCP commented the level of detail required by the annual report would impose unnecessary burdens on the CCO with little offsetting benefits. NSCP argues that a better approach would be to require a review of the adequacy of policies and the effectiveness of their implementation. EEI commented that the annual report requirements would be so lengthy and detailed that the usefulness of the annual report would be greatly diminished. The Working Group recommended that the Commission provide a standardized form for the annual report because such would mutually benefit the Commission and registrants. The Working Group also believes the annual report as proposed would be unnecessarily exhaustive, and without a materiality limitation, the report would be of limited use to the Commission and costly for firms to produce. The Working Group also objected to the requirement that firms preserve all materials relating to the preparation of an annual report because such would not promote any compliance policy other than facilitating regulatory enforcement actions. The Working Group believes that the scope of provisions means that a firm will spend considerable resources to meet its obligations under the compliance report, and preparation of the report will be quite expensive because the scope of policies and procedures will be very broad. The Working Group estimates that the burden of preparing a report is, at a minimum, 160 hours, 4 times the Commission's estimate.

FIA and SIFMA provided the following revised cost assessment: Form 8-R and related matters are 10 hours, not 1 hour; preparing, updating and maintaining policies and procedures is 1000 hours, not 80 hours; preparing the annual report is 500 hours not 40 hours; annually amending the annual report is 50 hours and not 5 hours; and recordkeeping is closer to 500 hours, not 10 hours. Therefore, FIA and SIFMA estimate that the total cost per registrant is closer to \$800,000 and the total to the industry is \$350 million.

Despite the fact that FIA and SIFMA did not provide an explanation for any of their revised burden estimates, the Commission is accepting their arguments, in part, and is revising its burden estimate to reflect some of their comments.

The Commission is not modifying the amount of time required to prepare and file a Form 8-R designating the chief compliance officer. This form requests only the information necessary about the individual designated as CCO that is necessary for the Commission to appropriately exercise its statutory registration and compliance oversight functions. This information generally includes the name, addresses, location of records, regulatory and disciplinary histories, and other similarly straightforward matters—all of which should be in the possession of the applicant and readily available for the applicant to provide. Most notably, the PRA estimates provided for these forms are averages that do not necessarily reflect the actual time expended by each and every individual to complete the forms.

The Commission is modifying its burden estimate for the amount of time it will take to draft and update compliance policies from 80 hours annually to 900 hours, which reflects half of a full-time employee's time. Additionally, the Commission is revising the burden estimate associated with preparing and furnishing to the Commission an annual report that describes the respondent's compliance policies and resources and the respondent's compliance with the CEA and Commission regulations. The Commission had estimated that it would take 40 hours per year. The revised estimate would double that number to 80 hours per year, which is in line with estimates made by the DCO final rulemaking. The Commission is maintaining its original estimate for the time required to amend a previously furnished annual report when material errors or omissions are identified at 5 hours annually, but the Commission is doubling the time estimate required to maintain records related to respondent's compliance policies and annual reports from 10 hours to 20 hours. With regard to recordkeeping required under the CCO rules, the Commission notes that much of the burden associated with this requirement has been included in the overall recordkeeping estimates for SDs and MSPs, and in existing regulations for FCMs, all of which require general business records to be kept.

There are 159 FCMs currently registered with the Commission and it is anticipated that there will be approximately 125 SDs and MSPs that will register with the Commission. Thus, the total number of respondents is expected to be 284. Based on comments received and the changes to the rules discussed above, the Commission has revised its estimate of the burden

associated with the regulations to be 1,006 hours, at a cost of \$100,600 annually for each respondent. Based upon the above, the aggregate cost for all respondents is 285,704 burden hours [1,006 hours × 284 respondents] and \$28,570,400 [285,704 burden hours × \$100 per hour].

### List of Subjects

#### 17 CFR Part 1

Brokers, Commodity futures, Conflicts of interest, Reporting and recordkeeping requirements.

#### 17 CFR Part 3

Administrative practice and procedure, Brokers, Commodity futures, Major swap participants, Reporting and recordkeeping requirements, Swap dealers.

#### 17 CFR Part 23

Antitrust, Commodity futures, Conduct standards, Conflict of Interests, Major swap participants, Reporting and recordkeeping, Swap dealers, Swaps.

For the reasons stated in the preamble, the CFTC amends 17 CFR parts 1, 3, and 23 as follows:

## PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

■ 1. The authority citation for part 1 is revised to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 2a, 5, 6, 6a, 6b, 6b-1, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 6s, 7, 7a-1, 7a-2, 7b, 7b-3, 8, 9, 9a, 10a, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 18, 19, 21, 23 and 24, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010).

■ 2. Section 1.71 is added to read as follows:

### § 1.71 Conflicts of interest policies and procedures by futures commission merchants and introducing brokers.

(a) *Definitions.* For purposes of this section, the following terms shall be defined as provided.

(1) *Affiliate.* This term means, with respect to any person, a person controlling, controlled by, or under common control with, such person.

(2) *Business trading unit.* This term means any department, division, group, or personnel of a futures commission merchant or introducing broker or any of its affiliates, whether or not identified as such, that performs, or personnel exercising direct supervisory authority over the performance of, any pricing (excluding price verification for risk management purposes), trading, sales, marketing, advertising, solicitation,

structuring, or brokerage activities on behalf of a futures commission merchant or introducing broker or any of its affiliates.

(3) *Clearing unit.* This term means any department, division, group, or personnel of a futures commission merchant or any of its affiliates, whether or not identified as such, that performs, or personnel exercising direct supervisory authority over the performance of, any proprietary or customer clearing activities on behalf of a futures commission merchant or any of its affiliates.

(4) *Derivative.* This term means:

(i) A contract for the purchase or sale of a commodity for future delivery;

(ii) A security futures product;

(iii) A swap;

(iv) Any agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i) of the Act; and

(v) Any commodity option authorized under section 4c of the Act; and (vi) any leverage transaction authorized under section 19 of the Act.

(5) *Non-research personnel.* This term means any employee of the business trading unit or clearing unit, or any other employee of the futures commission merchant or introducing broker, other than an employee performing a legal or compliance function, who is not directly responsible for, or otherwise not directly involved in, research or analysis intended for inclusion in a research report.

(6) *Public appearance.* This term means any participation in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons (individuals or entities), or interview or appearance before one or more representatives of the media, radio, television or print media, or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning a derivatives transaction. This term does not include a password-protected Webcast, conference call or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current research report or other documentation that contains the required applicable disclosures, and that the research analyst appearing at the event corrects and updates during the public appearance any disclosures in the research report that are inaccurate, misleading, or no longer applicable.

(7) *Research analyst.* This term means the employee of a futures commission merchant or introducing broker who is

primarily responsible for, and any employee who reports directly or indirectly to such research analyst in connection with, preparation of the substance of a research report relating to any derivative, whether or not any such person has the job title of “research analyst.”

(8) *Research department.* This term means any department or division that is principally responsible for preparing the substance of a research report relating to any derivative on behalf of a futures commission merchant or introducing broker, including a department or division contained in an affiliate of a futures commission merchant or introducing broker.

(9) *Research report.* This term means any written communication (including electronic) that includes an analysis of the price or market for any derivative, and that provides information reasonably sufficient upon which to base a decision to enter into a derivatives transaction. This term does not include:

(i) Communications distributed to fewer than 15 persons;

(ii) Commentaries on economic, political or market conditions;

(iii) Statistical summaries of multiple companies’ financial data, including listings of current ratings;

(iv) Periodic reports or other communications prepared for investment company shareholders or commodity pool participants that discuss individual derivatives positions in the context of a fund’s past performance or the basis for previously-made discretionary decisions;

(v) Any communications generated by an employee of the business trading unit that is conveyed as a solicitation for entering into a derivatives transaction, and is conspicuously identified as such; and

(vi) Internal communications that are not given to current or prospective customers.

(b) *Policies and procedures.* (1) Except as provided in paragraph (b)(2) of this section, each futures commission merchant and introducing broker subject to this rule must adopt and implement written policies and procedures reasonably designed to ensure that the futures commission merchant or introducing broker and its employees comply with the provisions of this rule.

(2) Small Introducing Brokers. An introducing broker that has generated, over the preceding 3 years, \$5 million or less in aggregate gross revenues from its activities as an introducing broker must establish structural and institutional safeguards reasonably

designed to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity or derivative are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in trading or clearing activities might potentially bias the judgment or supervision of the persons.

(c) *Research analysts and research reports.* (1) *Restrictions on relationship with research department.* (i) Non-research personnel shall not direct a research analyst's decision to publish a research report of the futures commission merchant or introducing broker, and non-research personnel shall not direct the views and opinions expressed in a research report of the futures commission merchant or introducing broker.

(ii) No research analyst may be subject to the supervision or control of any employee of the futures commission merchant's or introducing broker's business trading unit or clearing unit, and no employee of the business trading unit or clearing unit may have any influence or control over the evaluation or compensation of a research analyst.

(iii) Except as provided in paragraph (c)(1)(iv) of this section, non-research personnel, other than the board of directors and any committee thereof, shall not review or approve a research report of the futures commission merchant or introducing broker before its publication.

(iv) Non-research personnel may review a research report before its publication as necessary only to verify the factual accuracy of information in the research report, to provide for non-substantive editing, to format the layout or style of the research report, or to identify any potential conflicts of interest, provided that:

(A) Any written communication between non-research personnel and research department personnel concerning the content of a research report must be made either through authorized legal or compliance personnel of the futures commission merchant or introducing broker or in a transmission copied to such personnel; and

(B) Any oral communication between non-research personnel and research department personnel concerning the content of a research report must be documented and made either through authorized legal or compliance personnel acting as an intermediary or in a conversation conducted in the presence of such personnel.

(2) *Restrictions on communications.* Any written or oral communication by a research analyst to a current or prospective customer relating to any derivative must not omit any material fact or qualification that would cause the communication to be misleading to a reasonable person.

(3) *Restrictions on research analyst compensation.* A futures commission merchant or introducing broker may not consider as a factor in reviewing or approving a research analyst's compensation his or her contributions to the futures commission merchant's or introducing broker's trading or clearing business. Except for communicating client or customer feedback, ratings and other indicators of research analyst performance to research department management, no employee of the business trading unit or clearing unit of the futures commission merchant or introducing broker may influence the review or approval of a research analyst's compensation.

(4) *Prohibition of promise of favorable research.* No futures commission merchant or introducing broker may directly or indirectly offer favorable research, or threaten to change research, to an existing or prospective customer as consideration or inducement for the receipt of business or compensation.

(5) *Disclosure requirements.* (i) *Ownership and material conflicts of interest.* A futures commission merchant or introducing broker must disclose in research reports and a research analyst must disclose in public appearances whether the research analyst maintains a financial interest in any derivative of a type, class, or category that the research analyst follows, and the general nature of the financial interest.

(ii) *Prominence of disclosure.* Disclosures and references to disclosures must be clear, comprehensive, and prominent. With respect to public appearances by research analysts, the disclosures required by paragraph (c)(5) of this section must be conspicuous.

(iii) *Records of public appearances.* Each futures commission merchant and introducing broker must maintain records of public appearances by research analysts sufficient to demonstrate compliance by those research analysts with the applicable disclosure requirements under paragraph (c)(5) of this section.

(iv) *Third-party research reports.* (A) For the purposes of paragraph (c)(5)(iv) of this section, "independent third-party research report" shall mean a research report, in respect of which the person or entity producing the report:

(1) Has no affiliation or business or contractual relationship with the distributing futures commission merchant or introducing broker, or that futures commission merchant's or introducing broker's affiliates, that is reasonably likely to inform the content of its research reports; and

(2) Makes content determinations without any input from the distributing futures commission merchant or introducing broker or from the futures commission merchant's or introducing broker's affiliates.

(B) Subject to paragraph (c)(5)(iv)(C) of this section, if a futures commission merchant or introducing broker distributes or makes available any independent third-party research report, the futures commission merchant or introducing broker must accompany the research report with, or provide a web address that directs the recipient to, the current applicable disclosures, as they pertain to the futures commission merchant or introducing broker, required by this section. Each futures commission merchant and introducing broker must establish written policies and procedures reasonably designed to ensure the completeness and accuracy of all applicable disclosures.

(C) The requirements of paragraph (c)(5)(iv)(B) of this section shall not apply to independent third-party research reports made available by a futures commission merchant or introducing broker to its customers:

(1) Upon request; or

(2) Through a Web site maintained by the futures commission merchant or introducing broker.

(6) *Prohibition of retaliation against research analysts.* No futures commission merchant or introducing broker, and no employee of a futures commission merchant or introducing broker who is involved with the futures commission merchant's or introducing broker's trading or clearing activities, may, directly or indirectly, retaliate against or threaten to retaliate against any research analyst employed by the futures commission merchant or introducing broker or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made, in good faith, by the research analyst that may adversely affect the futures commission merchant's or introducing broker's present or prospective trading or clearing activities.

(7) *Small Introducing Brokers.* An introducing broker that has generated, over the preceding 3 years, \$5 million or less in aggregate gross revenues from its activities as an introducing broker is

exempt from the requirements set forth in this paragraph (c).

(d) *Clearing activities.* (1) No futures commission merchant shall permit any affiliated swap dealer or major swap participant to directly or indirectly interfere with, or attempt to influence, the decision of the clearing unit personnel of the futures commission merchant to provide clearing services and activities to a particular customer, including but not limited to a decision relating to the following:

(i) Whether to offer clearing services and activities to a particular customer;

(ii) Whether to accept a particular customer for the purposes of clearing derivatives;

(iii) Whether to submit a customer's transaction to a particular derivatives clearing organization;

(iv) Whether to set or adjust risk tolerance levels for a particular customer;

(v) Whether to accept certain forms of collateral from a particular customer; or

(vi) Whether to set a particular customer's fees for clearing services based upon criteria that are not generally available and applicable to other customers of the futures commission merchant.

(2) Each futures commission merchant shall create and maintain an appropriate informational partition between business trading units of an affiliated swap dealer or major swap participant and clearing unit personnel of the futures commission merchant to reasonably ensure compliance with the Act and the prohibitions specified in paragraph (d)(1) of this section. At a minimum, such informational partitions shall require that:

(i) No employee of a business trading unit of an affiliated swap dealer or major swap participant may review or approve the provision of clearing services and activities by clearing unit personnel of the futures commission merchant, make any determination regarding whether the futures commission merchant accepts clearing customers, or in any way condition or tie the provision of trading services upon or to the provision of clearing services or otherwise participate in the provision of clearing services by improperly incentivizing or encouraging the use of the affiliated futures commission merchant. Any employee of a business trading unit of an affiliated swap dealer or major swap participant may participate in the activities of the futures commission merchant as necessary for (A) participating in default management undertaken by a derivatives clearing organization during an event of default; and (B) transferring,

liquidating, or hedging any proprietary or customer positions during an event of default;

(ii) No employee of a business trading unit of an affiliated swap dealer or major swap participant shall supervise, control, or influence any employee of a clearing unit of the futures commission merchant; and

(iii) No employee of the business trading unit of an affiliated swap dealer or major swap participant shall influence or control compensation or evaluation of any employee of the clearing unit of the futures commission merchant.

(e) *Undue influence on customers.* Each futures commission merchant and introducing broker must adopt and implement written policies and procedures that mandate the disclosure to its customers of any material incentives and any material conflicts of interest regarding the decision of a customer as to the trade execution and/or clearing of the derivatives transaction.

(f) *Records.* All records that a futures commission merchant or introducing broker is required to maintain pursuant to this regulation shall be maintained in accordance with Commission Regulation § 1.31 and shall be made available promptly upon request to representatives of the Commission.

### PART 3—REGISTRATION

■ 3. The authority citation for part 3 is revised to read as follows:

**Authority:** 5 U.S.C. 552, 552b; 7 U.S.C. 1a, 2, 6a, 6b, 6b–1, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6m, 6n, 6o, 6p, 6s, 8, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21, and 23, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (Jul. 21, 2010).

■ 4. Amend § 3.1 by revising paragraph (a)(1) and by adding paragraphs (h) and (i) to read as follows:

#### § 3.1 Definitions.

(a) \* \* \*

(1) If the entity is organized as a sole proprietorship, the proprietor and chief compliance officer; if a partnership, any general partner and chief compliance officer; if a corporation, any director, the president, chief executive officer, chief operating officer, chief financial officer, chief compliance officer, and any person in charge of a principal business unit, division or function subject to regulation by the Commission; if a limited liability company or limited liability partnership, any director, the president, chief executive officer, chief operating officer, chief financial officer, chief compliance officer, the manager,

managing member or those members vested with the management authority for the entity, and any person in charge of a principal business unit, division or function subject to regulation by the Commission; and, in addition, any person occupying a similar status or performing similar functions, having the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the entity's activities that are subject to regulation by the Commission;

\* \* \* \* \*

(h) *Swaps activities.* Swaps activities means, with respect to a registrant, such registrant's activities related to swaps and any product used to hedge such swaps, including, but not limited to, futures, options, other swaps or security-based swaps, debt or equity securities, foreign currency, physical commodities, and other derivatives.

(i) *Board of directors.* Board of directors means the board of directors, board of governors, or equivalent governing body of a registrant.

■ 5. Add § 3.3 to read as follows:

#### § 3.3 Chief compliance officer.

(a) *Designation.* Each futures commission merchant, swap dealer, and major swap participant shall designate an individual to serve as its chief compliance officer, and provide the chief compliance officer with the responsibility and authority to develop, in consultation with the board of directors or the senior officer, appropriate policies and procedures to fulfill the duties set forth in 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 business as a futures commission merchant and 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 business as a futures commission merchant.

(1) The chief compliance officer shall report to the board of directors or the senior officer of the futures commission merchant, swap dealer, or major swap participant. The board of directors or the senior officer shall appoint the chief compliance officer, shall approve the compensation of the chief compliance officer, and shall meet with the chief compliance officer at least once a year and at the election of the chief compliance officer.

(2) Only the board of directors or the senior officer of the futures commission merchant, swap dealer, or major swap participant may remove the chief compliance officer.

(b) *Qualifications.* The individual designated to serve as chief compliance officer shall have the background and skills appropriate for fulfilling the responsibilities of the position. No individual disqualified, or subject to disqualification, from registration under section 8a(2) or 8a(3) of the Act may serve as a chief compliance officer.

(c) *Submission with registration.* Each application for registration as a futures commission merchant under § 3.10, a swap dealer under § 23.21, or a major swap participant under § 23.21, must include a designation of a chief compliance officer by submitting a Form 8-R for the chief compliance officer as a principal of the applicant pursuant to § 3.10(a)(2).

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

(1) Administering the registrant's policies and procedures reasonably designed to ensure compliance with the Act and Commission regulations;

(2) In consultation with the board of directors or the senior officer, resolving any conflicts of interest 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 business as a futures commission merchant;

(4) Establishing procedures, in consultation with the board of directors or the senior officer, for the remediation of noncompliance issues identified by the chief compliance officer through a compliance office review, look-back, internal or external audit finding, self-reported error, or validated complaint;

(5) Establishing procedures, in consultation with the board of directors or the senior officer, for the handling, management response, remediation, retesting, and closing 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:

(1) Contain a description of 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;

(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 areas for improvement, and recommend 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 financial, managerial, operational, and staffing resources set aside for compliance with respect to the Act and Commission regulations, including any material deficiencies in such resources; and

(5) Describe any material non-compliance issues identified, and the corresponding action taken.

(f) *Furnishing the annual report to the Commission.* (1) 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.

(2) 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, simultaneously with the submission of Form 1-FR-FCM, as required under § 1.10(b)(2)(ii), simultaneously with the Financial and Operational Combined Uniform Single Report, as required under § 1.10(h), or simultaneously with the financial condition report, as required under section 4s(f) of the Act, as applicable.

(3) 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.

(4) 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) 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) 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. 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.

(g) *Recordkeeping.* (1) The futures commission merchant, swap dealer, or major swap participant shall maintain:

(i) A copy of the registrant's policies and procedures reasonably designed to ensure compliance with the Act and Commission regulations;

(ii) Copies of materials, including written reports provided to the board of directors or the senior officer in connection with the review of the annual report under paragraph (e) of this section; and

(iii) Any records relevant to the annual report, including, but not limited to, work papers and other documents that form the basis of the report, and memoranda, correspondence, other documents, and records that are created, sent or received in connection with the annual report and contain conclusions, opinions, analyses, or financial data related to the annual report.

(2) All records or reports that a futures commission merchant, swap dealer, or major swap participant are required to maintain pursuant to this section shall be maintained in accordance with § 1.31 and shall be made available promptly upon request to representatives of the Commission and to representatives of the applicable prudential regulator, as defined in 1a(39) of the Act.

## PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

■ 6. The authority citation for part 23 is revised to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b–1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, and 21 as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (Jul. 21, 2010).

■ 7. Add Subpart F, §§ 23.200, 23.201, 23.202, 23.203, 23.204, 23.205, and 23.206 to read as follows:

### Subpart F—Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants

Sec.

23.200	Definitions.
23.201	Required records.
23.202	Daily trading records.
23.203	Records; retention and inspection.
23.204	Reporting to swap data repositories.
23.205	Real-time public reporting.
23.206	Delegation of authority to the Director of the Division of Swap Dealer and Intermediary Oversight to establish an alternative compliance schedule to comply with daily trading records.

### Subpart F—Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants

#### § 23.200 Definitions.

For purposes of subpart F, the following terms shall be defined as provided.

(a) *Business trading unit* means any department, division, group, or personnel of a swap dealer or major swap participant or any of its affiliates, whether or not identified as such, that performs, or exercises supervisory authority over the performance of, any pricing (excluding price verification for risk management purposes), trading, sales, purchasing, marketing, advertising, solicitation, structuring, or brokerage activities on behalf of a registrant.

(b) *Clearing unit* means any department, division, group, or personnel of a registrant or any of its affiliates, whether or not identified as such, that performs any proprietary or customer clearing activities on behalf of a registrant.

(c) *Complaint* means any formal or informal complaint, grievance, criticism, or concern communicated to the swap dealer or major swap participant in any format relating to, arising from, or in connection with, any trading conduct or behavior or with the swap dealer or major swap participant's performance (or failure to perform) any of its regulatory obligations, and

includes any and all observations, comments, remarks, interpretations, clarifications, notes, and examinations as to such conduct or behavior communicated or documented by the complainant, swap dealer, or major swap participant.

(d) *Executed* means the completion of the execution process.

(e) *Execution* means, with respect to a swap, an agreement by the parties (whether orally, in writing, electronically, or otherwise) to the terms of a swap that legally binds the parties to such swap terms under applicable law.

(f) *Governing body*. This term means:

- (1) A board of directors;
  - (2) A body performing a function similar to a board of directors;
  - (3) Any committee of a board or body;
- or

(4) The chief executive officer of a registrant, or any such board, body, committee, or officer of a division of a registrant, provided that the registrant's swaps activities for which registration with the Commission is required are wholly contained in a separately identifiable division.

(g) *Prudential regulator* has the meaning given to such term in section 1a(39) of the Commodity Exchange Act and includes the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Association, and the Federal Housing Finance Agency, as applicable to the swap dealer or major swap participant.

(h) *Registered entity* has the meaning given to such term in section 1a(40) of the Commodity Exchange Act, and includes boards of trade designated as contract markets, derivatives clearing organizations, swap execution facilities, and swap data repositories.

(i) *Related cash or forward transaction* means a purchase or sale for immediate or deferred physical shipment or delivery of an asset related to a swap where the swap and the related cash or forward transaction are used to hedge, mitigate the risk of, or offset one another.

(j) *Swaps activities* means, with respect to a registrant, such registrant's activities related to swaps and any product used to hedge such swaps, including, but not limited to, futures, options, other swaps or security-based swaps, debt or equity securities, foreign currency, physical commodities, and other derivatives.

(k) *Swap confirmation* means the consummation (electronically or otherwise) of legally binding documentation (electronic or otherwise)

that memorializes the agreement of the parties to all the terms of the swap. A confirmation must be in writing (whether electronic or otherwise) and must legally supersede any previous agreement (electronically or otherwise).

#### § 23.201 Required records.

(a) *Transaction and position records*. Each swap dealer and major swap participant shall keep full, complete, and systematic records, together with all pertinent data and memoranda, of all its swaps activities. Such records shall include:

(1) *Transaction records*. Records of each transaction, including all documents on which transaction information is originally recorded. Such records shall be kept in a form and manner identifiable and searchable by transaction and by counterparty, and shall include:

(i) All documents customarily generated in accordance with market practice that demonstrate the existence and nature of an order or transaction, including, but not limited to, records of all orders (filled, unfilled, or cancelled); correspondence; journals; memoranda; ledgers; confirmations; risk disclosure documents; statements of purchase and sale; contracts; invoices; warehouse receipts; documents of title; and

(ii) The daily trading records required to be kept in accordance with § 23.202.

(2) *Position records*. Records of each position held by each swap dealer and major swap participant, identified by product and counterparty, including records reflecting whether each position is "long" or "short" and whether the position is cleared. Position records shall be linked to transaction records in a manner that permits identification of the transactions that established the position.

(3) *Records of transactions executed on a swap execution facility or designated contract market or cleared by a derivatives clearing organization*. Records of each transaction executed on a swap execution facility or designated contract market or cleared by a derivatives clearing organization maintained in compliance with the Act and Commission regulations.

(b) *Business records*. Each swap dealer and major swap participant shall keep full, complete, and systematic records of all activities related to its business as a swap dealer or major swap participant, including but not limited to:

(1) *Governance*. (i) Minutes of meetings of the governing body and relevant committee minutes, including handouts and presentation materials;

(ii) Organizational charts for its governing body and relevant

committees, business trading unit, clearing unit, risk management unit, and all other relevant units or divisions;

(iii) Biographies or resumes of managers, senior supervisors, officers, and directors;

(iv) Job descriptions for manager, senior supervisor, officer, and director positions, including job responsibilities and scope of authority;

(v) Internal and external audit, risk management, compliance, and consultant reports (including management responses); and

(vi) Business and strategic plans for the business trading unit.

(2) *Financial records.* (i) Records reflecting all assets and liabilities, income and expenses, and capital accounts as required by the Act and Commission regulations; and

(ii) All other financial records required to be kept under the Act and Commission regulations.

(3) *Complaints.* (i) A record of each complaint received by the swap dealer or major swap participant concerning any partner, member, officer, employee, or agent. The record shall include the complainant's name, address, and account number; the date the complaint was received; the name of all persons identified in the complaint; a description of the nature of the complaint; the disposition of the complaint, and the date the complaint was resolved.

(ii) A record indicating that each counterparty of the swap dealer or major swap participant has been provided with a notice containing the physical address, email or other widely available electronic address, and telephone number of the department of the swap dealer or major swap participant to which any complaints may be directed.

(4) *Marketing and sales materials.* All marketing and sales presentations, advertisements, literature, and communications, and a record documenting that the swap dealer or major swap participant has complied with, or adopted policies and procedures reasonably designed to establish compliance with, all applicable Federal requirements, Commission regulations, and the rules of any self-regulatory organization of which the swap dealer or major swap participant is a member.

(c) *Records of data reported to a swap data repository.* With respect to each swap, each swap dealer and major swap participant shall identify, retain, and produce for inspection all information and data required to be reported in accordance with part 45 of this chapter, along with a record of the date and time

the swap dealer or major swap participant made the report.

(d) *Records of real-time reporting data.* Each swap dealer and major swap participant shall identify, retain, and produce for inspection all information and data required to be reported in accordance with part 43 of this chapter, along with a record of the date and time the swap dealer or major swap participant made the report.

#### § 23.202 Daily trading records.

(a) *Daily trading records for swaps.* Each swap dealer and major swap participant shall make and keep daily trading records of all swaps it executes, including all documents on which transaction information is originally recorded. Each swap dealer and major swap participant shall ensure that its records include all information necessary to conduct a comprehensive and accurate trade reconstruction for each swap. Each swap dealer and major swap participant shall maintain each transaction record in a manner identifiable and searchable by transaction and counterparty.

(1) *Pre-execution trade information.* Each swap dealer and major swap participant shall make and keep pre-execution trade information, including, at a minimum, records of all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the execution of a swap, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device, or other digital or electronic media. Such records shall include, but are not limited to:

(i) Reliable timing data for the initiation of the trade that would permit complete and accurate trade reconstruction; and

(ii) A record of the date and time, to the nearest minute, using Coordinated Universal Time (UTC), by timestamp or other timing device, for each quotation provided to, or received from, the counterparty prior to execution.

(2) *Execution trade information.* Each swap dealer and major swap participant shall make and keep trade execution records, including:

(i) All terms of each swap, including all terms regarding payment or settlement instructions, initial and variation margin requirements, option premiums, payment dates, and any other cash flows;

(ii) The trade ticket for each swap (which, together with the time of execution of each swap, shall be

immediately recorded electronically for further processing);

(iii) The unique swap identifier, as required by § 45.4(a), for each swap;

(iv) A record of the date and time of execution of each swap, to the nearest minute, using Coordinated Universal Time (UTC), by timestamp or other timing device;

(v) The name of the counterparty with which each such swap was executed, including its unique counterparty identifier, as required by § 45.4(b);

(vi) The date and title of the agreement to which each swap is subject, including but not limited to, any swap trading relationship documentation and credit support arrangements;

(vii) The product name of each swap, including its unique product identifier, as required by § 45.4(c);

(viii) The price at which the swap was executed;

(ix) Fees or commissions and other expenses, identified by transaction; and

(x) Any other information relevant to the swap.

(3) *Post-execution trade information.*

Each swap dealer and major swap participant shall make and keep records of post-execution trade information containing an itemized record of all relevant post-trade processing and events.

(i) Records of post-trade processing and events shall include all of the following, as applicable:

(A) Confirmation;

(B) Termination;

(C) Novation;

(D) Amendment;

(E) Assignment;

(F) Netting;

(G) Compression;

(H) Reconciliation;

(I) Valuation;

(J) Margining;

(K) Collateralization; and

(L) Central clearing.

(ii) Each swap dealer and major swap participant shall make and keep a record of all swap confirmations, along with the date and time, to the nearest minute, using Coordinated Universal Time (UTC), by timestamp or other timing device; and

(iii) Each swap dealer and major swap participant shall make and keep a record of each swap portfolio reconciliation, including the number of portfolio reconciliation discrepancies and the number of swap valuation disputes (including the time-to-resolution of each valuation dispute and the age of outstanding valuation disputes, categorized by transaction and counterparty);

(iv) Each swap dealer and major swap participant shall make and keep a

record of each swap portfolio compression exercise in which it participates, including the dates of the compression, the swaps included in the compression, the identity of the counterparties participating in the exercise, the results of the compression, and the name of the third-party entity performing the compression, if any; and

(v) Each swap dealer and major swap participant shall make and keep a record of each swap that it centrally clears, categorized by transaction and counterparty.

(4) *Ledgers.* Each swap dealer and major swap participant shall make and keep ledgers (or other records) reflecting the following:

(i) Payments and interest received;

(ii) Moneys borrowed and moneys loaned;

(iii) The daily calculation of the value of each outstanding swap;

(iv) The daily calculation of current and potential future exposure for each counterparty;

(v) The daily calculation of initial margin to be posted by the swap dealer or major swap participant for each counterparty and the daily calculation of initial margin to be posted by each counterparty;

(vi) The daily calculation of variation margin payable to or receivable from each counterparty;

(vii) The daily calculation of the value of all collateral, before and after haircuts, held by or posted by the swap dealer or major swap participant;

(viii) All transfers of collateral, including any substitutions of collateral, identifying in sufficient detail the amounts and types of collateral transferred; and

(ix) All charges against and credits to each counterparty's account, including funds deposited, withdrawn, or transferred, and charges or credits resulting from losses or gains on transactions.

(b) *Daily trading records for related cash and forward transactions.* Each swap dealer and major swap participant shall make and keep daily trading records of all related cash or forward transactions it executes, including all documents on which the related cash or forward transaction information is originally recorded. Each swap dealer and major swap participant shall ensure that its records include all information necessary to conduct a comprehensive and accurate trade reconstruction for each related cash or forward transaction. Each swap dealer and major swap participant shall maintain each transaction record in a manner identifiable and searchable by transaction and by counterparty. Such

records shall include, but are not limited to:

(1) A record of all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the conclusion of a related cash or forward transaction, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device, or other digital or electronic media;

(2) Reliable timing data for the initiation of the transaction that would permit complete and accurate trade reconstruction;

(3) A record of the date and time, to the nearest minute, using Coordinated Universal Time (UTC), by timestamp or other timing device, for each quotation provided to, or received from, the counterparty prior to execution;

(4) A record of the date and time of execution of each related cash or forward transaction, to the nearest minute, using Coordinated Universal Time (UTC), by timestamp or other timing device;

(5) All terms of each related cash or forward transaction;

(6) The price at which the related cash or forward transaction was executed; and

(7) A record of the daily calculation of the value of the related cash or forward transaction and any other relevant financial information.

#### **§ 23.203 Records; retention and inspection.**

(a) *Location of records.* (1) *Records.* All records required to be kept by a swap dealer or major swap participant by the Act and by Commission regulations shall be kept at the principal place of business of the swap dealer or major swap participant or such other principal office as shall be designated by the swap dealer or major swap participant. If the principal place of business is outside of the United States, its territories or possessions, then upon the request of a Commission representative, the swap dealer or major swap participant must provide such records as requested at the place in the United States, its territories, or possessions designated by the representative within 72 hours after receiving the request.

(2) *Contact information.* Each swap dealer and major swap participant shall maintain for each of its offices a listing, by name or title, of each person at that office who, without delay, can explain the types of records the swap dealer or major swap participant maintains at that office and the information contained in those records.

(b) *Record retention.* (1) The records required to be maintained by this chapter shall be maintained in accordance with the provisions of § 1.31, except as provided in paragraphs (b)(2) and (3) of this section. All records required to be kept by the Act and by Commission regulations shall be kept for a period of five years from the date the record was made and shall be readily accessible during the first two (2) years of the five-year period. All such records shall be open to inspection by any representative of the Commission, the United States Department of Justice, or any applicable prudential regulator. Records relating to swaps defined in section 1a(47)(A)(v) shall be open to inspection by any representative of the Commission, the United States Department of Justice, the Securities and Exchange Commission, or any applicable prudential regulator.

(2) Records of any swap or related cash or forward transaction shall be kept until the termination, maturity, expiration, transfer, assignment, or novation date of the transaction, and for a period of five years after such date. Such records shall be readily accessible until the termination, maturity, expiration, transfer, assignment, or novation date of the transaction and during the first two years of the 5-year period following such date. Provided, however, that records of oral communications communicated by telephone, voicemail, mobile device, or other digital or electronic media pursuant to § 23.202(a)(1) and (b)(1) shall be kept for a period of one year. All such records shall be open to inspection by any representative of the Commission, the United States Department of Justice, or any applicable prudential regulator. Records relating to swaps defined in section 1a(47)(A)(v) shall be open to inspection by any representative of the Commission, the United States Department of Justice, the Securities and Exchange Commission, or any applicable prudential regulator.

(3) Records of any swap data reported in accordance with part 45 of this chapter shall be maintained in accordance with the requirements of § 45.2 of this chapter.

#### **§ 23.204 Reports to swap data repositories.**

(a) *Reporting of swap transaction data to swap data repositories.* Each swap dealer and major swap participant shall report all information and data in accordance with part 45 of this chapter.

(b) *Electronic reporting of swap transaction data.* Each swap dealer and major swap participant shall have the electronic systems and procedures

necessary to transmit electronically all information and data required to be reported in accordance with part 45 of this chapter.

**§ 23.205 Real-time public reporting.**

(a) *Real-time public reporting of swap transaction and pricing data.* Each swap dealer and major swap participant shall report all information and swap transaction and pricing data required to be reported in accordance with the real-time public recording requirements in part 43 of this chapter.

(b) *Electronic reporting of swap transaction data.* Each swap dealer and major swap participant shall have the electronic systems and procedures necessary to transmit electronically all information and data required to be reported in accordance with part 43 of this chapter.

**§ 23.206 Delegation of authority to the Director of the Division of Swap Dealer and Intermediary Oversight to establish an alternative compliance schedule to comply with daily trading records.**

(a) The Commission hereby delegates to the Director of the Division of Swap Dealer and Intermediary Oversight or such other employee or employees as the Director may designate from time to time, the authority to establish an alternative compliance schedule for requirements of § 23.202 that are found to be technologically or economically impracticable for an affected swap dealer or major swap participant that seeks, in good faith, to comply with the requirements of § 23.202 within a reasonable time period beyond the date on which compliance by such swap dealer or major swap participant is otherwise required.

(b) A request for an alternative compliance schedule under this section shall be acted upon by the Director of the Division of Swap Dealer and Intermediary Oversight within 30 days from the time such a request is received, or it shall be deemed approved.

(c) Relief granted under this section shall not cause a registrant to be out of compliance or deemed in violation of any registration requirements.

(d) Notwithstanding any other provision of this section, in any case in which a Commission employee delegated authority under this section believes it appropriate, he or she may submit to the Commission for its consideration the question of whether an alternative compliance schedule should be established. Nothing in this section shall be deemed to prohibit the Commission, at its election, from exercising the authority delegated in this section.

■ 8. Add Subpart J, consisting of §§ 23.600 through 23.607, to read as follows:

**Subpart J—Duties of Swap Dealers and Major Swap Participants**

Sec.

23.600 Risk Management Program for swap dealers and major swap participants.

23.601 Monitoring of position limits.

23.602 Diligent supervision.

23.603 Business continuity and disaster recovery.

23.604 [Reserved]

23.605 Conflicts of interest policies and procedures.

23.606 General information: availability for disclosure and inspection.

23.607 Antitrust considerations.

**Subpart J—Duties of Swap Dealers and Major Swap Participants**

**§ 23.600 Risk Management Program for swap dealers and major swap participants.**

(a) *Definitions.* For purposes of subpart J, the following terms shall be defined as provided.

(1) *Affiliate.* *This term means*, with respect to any person, a person controlling, controlled by, or under common control with, such person.

(2) *Business trading unit.* *This term means* any department, division, group, or personnel of a swap dealer or major swap participant or any of its affiliates, whether or not identified as such, that performs, or personnel exercising direct supervisory authority over the performance of any pricing (excluding price verification for risk management purposes), trading, sales, marketing, advertising, solicitation, structuring, or brokerage activities on behalf of a registrant.

(3) *Clearing unit.* *This term means* any department, division, group, or personnel of a registrant or any of its affiliates, whether or not identified as such, that performs, or personnel exercising direct supervisory authority over the performance of any proprietary or customer clearing activities on behalf of a registrant.

(4) *Governing body.* *This term means:*

(1) A board of directors;

(2) A body performing a function similar to a board of directors;

(3) Any committee of a board or body; or

(4) The chief executive officer of a registrant, or any such board, body, committee, or officer of a division of a registrant, provided that the registrant's swaps activities for which registration with the Commission is required are wholly contained in a separately identifiable division.

(5) *Prudential regulator.* *This term has* the same meaning as section 1a(39) of the Commodity Exchange Act and

includes the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Association, and the Federal Housing Finance Agency, as applicable to the swap dealer or major swap participant.

(6) *Senior management.* *This term means*, with respect to a registrant, any officer or officers specifically granted the authority and responsibility to fulfill the requirements of senior management by the registrant's governing body.

(7) *Swaps activities.* *This term means*, with respect to a registrant, such registrant's activities related to swaps and any product used to hedge such swaps, including, but not limited to, futures, options, other swaps or security-based swaps, debt or equity securities, foreign currency, physical commodities, and other derivatives.

(b) *Risk management program.* (1) *Purpose.* Each swap dealer and major swap participant shall establish, document, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the swaps activities of the swap dealer or major swap participant. For purposes of this regulation, such policies and procedures shall be referred to collectively as a "Risk Management Program."

(2) *Written policies and procedures.* Each swap dealer and major swap participant shall maintain written policies and procedures that describe the Risk Management Program of the swap dealer or major swap participant.

(3) *Approval by governing body.* The Risk Management Program and the written risk management policies and procedures shall be approved, in writing, by the governing body of the swap dealer or major swap participant.

(4) *Furnishing to the Commission.* Each swap dealer and major swap participant shall furnish a copy of its written risk management policies and procedures to the Commission, or to a futures association registered under section 17 of the Act, if directed by the Commission, upon application for registration and thereafter upon request.

(5) *Risk management unit.* As part of its Risk Management Program, each swap dealer and major swap participant shall establish and maintain a risk management unit with sufficient authority; qualified personnel; and financial, operational, and other resources to carry out the risk management program established pursuant to this regulation. The risk management unit shall report directly to senior management and shall be

independent from the business trading unit.

(c) *Elements of the Risk Management Program.* The Risk Management Program of each swap dealer and major swap participant shall include, at a minimum, the following elements:

(1) *Identification of risks and risk tolerance limits.* (i) The Risk Management Program should take into account market, credit, liquidity, foreign currency, legal, operational, settlement, and any other applicable risks together with a description of the risk tolerance limits set by the swap dealer or major swap participant and the underlying methodology in written policies and procedures. The risk tolerance limits shall be reviewed and approved quarterly by senior management and annually by the governing body. Exceptions to risk tolerance limits shall be subject to written policies and procedures.

(ii) The Risk Management Program shall take into account risks posed by affiliates and the Risk Management Program shall be integrated into risk management at the consolidated entity level.

(iii) The Risk Management Program shall include policies and procedures for detecting breaches of risk tolerance limits set by the swap dealer or major swap participant, and alerting supervisors within the risk management unit and senior management, as appropriate.

(2) *Periodic Risk Exposure Reports.* (i) The risk management unit of each swap dealer and major swap participant shall provide to senior management and to its governing body quarterly written reports setting forth the market, credit, liquidity, foreign currency, legal, operational, settlement, and any other applicable risk exposures of the swap dealer or major swap participant; any recommended or completed changes to the Risk Management Program; the recommended time frame for implementing recommended changes; and the status of any incomplete implementation of previously recommended changes to the Risk Management Program. For purposes of this regulation, such reports shall be referred to as "Risk Exposure Reports." The Risk Exposure Reports also shall be provided to the senior management and the governing body immediately upon detection of any material change in the risk exposure of the swap dealer or major swap participant.

(ii) *Furnishing to the Commission.* Each swap dealer and major swap participant shall furnish copies of its Risk Exposure Reports to the Commission within five (5) business

days of providing such reports to its senior management.

(3) *New product policy.* The Risk Management Program of each swap dealer and major swap participant shall include a new product policy that is designed to identify and take into account the risks of any new product prior to engaging in transactions involving the new product. The new product policy should include the following elements:

(i) Consideration of the type of counterparty with which the new product will be transacted; the product's characteristics and economic function; and whether the product requires a novel pricing methodology or presents novel legal and regulatory issues.

(ii) Identification and analysis of all relevant risks associated with the new product and how they will be managed. The risk analysis should include an assessment, if relevant, of any product, market, credit, liquidity, foreign currency, legal, operational, settlement, and any other risks associated with the new product. Product risk characteristics may include, if relevant, volatility, non-linear price characteristics, jump-to-default risk, and any correlation between the value of the product and the counterparty's creditworthiness.

(iii) An assessment, signed by a supervisor in the risk management unit, as to whether the new product would materially alter the overall entity-wide risk profile of the swap dealer or major swap participant. If the new product would materially alter the overall risk profile of the swap dealer or major swap participant, the new product must be pre-approved by the governing body before any transactions are effectuated.

(iv) A requirement that the risk management unit review the risk analysis to identify any necessary modifications to the Risk Management Program and implement such modifications prior to engaging in transactions involving the new product.

(v) Notwithstanding the foregoing, a swap dealer's or major swap participant's new product policy may include provisions permitting limited preliminary approval of new products—

(A) At a risk level that would not be material to the swap dealer or major swap participant; and

(B) Solely in order to provide the swap dealer or major swap participant with the opportunity to facilitate development of appropriate operational and risk management processes for such product.

(4) *Specific risk management considerations.* The Risk Management Program of each swap dealer and major

swap participant shall include, but not be limited to, policies and procedures necessary to monitor and manage the following risks:

(i) *Market risk.* Market risk policies and procedures shall take into account, among other things:

(A) Daily measurement of market exposure, including exposure due to unique product characteristics, volatility of prices, basis and correlation risks, leverage, sensitivity of option positions, and position concentration, to comply with market risk tolerance limits;

(B) Timely and reliable valuation data derived from, or verified by, sources that are independent of the business trading unit, and if derived from pricing models, that the models have been independently validated by qualified, independent external or internal persons; and

(C) Periodic reconciliation of profits and losses resulting from valuations with the general ledger.

(ii) *Credit risk.* Credit risk policies and procedures shall take into account, among other things:

(A) Daily measurement of overall credit exposure to comply with counterparty credit limits;

(B) Monitoring and reporting of violations of counterparty credit limits performed by personnel that are independent of the business trading unit; and

(C) Regular valuation of collateral used to cover credit exposures and safeguarding of collateral to prevent loss, disposal, rehypothecation, or use unless appropriately authorized.

(iii) *Liquidity risk.* Liquidity risk policies and procedures shall take into account, among other things:

(A) Daily measurement of liquidity needs;

(B) Assessing procedures to liquidate all non-cash collateral in a timely manner and without significant effect on price; and

(C) Application of appropriate collateral haircuts that accurately reflect market and credit risk.

(iv) *Foreign currency risk.* Foreign currency risk policies and procedures shall take into account, among other things:

(A) Daily measurement of the amount of capital exposed to fluctuations in the value of foreign currency to comply with applicable limits; and

(B) Establishment of safeguards against adverse currency fluctuations.

(v) *Legal risk.* Legal risk policies and procedures shall take into account, among other things:

(A) Determinations that transactions and netting arrangements entered into have a sound legal basis; and

(B) Establishment of documentation tracking procedures designed to ensure the completeness of relevant documentation and to resolve any documentation exceptions on a timely basis.

(vi) *Operational risk.* Operational risk policies and procedures shall take into account, among other things:

(A) Secure and reliable operating and information systems with adequate, scalable capacity, and independence from the business trading unit;

(B) Safeguards to detect, identify, and promptly correct deficiencies in operating and information systems; and

(C) Reconciliation of all data and information in operating and information systems.

(vii) *Settlement risk.* Settlement risk policies and procedures shall take into account, among other things:

(A) Establishment of standard settlement instructions with each counterparty;

(B) Procedures to track outstanding settlement items and aging information in all accounts, including nostro and suspense accounts; and

(C) Procedures to ensure timely payments to counterparties and to resolve any late payments.

(5) *Use of central counterparties.* Each swap dealer and major swap participant shall establish policies and procedures relating to its use of central counterparties. Such policies and procedures shall:

(i) Require the use of central counterparties where clearing is required pursuant to Commission regulation or order, unless the counterparty has properly invoked a clearing exemption under Commission regulations;

(ii) Set forth the conditions for the voluntary use of central counterparties for clearing when available as a means of mitigating counterparty credit risk; and

(iii) Require diligent investigation into the adequacy of the financial resources and risk management procedures of any central counterparty through which the swap dealer or major swap participant clears.

(6) *Compliance with margin and capital requirements.* Each swap dealer and major swap participant shall satisfy all capital and margin requirements established by the Commission or prudential regulator, as applicable.

(7) *Monitoring of compliance with Risk Management Program.* Each swap dealer and major swap participant shall establish policies and procedures to detect violations of the Risk Management Program; to encourage employees to report such violations to

senior management, without fear of retaliation; and to take specified disciplinary action against employees who violate the Risk Management Program.

(d) *Business trading unit.* Each swap dealer and major swap participant shall establish policies and procedures that, at a minimum:

(1) Require all trading policies be approved by the governing body of the swap dealer or major swap participant;

(2) Require that traders execute transactions only with counterparties for whom credit limits have been established;

(3) Provide specific quantitative or qualitative limits for traders and personnel able to commit the capital of the swap dealer or major swap participant;

(4) Monitor each trader throughout the trading day to prevent the trader from exceeding any limit to which the trader is subject, or from otherwise incurring unauthorized risk;

(5) Require each trader to follow established policies and procedures for executing and confirming all transactions;

(6) Establish means to detect unauthorized trading activities or any other violation of policies and procedures;

(7) Ensure that all trade discrepancies are documented and, other than immaterial, clerical errors, are brought to the immediate attention of management of the business trading unit;

(8) Ensure that broker statements and payments to brokers are periodically audited by persons independent of the business trading unit;

(9) Ensure that use of trading programs is subject to policies and procedures governing the use, supervision, maintenance, testing, and inspection of the program; and

(10) Require the separation of personnel in the business trading unit from personnel in the risk management unit.

(e) *Review and testing.* (1) Risk Management Programs shall be reviewed and tested on at least an annual basis, or upon any material change in the business of the swap dealer or major swap participant that is reasonably likely to alter the risk profile of the swap dealer or major swap participant.

(2) The annual reviews of the Risk Management Program shall include an analysis of adherence to, and the effectiveness of, the risk management policies and procedures, and any recommendations for modifications to the Risk Management Program. The

annual testing shall be performed by qualified internal audit staff that are independent of the business trading unit being audited or by a qualified third party audit service reporting to staff that are independent of the business trading unit. The results of the quarterly reviews of the Risk Management Program shall be promptly reported to and reviewed by, the chief compliance officer, senior management, and governing body of the swap dealer or major swap participant.

(3) Each swap dealer and major swap participant shall document all internal and external reviews and testing of its Risk Management Program and written risk management policies and procedures including the date of the review or test; the results; any deficiencies identified; the corrective action taken; and the date that corrective action was taken. Such documentation shall be provided to Commission staff, upon request.

(f) *Distribution of risk management policies and procedures.* The Risk Management Program shall include procedures for the timely distribution of its written risk management policies and procedures to relevant supervisory personnel. Each swap dealer and major swap participant shall maintain records of the persons to whom the risk management policies and procedures were distributed and when they were distributed.

(g) *Recordkeeping.* (1) Each swap dealer and major swap participant shall maintain copies of all written approvals required by this section.

(2) All records or reports that a swap dealer or major swap participant is required to maintain pursuant to this regulation shall be maintained in accordance with Commission Regulation § 1.31 and shall be made available promptly upon request to representatives of the Commission and to representatives of applicable prudential regulators.

#### **§ 23.601 Monitoring of position limits.**

(a) Each swap dealer and major swap participant shall establish and enforce written policies and procedures that are reasonably designed to monitor for and prevent violations of applicable position limits established by the Commission, a designated contract market, or a swap execution facility, and to monitor for and prevent improper reliance upon any exemptions or exclusions from such position limits. For purposes of this regulation, such policies and procedures shall be referred to as "Position Limit Procedures." The Position Limit Procedures shall be incorporated into

the Risk Management Program of the swap dealer or major swap participant.

(b) For purposes of the Position Limit Procedures, each swap dealer and major swap participant shall convert all swap positions into equivalent futures positions using the methodology set forth in Commission regulations.

(c) Each swap dealer and major swap participant shall provide training to all relevant personnel on applicable position limits on an annual basis and shall promptly notify personnel upon any change to applicable position limits. Each swap dealer and major swap participant shall maintain records of such training and notifications including the substance of the training, the identity of those receiving training, and the identity of those notified of changes to applicable position limits.

(d) Each swap dealer and major swap participant shall diligently monitor its trading activities and diligently supervise the actions of its partners, officers, employees, and agents to ensure compliance with the Position Limit Procedures of the swap dealer or major swap participant.

(e) The Position Limit Procedures of each swap dealer and major swap participant shall implement an early warning system designed to detect and alert its senior management when position limits are in danger of being breached (such as when trading has reached a percentage threshold of the applicable position limit, and when position limits have been exceeded). Any detected violation of applicable position limits shall be reported promptly to the firm's governing body. Any detected violation of applicable position limits, other than on-exchange violations reported to the Commission by a designated contract market or a swap execution facility, shall be reported promptly to the Commission. Each swap dealer and major swap participant shall maintain a record of any early warning received, any position limit violation detected, any action taken as a result of either, and the date action was taken.

(f) Each swap dealer and major swap participant that transacts in instruments for which position limits have been established by the Commission, a designated contract market, or a swap execution facility shall test its Position Limit Procedures for adequacy and effectiveness at least once each calendar quarter and maintain records of such tests; the results thereof; any action that is taken as a result thereof including, without limitation, any recommendations for modifications to the firm's Position Limit Procedures; and the date action was taken.

(g) Each swap dealer and major swap participant shall document its compliance with applicable position limits established by the Commission, a designated contract market, or a swap execution facility in a written report on a quarterly basis. Such report shall be promptly reported to and reviewed by the chief compliance officer, senior management, and governing body of the swap dealer or major swap participant, and shall include, without limitation, a list of all early warnings received, all position limit violations, the action taken in response, the results of the quarterly position limit testing required by this regulation, any deficiencies in the Position Limit Procedures, the status of any pending amendments to the Position Limit Procedures, and any action taken to amend the Position Limit Procedures to ensure compliance with all applicable position limits. Each swap dealer and major swap participant shall retain a copy of this report.

(h) On an annual basis, each swap dealer and major swap participant shall audit its Position Limit Procedures as part of the audit of its Risk Management Program required by Commission regulations.

(i) All records required to be maintained pursuant to these regulations shall be maintained in accordance with Commission Regulation § 1.31 and shall be made available promptly upon request to representatives of the Commission and to representatives of applicable prudential regulators.

#### § 23.602 Diligent supervision.

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

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

(1) The designation, where applicable, of at least one person with authority to carry out the supervisory responsibilities of the swap dealer or major swap participant for all activities relating to its business as a swap dealer or major swap participant.

(2) The use of reasonable efforts to determine that all supervisors are qualified and meet such standards of training, experience, competence, and

such other qualification standards as the Commission finds necessary or appropriate.

#### § 23.603 Business continuity and disaster recovery.

(a) *Business continuity and disaster recovery plan required.* Each swap dealer and major swap participant shall establish and maintain a written business continuity and disaster recovery plan that outlines the procedures to be followed in the event of an emergency or other disruption of its normal business activities. The business continuity and disaster recovery plan shall be designed to enable the swap dealer or major swap participant to continue or to resume any operations by the next business day with minimal disturbance to its counterparties and the market, and to recover all documentation and data required to be maintained by applicable law and regulation.

(b) *Essential components.* The business continuity and disaster recovery plan of a swap dealer or major swap participant shall include the following components:

(1) Identification of the documents, data, facilities, infrastructure, personnel and competencies essential to the continued operations of the swap dealer or major swap participant and to fulfill the obligations of the swap dealer or major swap participant.

(2) Identification of the supervisory personnel responsible for implementing each aspect of the business continuity and disaster recovery plan and the emergency contacts required to be provided pursuant to this regulation.

(3) A plan to communicate with the following persons in the event of an emergency or other disruption, to the extent applicable to the operations of the swap dealer or major swap participant: employees; counterparties; swap data repositories; execution facilities; trading facilities; clearing facilities; regulatory authorities; data, communications and infrastructure providers and other vendors; disaster recovery specialists and other persons essential to the recovery of documentation and data, the resumption of operations, and compliance with the Commodity Exchange Act and Commission regulations.

(4) Procedures for, and the maintenance of, back-up facilities, systems, infrastructure, alternative staffing and other resources to achieve the timely recovery of data and documentation and to resume operations as soon as reasonably

possible and generally within the next business day.

(5) Maintenance of back-up facilities, systems, infrastructure and alternative staffing arrangements in one or more areas that are geographically separate from the swap dealer's or major swap participant's primary facilities, systems, infrastructure and personnel (which may include contractual arrangements for the use of facilities, systems and infrastructure provided by third parties).

(6) Back-up or copying, with sufficient frequency, of documents and data essential to the operations of the swap dealer or major swap participant or to fulfill the regulatory obligations of the swap dealer or major swap participant and storing the information off-site in either hard-copy or electronic format.

(7) Identification of potential business interruptions encountered by third parties that are necessary to the continued operations of the swap dealer or major swap participant and a plan to minimize the impact of such disruptions.

(c) *Distribution to employees.* Each swap dealer and major swap participant shall distribute a copy of its business continuity and disaster recovery plan to relevant employees and promptly provide any significant revision thereto. Each swap dealer and major swap participant shall maintain copies of the business continuity and disaster recovery plan at one or more accessible off-site locations. Each swap dealer and major swap participant shall train relevant employees on applicable components of the business continuity and disaster recovery plan.

(d) *Commission notification.* Each swap dealer and major swap participant shall promptly notify the Commission of any emergency or other disruption that may affect the ability of the swap dealer or major swap participant to fulfill its regulatory obligations or would have a significant adverse effect on the swap dealer or major swap participant, its counterparties, or the market.

(e) *Emergency contacts.* Each swap dealer and major swap participant shall provide to the Commission the name and contact information of two employees who the Commission can contact in the event of an emergency or other disruption. The individuals identified shall be authorized to make key decisions on behalf of the swap dealer or major swap participant and have knowledge of the firm's business continuity and disaster recovery plan. The swap dealer or major swap participant shall provide the Commission with any updates to this information promptly.

(f) *Review and modification.* A member of the senior management of each swap dealer and major swap participant shall review the business continuity and disaster recovery plan annually or upon any material change to the business. Any deficiencies found or corrective action taken shall be documented.

(g) *Testing and audit.* Each business continuity and disaster recovery plan shall be tested annually by qualified, independent internal personnel or a qualified third party service. The date the testing was performed shall be documented, together with the nature and scope of the testing, any deficiencies found, any corrective action taken, and the date that corrective action was taken. Each business continuity and disaster recovery plan shall be audited at least once every three years by a qualified third party service. The date the audit was performed shall be documented, together with the nature and scope of the audit, any deficiencies found, any corrective action taken, and the date that corrective action was taken.

(h) *Business continuity and disaster recovery plans required by other regulatory authorities.* A swap dealer or major swap participant shall comply with the requirements of this regulation in addition to any business continuity and disaster recovery requirements that are imposed upon the swap dealer or major swap participant by its prudential regulator or any other regulatory or self-regulatory authority.

(i) *Recordkeeping.* The business continuity and disaster recovery plan of the swap dealer and major swap participant and all other records required to be maintained pursuant to this section shall be maintained in accordance with Commission Regulation § 1.31 and shall be made available promptly upon request to representatives of the Commission and to representatives of applicable prudential regulators.

#### § 23.604 [Reserved]

#### § 23.605 Conflicts of interest policies and procedures.

(a) *Definitions.* For purposes of this section, the following terms shall be defined as provided.

(1) *Affiliate.* This term means, with respect to any person, a person controlling, controlled by, or under common control with, such person.

(2) *Business trading unit.* This term means any department, division, group, or personnel of a swap dealer or major swap participant or any of its affiliates, whether or not identified as such, that

performs, or personnel exercising direct supervisory authority over the performance of, any pricing (excluding price verification for risk management purposes), trading, sales, marketing, advertising, solicitation, structuring, or brokerage activities on behalf of a swap dealer or major swap participant or any of its affiliates.

(3) *Clearing unit.* This term means any department, division, group, or personnel of a swap dealer or major swap participant or any of its affiliates, whether or not identified as such, that performs, or personnel exercising direct supervisory authority over the performance of, any proprietary or customer clearing activities on behalf of a swap dealer or major swap participant or any of its affiliates.

(4) *Derivative.* This term means:

- (i) A contract for the purchase or sale of a commodity for future delivery;
- (ii) A security futures product;
- (iii) A swap;
- (iv) Any agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i) of the Act;

(v) Any commodity option authorized under section 4c of the Act; and

(vi) Any leverage transaction authorized under section 19 of the Act.

(5) *Non-research personnel.* This term means any employee of the business trading unit or clearing unit, or any other employee of the swap dealer or major swap participant, other than an employee performing a legal or compliance function, who is not directly responsible for, or otherwise not involved in, research or analysis intended for inclusion in a research report.

(6) *Public appearance.* This term means any participation in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons (individuals or entities), or interview or appearance before one or more representatives of the media, radio, television or print media, or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning a derivatives transaction. This term does not include a password-protected Webcast, conference call or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current research report or other documentation that contains the required applicable disclosures, and that the research analyst appearing at the event corrects and updates during the public appearance any disclosures in the research report that are

inaccurate, misleading, or no longer applicable.

(7) *Research analyst.* This term means the employee of a swap dealer or major swap participant who is primarily responsible for, and any employee who reports directly or indirectly to such research analyst in connection with, preparation of the substance of a research report relating to any derivative, whether or not any such person has the job title of "research analyst."

(8) *Research department.* This term means any department or division that is principally responsible for preparing the substance of a research report relating to any derivative on behalf of a swap dealer or major swap participant, including a department or division contained in an affiliate of a swap dealer or major swap participant.

(9) *Research report.* This term means any written communication (including electronic) that includes an analysis of the price or market for any derivative, and that provides information reasonably sufficient upon which to base a decision to enter into a derivatives transaction. This term does not include:

- (i) Communications distributed to fewer than 15 persons;
- (ii) Commentaries on economic, political, or market conditions;
- (iii) Statistical summaries of multiple companies' financial data, including listings of current ratings;
- (iv) Periodic reports or other communications prepared for investment company shareholders or commodity pool participants that discuss individual derivatives positions in the context of a fund's past performance or the basis for previously-made discretionary decisions;
- (v) Any communications generated by an employee of the business trading unit that is conveyed as a solicitation for entering into a derivatives transaction, and is conspicuously identified as such; and
- (vi) Internal communications that are not given to current or prospective customers.

(b) *Policies and procedures.* Each swap dealer and major swap participant subject to this rule must adopt and implement written policies and procedures reasonably designed to ensure that the swap dealer or major swap participant and its employees comply with the provisions of this rule.

(c) *Research analysts and research reports.* (1) *Restrictions on relationship with research department.* (i) Non-research personnel shall not direct a research analyst's decision to publish a research report of the swap dealer or

major swap participant, and non-research personnel shall not direct the views and opinions expressed in a research report of the swap dealer or major swap participant.

(ii) No research analyst may be subject to the supervision or control of any employee of the swap dealer's or major swap participant's business trading unit or clearing unit, and no employee of the business trading unit or clearing unit may have any influence or control over the evaluation or compensation of a research analyst.

(iii) Except as provided in paragraph (c)(1)(iv) of this section, non-research personnel, other than the board of directors and any committee thereof, shall not review or approve a research report of the swap dealer or major swap participant before its publication.

(iv) Non-research personnel may review a research report before its publication as necessary only to verify the factual accuracy of information in the research report, to provide for non-substantive editing, to format the layout or style of the research report, or to identify any potential conflicts of interest, provided that:

(A) Any written communication between non-research personnel and research department personnel concerning the content of a research report must be made either through authorized legal or compliance personnel of the swap dealer or major swap participant or in a transmission copied to such personnel; and

(B) Any oral communication between non-research personnel and research department personnel concerning the content of a research report must be documented and made either through authorized legal or compliance personnel acting as an intermediary or in a conversation conducted in the presence of such personnel.

(2) *Restrictions on communications.* Any written or oral communication by a research analyst to a current or prospective counterparty relating to any derivative must not omit any material fact or qualification that would cause the communication to be misleading to a reasonable person.

(3) *Restrictions on research analyst compensation.* A swap dealer or major swap participant may not consider as a factor in reviewing or approving a research analyst's compensation his or her contributions to the swap dealer's or major swap participant's trading or clearing business. Except for communicating client or customer feedback, ratings, and other indicators of research analyst performance to research department management, no employee of the business trading unit or

clearing unit of the swap dealer or major swap participant may influence the review or approval of a research analyst's compensation.

(4) *Prohibition of promise of favorable research.* No swap dealer or major swap participant may directly or indirectly offer favorable research, or threaten to change research, to an existing or prospective counterparty as consideration or inducement for the receipt of business or compensation.

(5) *Disclosure requirements.* (i) *Ownership and material conflicts of interest.* A swap dealer or major swap participant must disclose in research reports and a research analyst must disclose in public appearances:

(A) Whether the research analyst maintains a financial interest in any derivative of a type, class, or, category that the research analyst follows, and the general nature of the financial interest; and

(B) Any other actual, material conflicts of interest of the research analyst or swap dealer or major swap participant of which the research analyst has knowledge at the time of publication of the research report or at the time of the public appearance.

(ii) *Prominence of disclosure.* Disclosures and references to disclosures must be clear, comprehensive, and prominent. With respect to public appearances by research analysts, the disclosures required by this paragraph (c)(5) must be conspicuous.

(iii) *Records of public appearances.* Each swap dealer and major swap participant must maintain records of public appearances by research analysts sufficient to demonstrate compliance by those research analysts with the applicable disclosure requirements under this paragraph (c)(5).

(iv) *Third-party research reports.* (A) For the purposes of this paragraph (c)(5)(iv), "independent third-party research report" shall mean a research report, in respect of which the person or entity producing the report:

(1) Has no affiliation or business or contractual relationship with the distributing swap dealer or major swap participant, or that swap dealer's or major swap participant's affiliates, that is reasonably likely to inform the content of its research reports; and

(2) Makes content determinations without any input from the distributing swap dealer or major swap participant or that swap dealer's or major swap participant's affiliates.

(B) Subject to paragraph (c)(5)(iv)(C) of this section, if a swap dealer or major swap participant distributes or makes available any independent third-party

research report, the swap dealer or major swap participant must accompany the research report with, or provide a Web address that directs the recipient to, the current applicable disclosures, as they pertain to the swap dealer or major swap participant, required by this section. Each swap dealer and major swap participant must establish written policies and procedures reasonably designed to ensure the completeness and accuracy of all applicable disclosures.

(C) The requirements of paragraph (c)(5)(iv)(B) of this section shall not apply to independent third-party research reports made available by a swap dealer or major swap participant to its customers:

(1) Upon request; or

(2) Through a Web site maintained by the swap dealer or major swap participant.

(6) *Prohibition of retaliation against research analysts.* No swap dealer or major swap participant, and no employee of a swap dealer or major swap participant who is involved with the swap dealer's or major swap participant's pricing, trading, or clearing activities, may, directly or indirectly, retaliate against or threaten to retaliate against any research analyst employed by the swap dealer or major swap participant or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made, in good faith, by the research analyst that may adversely affect the swap dealer's or major swap participant's present or prospective pricing, trading, or clearing activities.

(d) *Clearing activities.* (1) No swap dealer or major swap participant shall directly or indirectly interfere with or attempt to influence the decision of the clearing unit of any affiliated clearing member of a derivatives clearing organization to provide clearing services and activities to a particular customer, including but not limited to a decision relating to the following:

(i) Whether to offer clearing services and activities to a particular customer;

(ii) Whether to accept a particular customer for the purposes of clearing derivatives;

(iii) Whether to submit a customer's transaction to a particular derivatives clearing organization;

(iv) Whether to set or adjust risk tolerance levels for a particular customer;

(v) Whether to accept certain forms of collateral from a particular customer; or

(vi) Whether to set a particular customer's fees for clearing services based upon criteria that are not

generally available and applicable to other customers of the swap dealer or major swap participant.

(2) Each swap dealer and major swap participant shall create and maintain an appropriate informational partition, as specified in section 4s(j)(5)(A) of the Act, between business trading units of the swap dealer or major swap participant and clearing units of any affiliated clearing member of a derivatives clearing organization to reasonably ensure compliance with the Act and the prohibitions specified in paragraph (d)(1) of this section. At a minimum, such informational partitions shall require that no employee of a business trading unit of a swap dealer or major swap participant shall supervise, control, or influence any employee of the clearing unit of any affiliated clearing member of a derivatives clearing organization.

(e) *Undue influence on counterparties.* Each swap dealer and major swap participant must adopt and implement written policies and procedures that mandate the disclosure to its counterparties of any material incentives and any material conflicts of interest regarding the decision of a counterparty:

(1) Whether to execute a derivative on a swap execution facility or designated contract market; or

(2) Whether to clear a derivative through a derivatives clearing organization.

(f) All records that a swap dealer or major swap participant is required to maintain pursuant to this regulation shall be maintained in accordance with Commission Regulation § 1.31 and shall be made available promptly upon request to representatives of the Commission and to representatives of the applicable prudential regulator, as defined in 7 U.S.C. 1a(39).

**§ 23.606 General information: availability for disclosure and inspection.**

(a) *Disclosure of information.* (1) Each swap dealer and major swap participant shall make available for disclosure to and inspection by the Commission and its prudential regulator, as applicable, all information required by, or related to, the Commodity Exchange Act and Commission regulations, including:

(i) The terms and condition of its swaps;

(ii) Its swaps trading operations, mechanisms, and practices;

(iii) Financial integrity and risk management protections relating to swaps; and

(iv) Any other information relevant to its trading in swaps.

(2) Such information shall be made available promptly, upon request, to Commission staff and the staff of the applicable prudential regulator, at such frequency and in such manner as is set forth in the Commodity Exchange Act, Commission regulations, or the regulations of the applicable prudential regulator.

(b) *Ability to provide information.* (1) Each swap dealer and major swap participant shall establish and maintain reliable internal data capture, processing, storage, and other operational systems sufficient to capture, process, record, store, and produce all information necessary to satisfy its duties under the Commodity Exchange Act and Commission regulations. Such systems shall be designed to produce the information within the time frames set forth in the Commodity Exchange Act and Commission regulations or upon request, as applicable.

(2) Each swap dealer and major swap participant shall establish, implement, maintain, and enforce written procedures for the capture, processing, recording, storage, and production of all information necessary to satisfy its duties under the Commodity Exchange Act and Commission regulations.

(c) *Record retention.* All records or reports that a swap dealer or major swap participant is required to maintain pursuant to this regulation shall be maintained in accordance with Commission Regulation § 1.31 and shall be made available promptly upon request to representatives of the Commission and to representatives of applicable prudential regulators.

**§ 23.607 Antitrust considerations.**

(a) No swap dealer or major swap participant shall adopt any process or take any action that results in any unreasonable restraint of trade, or impose any material anticompetitive burden on trading or clearing, unless necessary or appropriate to achieve the purposes of the Commodity Exchange Act.

(b) Consistent with its obligations under paragraph (a) of this section, each swap dealer and major swap participant shall adopt policies and procedures to prevent actions that result in unreasonable restraint of trade, or impose any material anticompetitive burden on trading or clearing.

Issued in Washington, DC, on February 23, 2012, by the Commission.

**David A. Stawick,**  
*Secretary of the Commission.*

**Note:** The following appendices will not appear in the Code of Federal Regulations:

**Appendices to Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer—Commission Voting Summary and Statements of Commissioners**

**Appendix 1—Commission Voting Summary**

On this matter, Chairman Gensler and Commissioners Chilton and Wetjen voted in the affirmative; Commissioners Sommers and O'Malia voted in the negative.

**Appendix 2—Statement of Chairman Gary Gensler**

I support the internal business conduct rule, which will lower the risk that swap dealers pose to the rest of the economy. These rules are the result of a critical reform in the Dodd-Frank Wall Street reform and Consumer Protection Act (Dodd-Frank Act) where Congress gave the Commodity Futures Trading Commission (CFTC) authority to write rules overseeing swap dealer business conduct. This rule is a collection of five CFTC proposals in four key areas.

First, the final rule establishes a number of duties for swap dealers (SDs) and major swap participants (MSPs), including a risk management program with policies and procedures to monitor and manage the risks associated with their swap activities. Among the requirements are: (a) Ensuring the risk management program takes into account market risk, credit risk, liquidity risk, foreign currency risk, legal risk, operational risk, settlement risk, and risk posed by traders; (b) establishing a system of diligent supervision by qualified personnel over the SD and MSP activities; and (c) ensuring risk management issues are elevated within management.

Second, the final rule establishes firewalls to protect against conflicts of interest that can arise between trading and research units of SDs, MSPs, futures commission merchants (FCMs), and introducing brokers. In addition, the rules establish a firewall between clearing and trading that will protect against conflicts of interest relating to a firm's clearing activities. A 2009 Commission study on harmonization between the Securities and Exchange Commission and the CFTC recommended that the Commission establish these firewalls, which are based upon similar protections in the securities markets.

Third, the final rule establishes the reporting, recordkeeping and daily trading requirements for SDs and MSPs. Importantly, this section creates an audit trail detailing the full history of trades so the SD or MSP can better ensure compliance internally, and, when appropriate, the CFTC can be a more effective cop on the beat.

Fourth, the final rule establishes requirements for the designation of a chief compliance officer of SDs, MSPs and FCMs. This compliance officer will ensure that the

firm's policies and procedures comply with the CEA and Commission regulations. The officer will prepare an annual report describing the registrant's compliance with its own policies, as well as CEA and Commission regulations.

**Appendix 3—Statement of Commissioner Scott O'Malia**

The latest issue of *The Economist* features an article titled "Over-regulated America"<sup>198</sup> that features as its archetype for excessive and badly-written regulation our own Dodd-Frank Act. The problem, the article points out, is that rules that sound reasonable on their own may impose a huge collective burden due, in part, to their complexity. Part of the problem is that we, as *The Economist* points out, are under the impression that we can anticipate and regulate for every eventuality. In our hubris, *The Economist* warns, our overreaching tends to defeat our good intentions and creates loopholes and perhaps unintentional safe-harbors, leaving our rules ineffectual and subject to abuse. The solution *The Economist* offers isn't so unfamiliar, at least to this Commissioner. It is rather simple. It is just that: Rules need to be simple. Echoing President Obama's 2011 Executive Order 13563 "Improving Regulation and Regulatory Review"<sup>199</sup> (which applies equally to independent Federal agencies such as the Commodity Futures Trading Commission (the "Commission" or "CFTC") per a subsequent Executive Order<sup>200</sup>), *The Economist* advises that we ought to cut out the verbiage and focus on writing rules that articulate broad goals and prescribe only what is strictly necessary to achieve them.

In my own words, in several prior statements, I have argued that we must ensure that regulations are accessible, consistent, written in plain language, guided by empirical data, and are easily understood. I cautioned that, with each piecemeal rulemaking, we risk creating redundancies and inconsistencies that result in costs—both opportunity costs and economic costs—without corresponding benefits. Consistent with Executive Order 13563, which reaffirms prior guidance on the subject of regulatory review issued in the 1993 Executive Order 12866<sup>201</sup> as well as Office of Management and Budget ("OMB") guidance to Federal agencies with respect to said Executive Order,<sup>202</sup> agencies like the CFTC must go out of their way to ensure responsible rulemaking by, among other things, undertaking thorough cost-benefit analyses, both qualitatively and quantitatively, to ensure that new rules do not impose unreasonable costs.

I accepted wholeheartedly the mission put upon this administration by the President to

<sup>198</sup> *Over-regulated America*, *Economist*, Feb. 18, 2012, at 9.

<sup>199</sup> Exec. Order No. 13,563, 76 FR 3821 (Jan. 21, 2011).

<sup>200</sup> Exec. Order No. 13,579, 76 FR 41,587 (July 14, 2011).

<sup>201</sup> Exec. Order No. 12,866, 58 FR 51,735 (Oct. 4, 1993).

<sup>202</sup> OMB Circular A-4, available at [http://www.whitehouse.gov/sites/default/files/omb/assets/regulatory\\_matters\\_pdf/a-4.pdf](http://www.whitehouse.gov/sites/default/files/omb/assets/regulatory_matters_pdf/a-4.pdf).

"[T]o root out regulations that conflict, that are not worth the cost, or that are just plain dumb."<sup>203</sup> Today, in furtherance of that mission, I will not support the final rules governing various internal business conduct standards for futures commission merchants, introducing brokers, swap dealers and major swaps participants (the "Internal Business Conduct Rules"). These rules fail to articulate necessary and clear performance objectives, are needlessly complex, and create a collective burden without the benefit of even an appropriate baseline cost-benefit analysis. The fact that OMB's Office of Information and Regulatory Affairs<sup>204</sup> has concurred<sup>205</sup> with our determination that this set of rules qualifies as a "Major Rule" under the Congressional Review Act with an annual effect on the economy of more than \$100 million without a fulsome discussion of anticipated costs, let alone an analysis based on reasoned assumptions or evaluation of the impacts of this rulemaking against the pre-statutory baseline, is regulatory malpractice in my book. While we set the bar low here at the Commission for our cost-benefit analyses, and accept what is "reasonably feasible," this rulemaking is nothing but unreasonably feeble.

After reviewing the Internal Business Conduct Rules, I have reached a tipping point and can no longer tolerate the application of such weak standards to analyzing the costs and benefits of our rulemakings. Our inability to develop a quantitative analysis, or to develop a reasonable comparative analysis of legitimate options, hurts the credibility of this Commission and undermines the quality of our rules. I believe it is time for professional help, and I will be following up this statement with a letter to the Director of the OMB seeking an independent review of the Internal Business Conduct Rules to determine whether or not this rulemaking fully complies with the President's Executive Orders and the OMB guidance found in OMB Circular A-4. To the extent that OMB finds any concerns with the Commission's economic analysis, I hope that it will provide specific recommendations as to how the Commission can improve its cost-benefit analysis and analytical capabilities.

Lest anyone think that I am inadvertently waiving a work-product or other privilege, the Commission's May 13, 2011 internal Staff Guidance on Cost-Benefit Considerations for Final Rulemakings under the Dodd-Frank Act ("Staff Guidance") was made public as Exhibit 2 to the CFTC's Office of Inspector General's June 13, 2011 Review of Cost-Benefit Analyses Performed by the CFTC in

<sup>203</sup> Barack Obama, *Toward a 21st-Century Regulatory System*, Wall St. J., Jan. 18, 2011, at A17.

<sup>204</sup> The Office of Information and Regulatory Affairs ("OIRA"), among other things, reviews draft regulations under Executive Order 12866. See Office of Information and Regulatory Affairs ("OIRA") Q & As, available at: [http://www.whitehouse.gov/omb/OIRA\\_QsandAs](http://www.whitehouse.gov/omb/OIRA_QsandAs).

<sup>205</sup> I use this term loosely since the only verification we received at the Commission was a perfunctory email from an OMB employee stating, "OMB concurs that the rule is major." It is unclear as to what data OMB could have relied upon in reaching its conclusion.

Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act, which is available on the CFTC's Web site.<sup>206</sup> While it is not my intent to walk you through the Staff Guidance (or the Inspector General's report for that matter), I do think it warrants attention for the inattention it gives to both the principles of Executive Orders 13563 and 12866 and OMB guidance found in Circular A-4 ("OMB Circular A-4"). More specifically, and among other things, the Staff Guidance provides that each rulemaking team should, "incorporate the principles of Executive Order 13563 to the extent they are consistent with section 15(a) [of the Commodity Exchange Act] and it is *reasonably feasible* to do so." Keep in mind that while Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its proposed regulations, the Commission has interpreted the language of section 15(a) to neither require quantification of such costs and benefits, nor to require the agency to determine whether the benefits exceed costs or whether the proposed rules are the most cost-effective means of reaching goals.<sup>207</sup> "Rather, section 15 simply requires the Commission to 'consider the costs and benefits' of its action."<sup>208</sup> That was a direct quote from the **Federal Register**.

Further, under the Staff Guidance—and clearly consistent with the Commission's interpretation of section 15—rulemaking teams need only quantify costs and benefits "to the extent it is *reasonably feasible and appropriate* to address comments received." As additional guidance, staff is advised that "reasonably feasible and appropriate" means "the extent to which (i) certain analyses, quantitative or qualitative, is [sic] needed to address comments received ("appropriate") and (ii) whether such an analysis may be performed with available resources ("reasonably feasible"). Accordingly, our interpretation of our duties pursuant to section 15(a) and Staff Guidance provides that we need not quantify the costs or benefits of our rules unless we need to do so in order to respond to comments, and that we can do so with whatever resources are immediately at our fingertips. As for the Executive Orders, it appears that we will incorporate their principles only when they neatly align with our own interpretation of section 15(a), and only when we can do so without utilizing the resources immediately within our coffers.

Setting the bar this low is pretty remarkable. Indeed, former Commissioner and Acting Chairman William P. Albrecht recently remarked that expecting any detailed cost-benefit analysis of the proposed

Dodd-Frank rules is impossible in part because, "[T]he CFTC has never had to develop CBA expertise."<sup>209</sup> Commissioner Albrecht advised that, "A good starting point might be to require more detailed analysis of the costs of alternative means of accomplishing a particular goal. This would help the agency develop CBA expertise and should, over time, lead to a deeper understanding of the costs of regulation."<sup>210</sup>

I believe that Commissioner Albrecht's advice is already well-articulated in both Executive Orders and OMB Circular A-4 as incorporated directly into the Staff Guidance. However, the Commission skirts these requirements and apparently refuses to develop expertise. Instead, the Commission limits itself to responding to comments, but only when it doesn't require any analysis beyond that which it did for the proposal.

Additionally, as in today's final rulemaking, the Commission has determined, in contradiction of OMB guidance directly on point, that in setting the baseline for comparison of the costs and benefits of regulatory alternatives, it may set the "baseline" to incorporate the costs of statutorily mandated rulemakings, regardless of how the CFTC has interpreted the statutory goals and regardless of the existence of alternative means to comply with such goals. Thereby, the Commission is relying on an arbitrary presumption that, "To the extent that \* \* \* new regulations reflect the statutory requirements of the Dodd-Frank Act, they will not create costs and benefits beyond those resulting from Congress's statutory mandates in the Dodd-Frank Act."<sup>211</sup> What does this mean? Well, according to the Commission in this rulemaking, it means that for commenters who "posit that there is no benefit to be derived from internal business conduct standards as mandated by Congress and that the mandated provisions do not generate sufficient benefits relative to costs or contribute to the purposes (e.g. mitigating systemic risk and enhancing transparency) of the Dodd-Frank Act. \* \* \* these commenters' concerns fall outside the Commission's regulatory discretion to implement sections 4s and 4d of the CEA and fail to raise issues subject to consider[ation] under section 15(a)."<sup>212</sup> That is, the Commission will ignore comments related to required rulemaking provisions that mirror statutory language in spite of the fact that the Commission always has some level of discretion in determining the means to achieve such mandates. Rather the

Commission will consider comments on new regulations "that reflect the Commission's own determinations regarding implementation of the Dodd-Frank Act's provisions. \* \* \* It is these other costs and benefits \* \* \* that the Commission considers with respect to the section 15(a) factors."<sup>213</sup> It is unacceptable that the Commission ignores pre-Dodd-Frank reality and establishes its own economic baseline for its rulemakings. This practice defies not only common sense, but rigorous and competent economic analysis as well.

I will briefly highlight how these rules not only fail to include a rational, rigorous, and sustainable cost-benefit analysis, but fail to articulate necessary and clear performance objectives, are complex, and create an unjustifiable cumulative burden within this rule and when considered with other CFTC regulations and those of prudential regulators.

I believe the Commission has failed to carefully and precisely identify a clear baseline against which the Commission measured costs and benefits and the range of alternatives under consideration in this rule. Specifically, the Commission's cost-benefit analysis with regard to this rule fails to comply with the basic direction in OMB Circular A-4 to establish an appropriate baseline that includes an evaluation of the pre-statutory baseline in light of the range of Commission discretion as to the manner in which the rules implement the statutory goals of section 4s.<sup>214</sup> The circular also directs the Commission to consider alternatives available "for the key attributes or provisions of the rule."<sup>215</sup> The Circular goes on to recommend that, "It is not adequate simply to report a comparison of the agency's preferred option to the chosen baseline. Whenever you report the benefits and the costs of alternative options, you should present both total and incremental benefits and costs."<sup>216</sup> It is at this most basic level of analysis where the Commission has failed to provide alternative options for consideration or has failed to justify its choice of regulation with a specific cost-benefit analysis.

In two examples articulated by the Commission, the Internal Business Conduct Rules dismisses out of hand, and without specific justification the concerns raised by two commenters: (1) The Federal Home Loan Banks who raised concerns regarding compliance burdens and duplicative nature of regulations for comparably regulated entities; and (2) The Working Group of Commercial Energy Firms, which raised concerns that the rules failed to provide benefits with regard to risk management and compliance that matched, much less exceeded, the cost of compliance. Both concerns were dismissed without consideration of alternatives and without any attempt to quantify the cited costs.

With regard to recordkeeping requirements, the Internal Business Conduct Rules impose a substantial burden on Swap

<sup>206</sup> Office of the Inspector General of the Commodity Futures Trading Commission, A Review of Cost-Benefit Analyses performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act, June 13, 2011, available at: [www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig\\_investigation\\_061311.pdf](http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig_investigation_061311.pdf).

<sup>207</sup> A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 FR 14,262, 14,267 (March 9, 2001).

<sup>208</sup> *Id.*

<sup>209</sup> William P. Albrecht, Cost Benefit Analysis and the Commodity Futures Trading Commission ("CFTC"), Discussion Paper, May 2011, available at <http://www.rff.org/RFF/Documents/RFF-DP-11-24.pdf>.

<sup>210</sup> *Id.* at 9.

<sup>211</sup> See Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer, Final Rule, at Section IV of the Preamble.

<sup>212</sup> *Id.* at Section IV of the Cost Benefit Considerations, note 64.

<sup>213</sup> *Id.* at Section IV of the Preamble.

<sup>214</sup> OMB Circular A-4 at 15-16.

<sup>215</sup> *Id.* at 16.

<sup>216</sup> *Id.*

Dealers (“SDs”) and Major Swap Participants (“MSPs”) to maintain extensive audio recordings including the requirement to tag each taped conversation and make it searchable by transaction and counterparty. Understandably, section 4s(g) does require the maintenance of such daily trading records for each counterparty and that they be identifiable with each swap transaction. However, in spite of enormous technological challenges it is unclear as to whether or not the Commission undertook any independent effort to determine the technical challenges of implementing such a system, including, whether such technology currently exists, the costs of acquiring and installing such technology, and whether such a system could be developed and/or installed within the timetable set by the Commission. The Commission has failed the fundamental test in Circular A–4 to establish an appropriate baseline and consider a range of alternatives with associated costs and benefits. Although the Commission modified its original proposal to not require each telephone record to be kept as a single file, it fails to quantify the specific cost of complying with a costly and technically challenging mandate. Moreover, in determining that such audio recordings are to be maintained for a one-year period, the Commission provides no analytical support for this retention period over a more reasonable six-month period other than to say that such period will be “most useful for the Commission’s enforcement purposes.”<sup>217</sup>

Further, the Commission also ignored commenters’ requests to allow firms to rely on swap data repositories (“SDRs”) for recordkeeping requirements. The analysis states:

The Commission considered this alternative to its recordkeeping rules, but determined that it is premature at this time to permit SDs and MSPs to rely solely on SDRs to meet their recordkeeping obligations under the rules. \* \* \* At present, SDRs are new entities under the Dodd-Frank Act with no track record of operations; and, for particular swap asset classes, SDRs have yet to be established.<sup>218</sup>

In addition to finalizing rules governing registration standards, duties and core principles for SDRs,<sup>219</sup> the Commission has already voted on the final rules that establish and compel the reporting of swap transaction information to SDRs for purposes of real-time public reporting (the “Real-Time Reporting Rule”) and to ensure that complete data concerning swaps is available to regulators throughout the existence of each swap and for fifteen years following termination.<sup>220</sup> In

<sup>217</sup> See Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer, Final Rule, at Section IV of the Preamble.

<sup>218</sup> *Id.*

<sup>219</sup> Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR 54,538 (Sept. 1, 2011) (to be codified at 17 CFR part 49).

<sup>220</sup> Real-Time Public Reporting of Swap Transaction Data, 76 FR 1,182 (Jan. 9, 2012) (to be

in addition, the track record of entities that will likely be our first registered SDRs is considered proven as data from these repositories in both rates and credit have been used to establish the foundation for today’s re-proposal of Procedures to Establish Appropriate Minimum Block Sizes For Large Notional Off-Facility Swaps and Block Trades; Further Measures to Protect the Identities of Parties to Swap Transactions (the “Block Proposal”).

If the Commission truly has doubts as to the fidelity and reliability SDR data, then it ought not to have relied upon it in a proposed rulemaking. That being said, although the analysis seems to indicate that the Commission considered alternatives, it is curious as to how the Commission came to the conclusion that the Internal Business Conduct Rules are cost-effective, given that they require firms to keep duplicative and redundant trade records when all trades must be reported to an SDR and stored by the SDR for the life of the swap, plus an additional fifteen years—which is ten years more than our rules require that such records be kept by registrants.

I would also point out that the Real-Time Reporting Rule provides that a party to a publicly-reportable swap transaction satisfies its real-time reporting requirements by executing the swap on or pursuant to the rules of an exchange or swap execution facility.<sup>221</sup> That is, SDs and MSPs, among others, may rely on exchanges and swap execution facilities to report all on-exchange trades; there is no mandated separate reporting requirement. However, the Internal Business Conduct Rules undermine this relief by requiring redundant recordkeeping and by mandating that SDs and MSPs save all transaction records and by failing to trust our own regulatory-creation to actually serve as a repository for all trade data as envisioned by Dodd-Frank Act. I have serious concerns about the Commission’s ability to monitor and reconcile two sets of records, which is the rationale put forth in this final rule.

Ironically, the SDRs were created in the Dodd-Frank Act to facilitate market transparency and reporting. The Commission could provide greater transparency into its own cost-benefit analysis by disclosing its assumptions and data to support its conclusions. OMB Circular A–4 outlines standards for transparency with the following direction, “A good analysis should be transparent and your results must be reproducible. You should clearly set out the basic assumptions, methods and data underlying the analysis and discuss the uncertainties associated with your estimates.”<sup>222</sup> It goes on to recommend that, “To provide greater access to your analysis, you should generally post it, with all the supporting documents, on the internet so the

codified at 17 CFR part 43); Swap Data Recordkeeping and Reporting Requirements, 76 FR 2,136 (Jan. 13, 2012) (to be codified at 17 CFR part 45).

<sup>221</sup> Real-Time Public Reporting of Swap Transaction Data, 76 FR 1,182, 1,244 (Jan. 9, 2012) (to be codified at 17 CFR part 43).

<sup>222</sup> OMB Circular A–4 at 17.

public can review the findings.”<sup>223</sup> I presume the Commission feels that this level of compliance is not appropriate, given that the commenters failed to demand it, and is simply not reasonably feasible.

One of my major criticisms is that the Internal Business Conduct Rules, and, in particular, section 23.600—Risk Management Program for Swap Dealers and Major Swap Participants, attempt to cover every possible contingency instead of articulating goals and performance objectives. Section 4s(j)(2) simply requires that the SD or MSP “establish robust and professional risk management systems adequate for managing the day-to-day business of the swap dealer or major swap participant.” Could anyone truly argue that that provision could not stand largely on its own as a performance objective? Did the Commission need to specify to the nth degree the behavior and manner of compliance that SDs and MSPs must adopt in order to meet that objective? And in doing so, has the Commission created loopholes and unintentional safe harbors for those who meet the regulatory requirements, but still manage to violate other provisions of the Commodity Exchange Act and regulations?

Another concern is that the Internal Business Conduct Rules do not provide for substituted compliance with any of these requirements for SDs and MSPs for which the CFTC is not their prudential regulator. While one distinct part of the preamble regarding rules pertaining to business continuity and disaster recovery suggest that if an SD or MSP is subject to other rules that meet the requirements of the Commission’s rule, then such SD or MSP would be in compliance with the Commission’s rule, the rules themselves do not evidence any attempts to coordinate our regulatory requirements with those of our fellow prudential regulators through the explicit provision for substituted compliance. More egregiously, section 23.603(h)—Business Continuity and Disaster Recovery Plans Required by Other Regulatory Authorities, specifically requires SDs and MSPs to comply with the business continuity and disaster recovery requirements of this regulation “in addition to any business continuity and disaster recovery requirements that are imposed on the swap dealer or major swap participant by its prudential regulator or any other regulatory or self-regulatory authority.”<sup>224</sup> There is no quantification or qualification of costs and benefits of this regulatory decision, and I am not surprised.

I believe our reasonably “feasible standard” as articulated in our own Staff Guidance has caused us to miss any marker for identifying and using the best, most innovative and least burdensome tools to meet the regulatory ends laid out in section 4s of the Commodity Exchange Act. We

<sup>223</sup> *Id.*

<sup>224</sup> Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer, Final Rule, at § 23.603(h).

should be held accountable for not only failing to even attempt to meet the goals set by the President, but for deliberately eschewing them. I agree with Chairman Albrecht that the CFTC ought to be required to undertake more rigorous cost-benefit analyses. I believe all of our analyses should be more rigorous. While it may not solve all of our problems with putting out complex and inefficient regulations, as noted by Chairman Albrecht, it should help.<sup>225</sup> I will be sending a letter to Acting OMB Director Jeffrey Zients requesting his assistance in determining just how far off the baseline the Commission has fallen. If OMB Circular A-4 means anything at all, then OMB should take action and hold the Commission to the Circular's standards.

#### Appendix 4—Statement of Chairman Gensler and Commissioners Chilton and Wetjen

The Commission fully considered all comments and the costs and benefits of its actions in this rulemaking. The preamble of this **Federal Register** release specifically addresses issues concerning compliance burdens and recordkeeping requirements. Indeed, the preamble addresses the comments received in response to, and proffers the Commission's rationale for, each of the final rules promulgated herein. The final rules also contain numerous examples in which the recommendations of commenters have been adopted and incorporated into the final rule text. Further, all comments relevant to the Commission's consideration of costs and benefits were expressly addressed in the Commission's discussion of its cost-benefit considerations.

With respect to comments received in response to the recordkeeping rules, for example, the Commission is aware that the technology exists to implement a recording system as required under section 4s(g) of the Commodity Exchange Act (CEA). Indeed, other regulatory regimes across the globe already require such recording. As explained in the preamble to the proposed recordkeeping rules, in 2008, the United Kingdom's Financial Services Authority (FSA) implemented rules relating to the recording and retention of voice conversations and electronic communications, including a recent determination that all financial service firms will be required to record any relevant

communication by employees on their work cell phones.<sup>226</sup> The FSA implemented this requirement based on significant technological advancements in recent years, particularly with respect to the cost of capturing and retaining copies of electronic material, including telephone communications, which have made recordkeeping requirements for digital and electronic communications more economically feasible and systemically prudent. Similar rules mandating the recording of certain voice and/or telephone conversations have been promulgated by the Hong Kong Securities and Futures Commission and by the Autorité des Marchés Financiers in France, and have been recommended by the International Organization of Securities Commissions (IOSCO).<sup>227</sup> Moreover, as noted on the Commission's Web site, Commission staff met with two firms that provide elements of the technology needed for compliance with the recording rules under section 4s(g). These meetings, as well as the international requirements, informed the Commission's response to comments received.

In addition, one commenter asked that swap dealers (SDs) and major swap participants (MSPs) be permitted to rely upon swap data repositories (SDRs) to retain records beyond the time periods that registrants currently retain such records. In concluding that SDs and MSPs must retain their own records as well as submit a certain subset of data to SDRs, the Commission did not call into question the integrity of its final swap data reporting rules or SDRs themselves; rather, the Commission determined that the retention of such records by SDs and MSPs is necessary for purposes of risk management and monitoring the entity's trading activities for unlawful conduct, among other things. Certain trade

<sup>226</sup> 75 FR 76666, 76668–69 (Dec. 9, 2010) (Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants) (citing Financial Services Authority, "Policy Statement: Telephone Recording: Recording of voice conversations and electronic communications," (March 2008)).

<sup>227</sup> *Id.* at 76669 (citing Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission para. 3.9 (2010) (H.K.); General Regulation of the Autorité des Marchés Financiers art. 313–51 (2010) (Fr.); and Press Release, International Organization of Securities Commissions, "IOSCO Publishes Recommendations to Enhance Commodity Futures Markets Oversight," (Mar. 5, 2009), <http://www.iosco.org/news/pdf/IOSCONEW137.pdf>).

execution information that is critical for risk management and monitoring purposes, such as reconciliations to the general ledger, will not be retained at SDRs.

With regard to cost-benefit considerations of these elements of the recordkeeping rules, as well as for all of the final rules, the Commission strove to limit the burden on SDs and MSPs to the extent reasonably possible. For instance, as originally proposed, the recording requirement (discussed above) included a provision that would have required each transaction record to be maintained as a separate electronic file. The Commission dropped this requirement and clarified that the rule permits the data to be stored in databases that do not need to be tagged with transaction and counterparty identifiers so long as the SD or MSP can readily access and identify records by running a search on the data. By making this change, the Commission responded to comments and limited the rule's requirements to those dictated by statute,<sup>228</sup> reducing the burden to the extent reasonably possible.

Additionally, during the February 23, 2011 public meeting at which the Commission adopted these final rules, there was discussion of a concern relating to the technological and economic feasibility of the recordkeeping requirements. Responding to the concern, the Commission adopted 5 CFR 23.206, which delegates to the Director of the Division of Swap Dealer and Intermediary Oversight "the authority to establish an alternative compliance schedule for requirements of § 23.202 that are found to be technologically or economically impracticable for an affected swap dealer or major swap participant that seeks, in good faith, to comply with the requirements of § 23.202 within a reasonable time period beyond the date on which compliance by such swap dealer or major swap participant is otherwise required."

In sum, in this rulemaking the Commission has adequately addressed comments and considered the costs and benefits of its actions as required by section 15(a) of the CEA.

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<sup>228</sup> See, e.g., CEA § 4s(g)(3) ("Each registered swap dealer and major swap participant shall maintain daily trading records for each counterparty in a manner and form that is identifiable with each swap transaction.").

<sup>225</sup> Albrecht, *supra*, at 10.