CFTC Proposes Expanded Duties and Liability for Chief Compliance Officers

The Dodd-Frank Act’s amendments to the Commodity Exchange Act (CEA) require each of the new types of regulated entities dealing with swaps, i.e., swap dealers (SDs), major swap participants (MSPs), swap execution facilities (SEFs), and swap data repositories (SDRs), as well as traditional futures commission merchants (FCMs), to designate a chief compliance officer (CCO) to assume responsibility for the entity’s regulatory compliance. Under the statute, CCOs will have significantly increased responsibilities including, among other matters, annually self-reporting instances of noncompliance. They will also bear potential personal liability for an entity’s regulatory compliance.

In seeking to implement this legislation, the Commodity Futures Trading Commission (CFTC) has proposed rules that would aggressively define this expanded CCO liability. The CFTC proposals also raise a question about the scope of a CCO’s right to assert attorney-client privilege in the context of regulatory inquiries, which by implication could call into question whether legal advice received by a CCO is ever privileged. The privilege issue is raised expressly in the proposed rules to govern CCOs of SEFs and the final rules governing CCOs of SDRs, but the treatment of the issue there implies a policy view that might extend to all CCOs.

Action Items for CCOs

Under the proposed rules, the many responsibilities of a CCO will include developing and implementing a compliance manual, code of ethics, employee training program, a monitoring and surveillance regime, and systems for (a) documentation of transactions and compliance oversight; (b) recordkeeping; and (c) discipline and sanctions for noncompliance. The extensive recordkeeping requirements under Dodd-Frank will likely require the maintenance of records of transactions at every stage of their existence, periodic position reports, daily values used for margin and marking positions to market, and information reported to SDRs and trade publications. In addition, a CCO must prepare and certify an annual report that discloses:

- the entity’s compliance efforts with applicable laws and regulations, and the entity’s own compliance policies;
- the effectiveness of the entity’s policies and areas for improvement;
- the resources dedicated to compliance; and
- any instances of noncompliance that were identified and how they were addressed, including any disciplinary action that may have been taken.

The CCO’s Role in an Organization

Pursuant to the CFTC’s proposed rules, the CCO must report directly to the board of directors or a senior officer. The CCO must meet with the board or a senior officer at least quarterly to discuss the effectiveness of compliance policies, and a SEF’s CEO also must meet at least quarterly with the regulatory oversight committee. The CCO will
be considered to be a “principal” of a registrant, which will require the CCO to complete the registration forms and pass the background checks for principals. The CCO will be subject to the statutory disqualification standards applicable to registrants under the CEA.

The requirement for the CCO to ensure compliance with the CEA and CFTC regulations raises an issue whether the CFTC intends for the CCO to be deemed a line supervisor rather than, as has been customary, merely an adviser to the entity on compliance matters, and, if so, what the extent of a CCO’s supervisory responsibilities is. The proposed implementing regulations for CCOs of SDs and MSPs state that a CCO could be charged with a failure to supervise in connection with false, incomplete, or misleading statements or representations in the annual report, and that the CCO or the registrant, or both, either directly or vicariously, could be subject to criminal penalties for such false statements.

The proposed SEF CCO regulations would specify that the CCO cannot act as the SEF’s general counsel or be a member of the SEF’s legal department. The CFTC stated that one basis for this separation of roles is that the CCO should not be able to assert attorney-client privilege in responding to CFTC information requests. The CFTC further stated that while there may be circumstances where a SEF could assert the privilege, such circumstances do not include the areas of responsibility assigned to CCOs by the CEA or CFTC regulations. The CFTC’s final rules for SDRs require separation of the CCO and general counsel roles in the organization. It remains to be seen whether this principle also will be incorporated in the final regulations governing CCOs for the other swap entities and FCMs.

The regulator’s interest in disallowing privilege for advice given by a CCO is perhaps understandable, but preventing a CCO from receiving privileged advice from the entity’s general counsel or outside counsel is another matter. The latter could effectively result in CCOs acting without legal counsel, which would seem contrary to the well-recognized public interest supporting attorney-client privilege. Moreover, as a practical matter, it potentially could leave CCOs uninformed or less informed about sensitive firm matters in circumstances where risking the loss of confidentiality for the information by disclosure to the CCO might be harmful to the entity’s or its shareholders’ interests.

**Conclusion**

The CFTC’s proposed regulations for swap entity CCOs, if adopted as proposed, would significantly increase the responsibilities, legal obligations and exposure to liability for CCOs beyond that historically assumed by CCOs of CFTC and Securities and Exchange Commission registrants, while at the same time potentially effectively constraining their ability to assert privilege with respect to legal advice. The adoption of such regulatory requirements would likely require, as Dodd-Frank and the CFTC would intend, deploying greater resources to the compliance function, but its draconian features may also significantly limit the pool of qualified persons willing to assume the role of the chief compliance officer.

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