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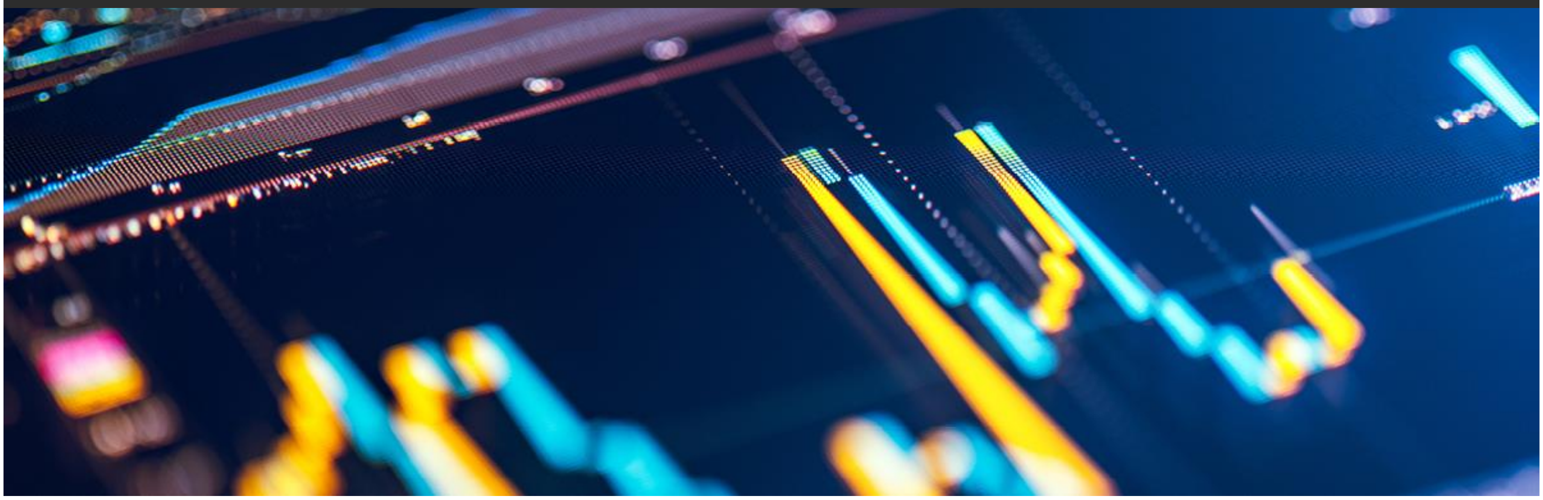

March 2019

CFTC and NFA Commodities Regulatory Update

Departing from its historical practice but following the approach taken by the SEC and FINRA, the Commodity Futures Trading Commission (CFTC) on Feb. 12, 2019, announced its first release of examination priorities (Release) for each of its regulatory divisions. In making the announcement, CFTC Chairman J. Christopher Giancarlo indicated the release is part of CFTC's "initiative to improve the relationship between the Agency and the entities it regulates, while promoting a culture of compliance at our registrants." In another regulatory first, the National Futures Association (NFA) issued a notice to members (Notice) requiring adoption and implementation of certain internal controls by registered commodity pool operators (CPOs).

CFTC Release

CFTC's list of priorities follows Chairman Giancarlo's regulatory emphasis on transparency. While not exhaustive, the list indicates to regulated entities the areas of current focus for the various CFTC divisions, and can be used by such entities in evaluating their own compliance procedures and protocols.

The Release is divided into three main areas:

Division of Market Oversight (DMO)

DMO is charged with responsibility for oversight and examination of designated contract markets (DCMs) and swap execution facilities (SEFs). In the Release, DMO indicated it will be focusing on "more frequent and prompt" compliance examinations of DCMs in 2019 and further stated that most DCMs will likely undergo at least one examination in the coming calendar year. While DMO did not provide an equivalent timetable for examining SEFs, DMO indicated it intends to begin consulting with SEFs during 2019 as a preliminary step to designing an examination protocol for such platforms. The pendency of an SEF compliance regime may be attributable, in part, to looming changes in SEF regulation in connection with CFTC proposed rules.

The priorities DMO identified in examining DCMs are based on four fundamental “pillars”:

1. Effective communication between DMO and DCMs to increase awareness of DMO’s priorities and areas of concern;
2. Risk-based determination of key entities and subject areas;
3. Improvements by DCMs in responsiveness to regulatory and market developments; and
4. Efficiency in the examination process.

A 2018 review by DMO of DCM self-regulatory programs identified the following areas for potential scrutiny:

1. Cryptocurrencies;
2. Disruptive trading practices (including a DCM’s rules, surveillance, investigation and disciplinary history);
3. Trade practices;
4. Block trade practices;
5. Market practices;
6. Market maker and trading incentive programs; and
7. Relationships between a DCM and its third-party service providers.

Division of Swap Dealer & Intermediary Oversight (DSIO)

DSIO oversees futures markets intermediaries and focuses primarily on futures commission merchants (FCMs). For 2019, DSIO identified the following six areas as examination priorities:

1. Residual interest in customer accounts;
2. Forms of non-cash margin;
3. Segregation requirements;
4. Use of third-party depositories;
5. Customer account documentation; and
6. Swap dealer/major swap participant relationships with third-party vendors.

Division of Clearing and Risk (DCR)

DCR examines derivative clearing organizations (DCOs) to identify areas of potential weakness or non-compliance that may adversely affect an efficient clearing process. Historically, DCR examinations have included a review of a DCO's financial resources, risk management system, system safeguard and cybersecurity policies, practices, and procedures.

NFA Interpretive Notice

In Notice I-19-03, dated Jan. 31, 2019, NFA announced a requirement that CPOs adopt and implement an internal control system designed to improve protection of customer funds and provide reasonable assurance that a CPO's books and records are accurate and compliant with applicable CFTC and NFA requirements.

Although NFA recognized that a CPO's internal control system may vary based on the size and operation of the CPO, at a minimum a system must include the following:

- Separation of duties, where possible, such that no single person is in a position to carry out or conceal errors or misconduct or have control over any two phases of a transaction or operation; and
- Performance of a risk assessment to identify a CPO's most critical risk areas, with development and implementation of controls to address such risks.

In the Notice, NFA identifies three risk areas that are generally applicable to most CPOs' businesses:

1. Pool/fund subscriptions, redemptions and account transfers;
2. Risk management and investment valuation of pool/fund assets; and
3. Use of third-party administrators.

The Notice will become effective for CPO members of NFA on April 1, 2019.

Authors

This GT Alert was prepared by **Jeffry M. Henderson** and **Douglas E. Arend**. Questions about this information can be directed to:

- Jeffry M. Henderson | +1 312.456.8453 | hendersonj@gtlaw.com
- Douglas E. Arend | +1 312.476.5029 | arendd@gtlaw.com
- Or your Greenberg Traurig attorney

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