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Division of Swap Dealer and Intermediary Oversight

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Division of Swap Dealer and Intermediary Oversight

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

Topic: Chief Compliance Officer Reporting Lines

I. Introduction

The Division of Swap Dealer and Intermediary Oversight ("**DSIO**" or "**Division**") of the Commodity Futures Trading Commission ("**Commission**") is issuing this advisory in response to inquiries regarding chief compliance officer ("**CCO**") reporting lines under Commission regulation 3.3.[1] Regulation 3.3 implements sections 4d(d) and 4s(k) of the Commodity Exchange Act (the "**CEA**") by, among other things, establishing CCO reporting line requirements for swap dealers ("**SDs**"), futures commission merchants ("**FCMs**"), and major swap participants ("**MSPs**") (collectively, "**Registrants**").[2] Specifically, this advisory is intended to clarify the required elements of regulation 3.3's CCO reporting line requirements and address additional supervisory relationships that the CCO may have with senior management other than the board or the senior officer under certain circumstances.

II. Request for Guidance

Since regulation 3.3 was promulgated in April 2012, a number of Registrants have sought guidance regarding the practical implementation of the CCO reporting line requirements. For example, some provisionally registered SDs are very large financial institutions for which the swap dealing activities constitute only a small portion of their activities. In these instances, Registrants have indicated that while the board and the senior officer stay informed of the condition of the various business lines of the Registrant, they may not have the direct involvement in the swaps business necessary to provide detailed direction regarding compliance-related matters on a day-to-day basis. Instead, the board and the senior officer are generally supported by members of senior management who are more directly involved in the daily activities of the derivatives businesses.

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1 Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 20128 (April 3, 2012).

2 *Id*. at 20156-20157. CEA section 4d(d) requires an FCM to designate an individual to serve as its CCO. CEA section 4s(k) requires the CCO to "report directly to the board or to the senior officer" of an SD/MSP and also assigns certain duties.

As a result, the Division understands that a number of Registrants have designated members of senior management with the appropriate involvement to support and consult with the CCO on compliance matters in the normal course. Registrants have indicated that many routine compliance matters can be effectively discussed and addressed at this level of management through routine processes and with the attendant escalation procedures. Registrants have inquired whether the scope of these supervisory and consultative relationships is consistent with regulation 3.3.

III. Guidance

This advisory clarifies that additional supervisory reporting and consultative relationships for the CCO may be consistent with regulation 3.3, provided that these reporting lines are in addition to, and do not supplant, the reporting line requirements of regulation 3.3(a)(1)-(2). Below is a discussion of the reporting line requirements under regulation 3.3, followed by a discussion of the types of factors that should be considered when evaluating whether additional supervisory relationships would not be in conflict with the regulatory requirements given a Registrant's particular facts and circumstances.

A. CCO Required Reporting Line

Consistent with the requirement to "report directly" to the board or the senior officer in CEA section 4s(k)(2)(A), regulations 3.3(a)(1) and (2) require either the board or the senior officer to: (i) appoint the CCO; (ii) approve the CCO's compensation; (iii) meet with the CCO at least annually and at the CCO's election; and (iv) make any removal decisions regarding the CCO. In the adopting release for regulation 3.3, the Commission noted that compliance with these requirements would "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." [3] In turn, the Commission noted that CCO independence is likely to facilitate a more effective compliance function because "an independent CCO is more likely to: (i) [q]uestion business line decisions, (ii) 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."[4] Accordingly, compliance with these elements of regulation 3.3(a)(1) and (2) satisfies the reporting line requirement in CEA section 4s(k)(2)(A).

B. Other Supervisory Relationships

The Division recognizes that, depending on the facts and circumstances, additional supervisory reporting and consultative relationships for the CCO may be consistent with regulation 3.3 and the CEA. Including an additional supervisory line for addressing compliance matters in the normal course may result in a more substantive, productive oversight dialogue. Senior management who have more direct, relevant experience are likely able to provide meaningful insights and assistance to the CCO in addressing compliance issues that arise in the normal course.

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3 77 Fed. Reg. at 20188. *See also* 77 Fed. Reg. at 20159-60.

4 77 Fed. Reg. at 20188.

The language of regulation 3.3 is consistent with this interpretation. Regulation 3.3(a)(1) only requires the CCO to meet with the board or the senior officer once annually and additionally at the CCO's election. Providing for more frequent meetings at the CCO's election, instead of *requiring* more regular meetings to address compliance issues as they arise, indicates that the Commission did not expect the CCO to seek direction from the board or the senior officer in the resolution of every compliance matter.[5] Rather the required meeting is an opportunity for the CCO to annually inform the board or the senior officer on compliance matters and the additional meetings at the CCO's discretion provide for the opportunity to escalate compliance issues to that level when the CCO determines that such escalation is appropriate.

However, depending upon how the additional supervisory relationships are structured, concerns about the CCO's independence may be raised. When considering whether additional supervisory relationships may be appropriate, a Registrant should consider all relevant facts and circumstances, including the following factors. Foremost, under all circumstances, the reporting line requirements under regulation 3.3(a)(1)-(2) must be satisfied and the CCO must have unfettered access to the board or the senior officer to address compliance issues. Additionally, in all cases, any additional supervisor should be sufficiently senior so as to provide a level of independence from the risk-taking aspects (*i.e.*, profit and loss considerations) of the swaps or FCM business that could otherwise create inherent conflicts when considering compliance matters. Finally, additional supervisory senior management should be appropriate,[6] and knowledgeable of the Registrant's regulated activities and compliance requirements.

By way of example, the Division has observed that some Registrants have established an additional formalized supervisory relationship between the CCO and a global chief compliance officer who reports into the parent of the Registrant. As another example, some CCOs may additionally report to a senior officer responsible for multiple lines of business (in addition to the swaps or FCM business) who reports directly to the chief executive officer. Both of these examples could be permissible based on the relevant facts and circumstances. In contrast to the above examples, an additional reporting line to senior swap traders or the head of a swap trading desk would raise conflict of interest concerns and potentially undermine the independence of the CCO in contravention of regulation 3.3.

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5 Similarly, one meeting a year with the board or the senior officer would not likely be sufficient for providing effective oversight and guidance to the CCO on all compliance matters.

6 For example, the Commission observed that a potential conflict might occur if a person serves simultaneously as the CCO and a member of the firm's legal department, which could, for example, compromise the attorney-client privilege, the work-product doctrine, or other similar protections. *See* 77 Fed. Reg. at 20160-61. That same potential conflict exists if an additional supervisor of the CCO is a member of the legal department. As noted by the Commission, to the extent Registrants include the legal department in the CCO's supervisory chain, the Registrant should be prepared to articulate clearly the segregation of compliance and non-compliance functions performed by that supervisor. *See id.*

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