



CFTC Recordkeeping Compliance Obligations

FIA Webinar

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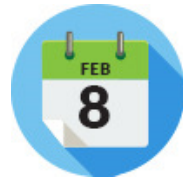


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OVERVIEW

1. Amendments to CFTC Regulation 1.31
2. FCM Recordkeeping Requirements
3. Swaps Records
4. Recent Developments in Recordkeeping Rules Applicable to CPOs, CTAs and Registered Investment Advisers
5. Enforcement Actions
6. Key Takeaways





AMENDMENTS TO CFTC REGULATION 1.31



CFTC Regulation 1.31

- Background of Regulation 1.31
- Goal of Amendments

Modernize and make technology neutral the form and manner in which records must be kept.

- The amendments eliminate the requirements that electronic regulatory records be stored in their native file format and that a “records entity” retain a third-party technical consultant for electronic regulatory records.
 - The CFTC explicitly provides that the new rules, including the elimination of certain requirements, apply to existing regulatory records.
- The amendments do not impose new recordkeeping requirements. The CFTC explains that compliance with existing requirements under Regulation 1.31 would permit a records entity to continue to comply under the amended regulation.



Form & Manner Requirements

- Regulatory Records
 - All books and records required to be kept by the CEA or CFTC regulations, including any record of any correction or other amendment to such books and records.
 - When records are stored electronically, a records entity must keep:
 - (i) Any data necessary to access, search, or display any such books and records; and
 - (ii) All data produced and stored electronically describing how and when such books and records were created, formatted, or modified.
- Metadata
 - The CFTC determined not to define metadata, noting that it and the SEC have been requesting metadata in connection with information requests for more than five years through standardized data delivery standards. For example, the CFTC asks for metadata in connection with Division of Enforcement investigations.
 - Although the CFTC did not define metadata, the CFTC states that the definition of “regulatory record” is sufficient to support its statutory inspection and investigative functions. Expect the CFTC to continue to ask for metadata in information requests.



Cloud Storage

- Storage Methods (Electronic Records)
 - In its comment letter, DTCC requested the CFTC to confirm that **cloud storage** for electronic records would be an acceptable means of storing electronic regulatory records.
 - The CFTC responded to the comment without endorsing, but implicitly permitting, cloud storage.



Written Policies and Procedures

- The CFTC did not adopt the proposed requirement that a records entity establish and maintain written recordkeeping policies and procedures, but the CFTC provides guidance on this topic in the adopting release.
- “The obligation to satisfy the requirements regarding § 1.31 is one that a records entity ignores at its peril.”
- CFTC registrants are subject to a duty to diligently supervise all activities related to their business as a CFTC registration under CFTC Regulation 166.3.
- The withdrawal of the WPP requirement does not create “an explicit or implicit defense against recordkeeping violations or failure to supervise violations”.





FCM RECORDKEEPING REQUIREMENTS



General Recordkeeping Requirements

An FCM must keep:

- Full, complete, and systematic records, together with all pertinent data and memoranda, of all transactions.
- A written record of a customer's order, including the date and time of receipt and the date and time it is transmitted for execution. (An FCM must prepare this record immediately upon receipt of a customer's order.)
- A **permanent record** pertaining to its customers (including each customer's name, address, and occupation).
- A financial ledger for each customer must be maintained that includes a record of all transactions, credits, debits, etc. in **permanent form**.
- A record or journal that shows all transactions made on each business day by the FCM in **permanent form**.



Amendments to CFTC Regulation 1.35

- Under Regulation 1.35, a registered FCM must maintain:
 - Transaction Records; and
 - Oral and Written Pre-Trade Communications.
- Regulation 1.35 is broad in the scope of records that an FCM must maintain.
 - Within the definition of “transaction records”, an FCM is required to maintain **“all other records, which have been prepared in the course of its business of dealing in commodity interests and related cash or forward transactions”**.
- Subject to the Form and Manner Requirement (maintaining records in a way that allows for the identification of a particular transaction) and Regulation 1.31.



Customer Funds

An FCM must keep records related to customer segregated funds. Examples of these records include:

- The written acknowledgment letter, which must be maintained for as long as the account remains open plus five years.
- Records of investments made with customer funds, which must include specific information about the investments, pursuant to Regulation 1.27.
- In addition, an FCM must keep records specific to the types of investments it makes with customer funds.
 - Money Market Mutual Funds
 - An FCM must keep the confirmation relating to the purchase in its records and note the ownership of fund shares (by book-entry or otherwise) in a custody account of the FCM.
 - Repurchase Agreements and Reverse Repurchase Agreements
 - The transaction must be recorded as prescribed by Regulation 1.27.
 - Such record must specifically identify the securities subject to the transaction by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number.
 - The record must describe the securities as being subject to a repurchase or reverse repurchase transaction.
 - FCM-Owned Securities
 - An FCM is permitted to deposit certain securities into a customer segregated account. Upon making this kind of deposit, an FCM must keep a record, pursuant to Regulation 1.27, of the securities, transfers of securities, and disposition of proceeds from the sale or maturity of the securities.





SWAPS RECORDS



CFTC Regulation 45.2

- A registered swap dealer must keep full, complete, and systematic records, together with all pertinent data and memoranda, *of all activities relating to the business of the swap dealer with respect to swaps.*
- A non-SD counterparty must keep full, complete, and systematic records, together with all pertinent data and memoranda, *with respect to each swap*, including all records demonstrating that it is entitled, with respect to any swap, to elect the clearing requirement exception pursuant to Section 2(h)(7) of the CEA.
- Swap-related records be retained throughout the life of the swap and at least five years following the swap's final termination.



CFTC Regulation 45.2

- Form and Manner Requirements:
 - A swap dealer may keep its swap-related records in electronic form, or kept in paper form if originally created and exclusively maintained in paper form, so long as the records are retrievable, and information in them is reportable to an SDR. Non-SDs may keep swap-related records in either electronic or paper form, so long as they are retrievable, and information in them is reportable to an SDR.
 - A swap dealer is subject to more onerous retrievability requirements than non-SD counterparties.
 - A swap dealer must keep each record readily accessible via real time electronic access throughout the life of the swap and for two years following the final termination of the swap. For the remainder of the retention period following the swap's final termination, records must be retrievable within three business days.
 - A non-SD counterparty must keep each record in a manner that permits its retrieval within five business days throughout the period during which the record is required to be kept.



Special Rules Applicable to Registered Swap Dealers

- General requirements: Regulation 23.201
 - Transaction and position records;
 - Records of swaps executed on an exchange or cleared by a DCO;
 - Business records; and
 - Records of all swap data reports to SDRs submitted pursuant to Parts 43 and 45, including, for purposes of Part 43 records, the date and time the SD made the report.
- Daily Trading Records: Regulation 23.202
 - Pre-execution trade records, including oral and written communications;
 - Execution records; and
 - Post-execution trade records.
 - The amendments to Regulation 1.31 modify the retention period of records of oral and written pre-execution communications from the life of a swap plus 5 years to just 5 years.
 -
- Record Retention and Inspection: Regulation 23.203
 - A swap dealer must maintain records at its principal business office.





RECENT DEVELOPMENTS IN CPO/CTA/RIA RECORDKEEPING



Location of Records (CPO/CTA)

- General Requirement Under Regulations 4.23 and 4.33
- CFTC Harmonization Relief
 - Expanded the Main Business Office Requirement, permitting a CPO to maintain books and records at a pool's administrator, distributor or custodian, or a bank or registered broker or dealer acting in a similar capacity with respect to the pool.
- No-Action Letter No. 14-114 (CPO Relief)
 - The CFTC acknowledged that the enumerated list of third-party recordkeepers is unnecessarily restrictive.
 - A CPO may maintain books and records at any third party subject to the relief's conditions, but the CPO remains ultimately responsible for compliance.
- No-Action Letter No. 17-24 (CTA Relief)
 - Permits a CTA to maintain books and records at any third party, subject to the relief's conditions and similar notice filing requirements that are applicable to CPOs.



Amendments to CFTC Regulation 1.35

- Registered CPOs and CTAs that are Members of a DCM or SEF must maintain:
 - Transaction Records; and
 - Written Pre-Trade Communications.
- Subject to Form and Manner Requirement (maintaining records in a way that allows for the identification of a particular transaction) and Regulation 1.31.
- Unregistered Members of a DCM or SEF must maintain Transaction Records, except records of text messages (SMS or MMS). The Form and Manner Requirement is limited to Regulation 1.31.



RIA Recordkeeping Requirements

- Rule 204-2(a) sets out the general RIA recordkeeping requirements
 - Books and records that relate to business accounting, client communications, performance, and fiduciary duties
- Additional books and records are required by Rule 204-2(b) for RIAs with custody or possession of client securities or funds, and Rule 204-2(c) for RIAs that render investment supervisory or management services to clients
- Rules 204-2(d), (e), (f) and (g) set out storage format, accessibility and duration requirements



Amendments to SEC Rule 204-2

- Changes went into effect in October 2017
- Rule 204-2(a)(16) now requires RIAs to maintain “all documents or records that are necessary to form the basis for, or demonstrate the calculation of, the performance or rate of return of any or all managed accounts or securities recommendations in any communication distributed ... to any person”
 - No longer limited to communications that an RIA distributes or circulates to 10 or more persons
- Rule 204-2(a)(7) expanded to require RIAs to maintain originals of all written communications received and copies of written communications sent by an RIA relating to the performance or rate of return of any or all managed accounts or securities recommendations
 - Previously limited to originals of written communications relating to securities recommendations, advice, and transactions
- Amendment was motivated by, among other things, a recent enforcement action where the lack of evidentiary record prevented the action from moving forward.
 - *In the Matter of Michael R. Pelosi*, Investment Advisers Act Release No. 3141 (Jan. 14, 2011); Initial Decision Release No. 448 (Jan. 5, 2012); Investment Advisers Act Release No. 3805 (Mar. 27, 2014) (Commission opinion dismissing proceeding against associated person of RIA charged with providing false and misleading performance information because the record lacked an evidentiary basis from which to determine that the performance information was materially false or misleading).





ENFORCEMENT ACTIONS



CFTC Block Trade Enforcement Actions

Merrill, Lynch, Pierce, Fenner & Smith Inc. (Sept. 22, 2017)

- During a CME investigation, the CFTC found that Merrill Lynch failed to prepare or maintain the trade ticket and other records on which its employees were to record information regarding an executed block trade, including the execution time. The CFTC also found that where Merrill Lynch did prepare and maintain records related to block trades, the records contained inaccurate, illegible, or missing or incomplete information regarding the block trade. The CFTC found that Merrill Lynch violated Regulations 166.3, 1.31 and 1.35, and Section 4g of the CEA.
- The settlement order mandated that Merrill Lynch pay a \$2.5 million civil monetary penalty and develop procedures and controls regarding block trades that, at a minimum:
 - Clearly specify that Merrill Lynch sales personnel are responsible for recording the block trade execution time and reporting the block trade to the relevant exchange;
 - Ensure that the technology used to record block trade execution time: (1) is synchronized for all persons responsible for recording block trade execution times; and (2) derives the time used to record the block trade execution time from a common source;
 - Provide for regular, periodic checks of the technology used to record block trade execution time;
 - Ensure that the records of block trade executions are maintained in electronic format and unambiguously and legibly indicate the actual execution time of the block trade; and,
 - Be accessible and available to all persons with responsibility under these procedures and controls for recording block trade execution times and reporting block trades to the relevant exchanges.
- The CFTC also required Merrill Lynch to have an audit conducted every three months (for a two-year period) and thereafter every six months for an additional three years.



CFTC Block Trade Enforcement Actions

Deutsche Bank Securities Inc. (Dec. 22, 2014)

- The CFTC found that Deutsche Bank Securities Inc. (DBSI) failed to keep records related to block trades, among other violations (including improper investment of customer funds) and ordered DBSI to pay a \$3 million civil monetary penalty. Specifically, the CFTC found that DBSI violated Regulations 1.10(b)(1)(i) and (ii), 1.25(b)(3)(i)(F), 1.35(a)(1) and (b)(1) and 166.3.



CFTC EFRP Enforcement Actions

Ikon Global Markets, Inc. (Aug. 31, 2017)

- Failure to maintain records of EFRP transactions in violation of Section 4g(a) of the CEA and Regulations 1.31(a)(1) and (2) and 1.35(a).
- \$200,000 civil monetary penalty.
- Ikon agreed to withdraw from registration with the CFTC and to never, directly or indirectly, apply for registration or claim exemption from registration with the CFTC in any capacity, or engage in any activity requiring such registration or exemption (except as provided for in Reg. 4.14(a)(9)).

Barclays Bank PLC (Sept. 22, 2016)

- CFTC staff requested that Barclays' affiliate through which EFRPs were cleared, Barclays Capital, Inc. (BCI), provide documentation relating to EFRPs by Barclays or its affiliates. BCI and Barclays did not provide all of the documentation (missing at least 1358 metals and energy trades out of over 3700) until more than one year later.
- The CFTC found that the failure to produce in a timely manner the requested EFRP confirmations that did exist violated Regulations 1.31(a)(2) and 1.35(a-2) (currently (c)).
- In light of these findings, the CFTC ordered Barclays Bank to pay a \$500,000 civil monetary penalty.



CFTC Audit Trail Enforcement Action

E*TRADE Securities LLC and E*TRADE Clearing LLC (Jan. 26, 2017)

- Violations of Section 4g(a) of the CEA and Regulations 1.31(a), 1.35(a) and 166.3 for failure to retain and promptly produce certain records for inspection to CFTC staff, as well as supervisory failures.
- \$280,000 civil monetary penalty.
- Important CFTC findings:
 - E*TRADE Securities (a registered IB) used a third-party vendor to provide the front-end order entry system for all of its futures customers. The third-party vendor generated audit trail logs on a monthly basis, but stored these records for 10 days (E*TRADE Securities wrongly believed that it could access the logs at any time despite the vendor's warnings about its retention policy).
 - E*TRADE Clearing (a registered FCM) erroneously believed that its audit log documents were stored on an internal database and, therefore, it satisfied its recordkeeping obligations. In reality, the database did not store audit logs.
 - Neither registrant had written policies or procedures in place to comply with CFTC recordkeeping requirements. (NOTE: There was no such requirement at the time of this violation, and there is no such requirement post-1.31 amendments.) The CFTC noted that the registrants did not update their manuals with recordkeeping requirements more than a year after it learned of its failure to comply with such requirements.



Key Takeaways

- Amendments to Regulation 1.31 reduce antiquated requirements, like storing electronic records in their native file or WORM format, and using a technical consultant for electronic record storage.
- Regulation 1.35 is broad, and records entities (including non-registrants) should carefully consider which records must be retained pursuant to these requirements. Recordkeeping violations often are associated with CFTC investigative sweeps, and a records entity can work to prevent these types of violations by implementing proactive compliance practices.



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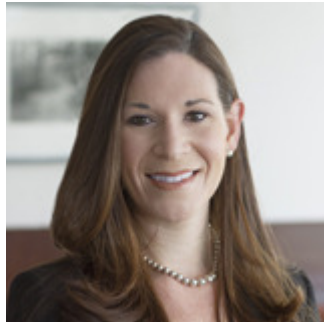
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Akshay N. Belani focuses his practice on the application of derivatives in trading, structured products, and capital markets. Akshay represents hedge funds, banks, institutional investors, broker-dealers and other financial institutions in all aspects of their futures, derivatives and commodities trading. He has experience in futures, derivatives and commodities laws, and regulations affecting both buy- and sell-side market participants and is a frequent speaker and writer on topics related to the new global derivatives market structure (with an emphasis on Dodd-Frank).

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