

CFTC Adopts Internal Business Conduct Rules for Swap Dealers and Major Swap Participants

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On February 23, 2012, the CFTC adopted final rules regarding the internal business conduct of swap dealers and major swap participants (“**swap entities**”) under the Dodd-Frank Act.¹ The rules combine five separate CFTC proposals and address:

- reporting, recordkeeping and daily trading records requirements;
- conflicts of interest involving research and clearing activities;
- chief compliance officer designation and duties; and
- risk management and operational requirements.

The adopted rules are largely similar to the rules proposed by the CFTC at the end of 2010, with a small number of changes in response to comments. Some of these changes will have significant ramifications for swap entities. Most importantly, the CFTC has restricted many of the risk management requirements, recordkeeping requirements and chief compliance officer (“**CCO**”) duties to the “swaps activities” of a swap entity rather than applying them to all of a swap entity’s activity. The rule, however, remains quite burdensome in many ways. For example, swap entities must make and maintain records of all oral or written communications that lead to the execution of a swap and must tape all telephone conversations that include such information.

The CFTC rejected a request to modify its proposed rules to defer to the risk management, compliance and recordkeeping regimes already imposed by other domestic and foreign regulators on swap entities, leaving many prospective swap entities concerned about duplicative requirements. In addition, the breadth of many of the requirements, including the risk management program and separation of research and clearing, will affect non-swaps functions of large, multi-service entities that operate out of multiple legal entities on a global basis. The final rules provide swap entities with some additional organizational flexibility by permitting the CCO to report to the senior officer of a division (rather than of the entire company) if the division is registered as a swap entity. The NFA has indicated, however, that it is not aware that the CFTC intends to depart from the general rule that only legal entities may register.

The rules will become effective 60 days after publication in the Federal Register, which is expected shortly. However, the compliance dates for

¹ 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, *available at* <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister022312b.pdf>.

Trade information Required to be Retained by Swap Entities

Pre-execution trade information includes, but is not limited to:

- 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, regardless of how they are communicated;
- reliable timing data that would permit complete and accurate trade reconstruction; and
- a date and timestamp.

Execution trade information includes, but is not limited to:

- the terms of the swap, including all terms regarding payment or settlement instructions, initial and variation margin requirements, option premiums, payment dates, and any other cash flows;
- the trade ticket;
- names and identifiers for the swap and counterparties;
- the date and title of agreements to which the swap is subject;
- fees or commissions and other expenses, identified by transaction;
- a date and timestamp; and
- other relevant information.

Post-execution trade information includes, but is not limited to:

- records of post-trade processing and events.

different provisions depend on the regulatory status of the swap entity, as discussed in greater detail below.

Reporting, Recordkeeping and Daily Trading Records

The final rules impose comprehensive reporting and recordkeeping obligations on swap entities with respect to their swaps business and related transactions. These obligations will require significant and perhaps unprecedented technological and operational changes for swap entities.

The rules require swap entities to keep full, complete and systemic transaction and position records. The required transaction records include all information necessary to conduct a comprehensive and accurate trade reconstruction, both oral and written. This includes nearly all information collected during pre-execution, execution and post-execution processes, as described further in the sidebar at left. Importantly, records must be made of any oral or written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading and prices that lead to the execution of a swap. The CFTC notes in guidance that all telephone conversations that include such information must be taped. All quotations must have a timestamp, to the nearest minute, in Coordinated Universal Time (UTC). While the rules require that all records be searchable by transaction or counterparty, the final rules differ from the proposed rules in not requiring swap entities to keep each transaction in a separate electronic file.

Swap entities must make and keep ledgers or other records of the daily calculation of the value of each swap, the daily current and potential future exposure for each counterparty and the daily value of all collateral both before and after haircuts. Daily trading records must also be kept for related cash and forward transactions, including enough information to conduct a comprehensive and accurate reconstruction for each such transaction. Position records must link to the record of the transaction that gave rise to the position.

Swap entities also will be required to keep full, complete and systematic records of all activities related to their business as a swap entity. These include records related to governance (such as meeting minutes, organizational charts, job descriptions, reports and business and strategic plans for the business trading unit), financial records, complaints and marketing and sales materials. Data relating to a swap entity's compliance with CFTC swap reporting requirements, including real-time reporting and reporting to swap data repositories, also must be retained.

The rules require all records to be retained for five years from the date the record was made, consistent with the five-year retention period under the

swap data reporting rule.² Such records must be “readily accessible” for the first two years they are retained, which the CFTC has elsewhere interpreted to mean that the records are retrievable in real time or on the same day requested. Records of any swap or related cash or forward transaction must be kept for five years after the termination, maturity, expiration, transfer, assignment or novation of the transaction, although voice recordings related to the transaction need only be kept for one year. Such records must be “readily accessible” for all but the last three years they are required to be retained. Records of data reported under the CFTC’s Part 45 reporting rules must be maintained in accordance with that rule—swap data required by any section of the CEA must be kept throughout the life of the swap and five years thereafter and must be readily accessible via real-time electronic access for all but the last three years, during which it must be retrievable within three business days. Under Part 45, records may be kept in paper form if originally created and maintained exclusively in that form.

In addition, in response to commenters’ concerns regarding the technological and operational difficulty of a number of the daily trading records requirements, the CFTC has provided to its staff the authority to create alternative compliance schedules for requirements that are found to be “technologically and economically impracticable.”

Duties of Swap Entities

The CFTC’s rules require swap entities to:

- monitor trading to prevent violations of applicable position limits;
- establish robust risk management systems for managing the day-to-day business of the swap entity;
- disclose to the CFTC and prudential regulator information concerning terms and conditions of its swaps, swap trading operations, mechanisms and practices, financial integrity protections relating to swaps and other information relevant to its trading in swaps;
- establish and enforce internal systems and procedures; and
- prohibit anticompetitive activity.

² Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136, 2198 (adding 17 CFR § 45.2(c)).

Risk Management Program

Swap entities' risk management programs must also:

- require the risk management unit to create detailed quarterly "risk exposure reports";
- require reporting of any material change in the risk exposure of the swap entity;
- require quarterly review by senior management and annual review by the governing body of risk tolerance limits;
- establish policies and procedures relating to central counterparties that set forth the conditions for the voluntary use of central counterparties to mitigate counterparty credit risk and require investigation into the adequacy of the financial resources and risk management procedures of used central counterparties;
- provide for periodic auditing and testing; and
- ensure that capital and margin requirements are met.

Risk Management Program

The rules require swap entities to create a risk management program that includes written policies and procedures. Unlike in the proposed rules, the risk management program in the final rules applies to the swaps activities of the swap entity. The risk management program must be approved by the governing body of the swap entity and be provided to the CFTC (or to the NFA if directed by the CFTC) at the time of registration and thereafter upon request. However, the final rules give somewhat greater flexibility than the proposed rules. In the final rules, the definition of "governing body" includes the CEO or committees of a board of directors or body performing a similar function, as well as a board, body, committee or officer of a division of a registrant if registration is required of a separately identifiable division.

The rules require that the risk management program consider not only the swap-related risks of the swap entity, but also risks posed by the swap entity's affiliates, whether or not swap-related. In addition, the rules require the risk management program to be integrated into risk management at the consolidated entity level.

As part of the risk management program, swap entities will be required to create a "risk management unit" that must report directly to "senior management"³ and be independent of the swap entity's business trading unit.⁴ This risk management unit does not have to be a formal division, but its members must be identified. The rules require significant ongoing approvals related to the risk management program, including for the program's risk limits and "new product policy."

The risk management program must be designed to document, monitor and enforce a system of policies and procedures to monitor and manage risks of the swap entity. The key elements of this oversight can be found in the accompanying sidebar.

As part of this oversight of trading activities, swap entities must subject trading programs to policies and procedures governing use, supervision, maintenance, testing and inspection of programs. Review and testing of the risk management program are required at least annually and whenever there is a material change in the business of the swap entity that is likely to alter its risk profile. Such assessments must be done by either qualified

³ "Senior management" is defined as "any officer or officers specifically granted the authority and responsibility to fulfill the requirements of senior management by the registrant's governing body." "Governing body" is defined as "(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 [CFTC] is required are wholly contained in a separately identifiable division."

⁴ For example, the risk management unit and business trading unit may not have a shared senior officer. However, the risk management unit and business trading unit do not have to be physically separated.

**Risk Management Program:
Required Oversight of Trading
Activities**

The risk management program must:

- be approved by the governing body of the swap entity;
- include counterparty credit and exposure limits;
- monitor traders to prevent them from exceeding limits;
- detect unauthorized trading activities and violations of policies and procedures;
- ensure that trade discrepancies are documented and brought to the immediate attention of management;
- ensure that broker statements and payments to brokers are periodically audited by independent persons; and
- separate the personnel in the business trading unit from personnel in the risk management unit.

internal audit staff that are independent of the business trading unit or by a qualified third-party audit service, and they must be reported to and reviewed by key personnel of the swap entity. Reviews and testing must be documented fully and provided to the CFTC upon request.

Position Limits

Policies and procedures must be reasonably designed to monitor for and prevent violations of position limits set by the CFTC, designated contract markets and swap execution facilities. Swap entities must establish a position limit early warning system and report quarterly to the CCO, senior management and governing body of the swap entity regarding position limit compliance.

Business Continuity and Disaster Recovery Plans

In addition, swap entities will be required to establish and maintain written business continuity and disaster recovery plans designed to enable the swap entity to resume operations the business day after a disruption with minimal disturbance to counterparties and to recover all required documentation and data.

Conflict of Interest Policies and Procedures

Research Conflicts

The provisions relating to conflict of interest policies and procedures are based largely on FINRA's equity research rule and apply to research analysts -- employees of a swap entity primarily responsible for preparation of the substance of a research report relating to a derivative and employees who report to such a person. These provisions:⁵

- prohibit "non-research personnel" from directing a research analyst's decision to publish a research report of the swap entity or the views and opinions expressed in a research report of the swap entity;
- prohibit research analysts from being subject to supervision or control of employees of the swap entity's business trading unit or clearing unit;
- prohibit employees of the business trading unit or clearing unit from having influence or control over evaluation or compensation of research analysts;
- prohibit non-research personnel from reviewing or approving a research report of the swap entity before publication other than to

⁵ The rules also apply similar conflict of interest rules to FCMs and introducing brokers.

Research Report

“**Research report**” is defined as: 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, but does not include:

- communications distributed to fewer than 15 persons;
- commentaries on economic, political or market conditions;
- statistical summaries of multiple companies’ financial data;
- periodic investment performance reports or other communications prepared for investment company shareholders or commodity pool participants;
- any 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; and
- purely internal communications.

review for conflicts of interest and for errors (subject to certain controls);

- require that all communications from research analysts to current or potential counterparties relating to derivatives not omit material facts;
- prohibit swap entities from considering a research analyst’s contribution to trading or clearing business in determining compensation;
- prohibit swap entities from promising favorable research or threatening unfavorable research to induce business or compensation;
- require, in a prominent way and with records to demonstrate compliance, swap entities to disclose in research reports, and a research analyst to disclose in public appearances, financial interests in derivatives that the analyst follows and other material conflicts of interest known by the research analyst;
- require conflict disclosures by independent third-party research reports that are not provided by request of the customer or through a website maintained by the swap entity; and
- prohibit retaliation against research analysts.

Clearing Conflicts

The CFTC’s clearing conflict of interest rules:

- prohibit swap entities from interfering with the determinations of a clearing unit of an affiliated clearing member to:
 - provide clearing services to a particular customer;
 - submit a transaction to a particular clearinghouse;
 - set or adjust risk tolerance levels for particular customers;
 - accept certain forms of collateral from particular customers; or
 - 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 entity;
- require swap entities to create and maintain informational partitions between business trading units of the swap entity and clearing units of any affiliated clearing member, which must require that no employee of a business trading unit of a swap entity supervise, control or influence employees of the clearing unit; and
- require swap entities to adopt and implement written policies and procedures mandating disclosure to counterparties of material incentives and material conflicts of interest regarding the decision whether to execute a swap on a swap execution facility or designated contract market and whether to clear the swap.

The rules demonstrate the CFTC’s intention to strictly regulate the behavior of employees of swap entities *and their affiliates*. The rules also evidence

CCO Annual Report

The CCO's annual report must:

- contain a description of the written policies and procedures, including the code of ethics and conflicts of interest policies, of the swap entity;
- identify the policies and procedures that are reasonably designed to ensure compliance with each Dodd-Frank provision and CFTC regulation, assess the effectiveness of those policies and procedures, discuss areas for improvement and make appropriate recommendations;
- list material changes to compliance policies since the last annual report;
- describe financial, managerial, operational and staffing resources for compliance and any deficiencies in those resources; and
- describe any material non-compliance issues identified, and the corresponding action taken.

the CFTC's fear that internal pressures at swap entities will translate into unequal access to clearing facilities for customers. However, as a practical matter, these rules will limit swap entity personnel with knowledge of and background in swaps and swap clearing from being involved in clearing credit or risk management analysis.

Designation of a Chief Compliance Officer

The rules require swap entities⁶ to designate a single CCO who will report to the board of directors or senior officer of the swap entity. The CCO is required to meet with the board of directors or senior officer at least once a year. The CCO may be a member of the legal department of the swap entity or its general counsel although, in either case, the CFTC notes that the CCO and swap entity are expected to "articulate clearly the segregation of that individual's CCO and non-CCO responsibilities."

The CCO is responsible for:

- administering the policies and procedures reasonably designed to ensure compliance with the Commodity Exchange Act and CFTC regulations;
- resolving any conflicts of interest in consultation with the board of directors or senior officer;
- establishing procedures to respond to noncompliance, in consultation with the board of directors or senior officer;
- preparing and signing an annual report, described in more detail in the sidebar;⁷ and
- significantly, taking reasonable steps to ensure compliance with the Commodity Exchange Act and CFTC regulations relating to the swap entity's swaps activities.

The CCO is required to provide its annual report to the board or senior officer for their review. In addition, the CCO must submit the report electronically to the CFTC within 90 days of the end of the swap entity's fiscal year, although the swap entity may apply to the CFTC for an extension. Swap entities may petition for confidential treatment of the report under existing CFTC regulations.

The final rule, like the proposed rule, requires a certification that, to the certifier's best knowledge and reasonable belief, the information in the annual report is accurate and complete. However, the final rules allow this certification to be given either by the CCO or the chief executive officer of

⁶ The rules also require FCMs to have a CCO with similar duties.

⁷ Unlike the proposed rule, the final rules do not require the CCO's report to certify compliance with the Volcker Rule or Swaps Pushout Rule.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Daniel N. Budofsky
212 450 4907
daniel.budofsky@davispolk.com

Gerard Citera
212 450 4881
gerard.citera@davispolk.com

Robert L.D. Colby
202 962 7121
robert.colby@davispolk.com

Susan C. Ervin
202 962 7141
susan.ervin@davispolk.com

Annette L. Nazareth
202 962 7075
annette.nazareth@davispolk.com

Lanny A. Schwartz
212 450 4174
lanny.schwartz@davispolk.com

Gabriel D. Rosenberg
212 450 4537
gabriel.rosenberg@davispolk.com

the registrant. Record retention requirements apply to documents related to the annual report.

Compliance Timing

The rules become effective 60 days after publication in the Federal Register. The date by which swap entities must comply with the rule's provisions depends on the individual provision and on whether the swap entity is currently regulated by a US prudential regulator or is an SEC registrant. In all cases, compliance will be required no earlier than the date on which swap entities are required to apply for registration with the CFTC, which will be 60 days after both the swap entity and swaps products definitional rules are finalized. A detailed description of the compliance dates can be found in the chart in Appendix A.

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Compliance Dates for Internal Business Conduct Rules

Provision	Swap entities that are Currently Regulated by a US Prudential Regulator or are SEC Registrants	Swap entities that are not Currently Regulated by a US Prudential Regulator and are not SEC Registrants
<i>Reporting, recordkeeping and daily trading records requirements (§§ 23.200-23.205); Risk management programs (§ 23.600)</i>	<p>The later of:</p> <ul style="list-style-type: none"> ▪ 90 days after publication of final rules in the Federal Register; and ▪ the date on which swap entities are required to apply for registration. 	<p>The later of:</p> <ul style="list-style-type: none"> ▪ 180 days after publication of final rules in the Federal Register; and ▪ the date on which swap entities are required to apply for registration.
<i>Business continuity and disaster recovery (§ 23.603)</i>	<p>The later of:</p> <ul style="list-style-type: none"> ▪ 180 days after publication of final rules in the Federal Register; and ▪ the date on which swap entities are required to apply for registration. 	<p>The later of:</p> <ul style="list-style-type: none"> ▪ 270 days after publication of final rules in the Federal Register; and ▪ the date on which swap entities are required to apply for registration.
<i>Position limits, diligent supervision, conflict of interest policies and procedures, availability for disclosure and inspection, antitrust considerations (§§ 23.601-23.602, 23.605-23.607)</i>	<p>The later of:</p> <ul style="list-style-type: none"> ▪ the effective date of the rules; and ▪ the date on which swap entities are required to apply for registration. 	<p>The later of:</p> <ul style="list-style-type: none"> ▪ the effective date of the rules; and ▪ the date on which swap entities are required to apply for registration.
<i>Chief compliance officer (§ 3.3)</i>	<p>The later of:</p> <ul style="list-style-type: none"> ▪ 180 days after publication of final rules in the Federal Register; and ▪ the date on which swap entities are required to apply for registration. 	<p>The later of:</p> <ul style="list-style-type: none"> ▪ 360 days after publication of final rules in the Federal Register; and ▪ the date on which swap entities are required to apply for registration.

* Different compliance dates apply to the FCM-specific provisions of the rules.