

THE ROLE OF INTERNAL CONTROLS IN FACILITATING  
SWAP DEALER COMPLIANCE WITH  
COMMODITY FUTURES TRADING COMMISSION REGULATIONS

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**The Role of Internal Controls in Facilitating Swap Dealer Compliance  
with Commodity Futures Trading Commission Regulations**

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**I. Introduction**

In the Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, the Financial Crisis Inquiry Commission (“FCIC”) concludes that the 2008 financial crisis was avoidable, observing that “the crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire.”<sup>2</sup> The FCIC further concludes that “dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.”<sup>3</sup> The FCIC blamed the “captains of finance and the public stewards of our financial system,” calling their behavior “a big miss, not a stumble.”<sup>4</sup>

In response to the financial crisis, Congress passed the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).<sup>5</sup> Title VII of the Dodd-Frank Act expands the scope of the Commodity Exchange Act (“CEA”) and the Securities Exchange Act of 1934 by providing for the regulation and oversight of the swap and security-based swap markets, respectively. As the Commodity Futures Trading Commission (“CFTC” or “Commission”) explained, “[o]ne of the cornerstones of this legislation is the establishment of a new statutory framework for comprehensive regulation of financial institutions that participate in the swaps market as [swap dealers] or [major swap participants], which must register and are subject to greater oversight and regulation.”<sup>6</sup>

This paper analyzes the expectations set by the CFTC in promulgating its Dodd-Frank Title VII regulations for swap dealers with respect to internal controls in order to facilitate compliance, as well as recent CFTC swap dealer enforcement cases where controls’ failures were significant factors in alleged instances of noncompliance.

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<sup>2</sup> *The Financial Crisis Inquiry Report*, Financial Crisis Inquiry Commission (Jan. 2011) at xvii, [https://fcic-static.law.stanford.edu/cdn\\_media/fcic-reports/fcic\\_final\\_report\\_full.pdf](https://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf).

<sup>3</sup> *Id.* at xviii.

<sup>4</sup> *Id.* at xvii.

<sup>5</sup> Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>6</sup> Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55943.

## II. CFTC, NFA Standards for Adequate Internal Controls

The CFTC's swap dealer regulatory regime focuses on registration, capital, margin, reporting, recordkeeping, and business conduct standards. In promulgating rules to implement the new provisions set forth in CEA Section 4s, the CFTC enumerated in various rulemakings its expectations with respect to internal controls and oversight within the operations and supervision of the swap dealer, as well as an independent and empowered compliance function led by a chief compliance officer ("CCO").

The CFTC, consistent with its principles-based approach to regulation, gives some flexibility and discretion to registrant swap dealers on how to fashion its compliance regime. The CFTC stresses the importance of "proper internal oversight" but also ensures that these participants retain the flexibility to comply in the manner best suited for their individual needs.<sup>7</sup>

However, the CFTC is clear that internal controls are a fundamental pillar of a compliance program. In the adopting release and final rule, for example, the CFTC established its view that "[s]ound risk management and internal controls on an individual firm level is the basis of systemic risk mitigation."<sup>8</sup> The CFTC reminds market participants that "registrants will benefit from the required oversight of their internal operations," noting that "the required monitoring . . . protects the entity from an unforeseen violation that could lead to, among other things, an enforcement action from an exchange or the Commission" and determining that "the stability of any entity rests on its ability to manage the risks inherent in its business; by requiring stringent internal oversight, the Commission believes these regulations will aid in the growth and competitiveness of SDs and MSPs by ensuring the stability that flows from the most basic forms of risk management."<sup>9</sup>

In another adopting release, the CFTC offered that it views its chief compliance officer rules for swap dealers as "broadly compatible" with those required for Federal Home Loan Banks subject to Federal Housing Finance Agency ("FHFA") regulation, such as internal control systems under 12 CFR 917.6. The CFTC, in finalizing its swap dealer CCO rules, found similarities between the two regimes, citing the FHFA requirement that senior management must establish and implement an effective system to track internal control weaknesses and the actions taken to correct them, and must monitor and report to the bank's board on the effectiveness of the internal control system.<sup>10</sup>

Similarly, the National Futures Association ("NFA") has established certain diligent supervision expectations with respect to its swap dealer members. NFA Compliance Rule 2-9(d) requires each swap dealer member to "diligently supervise its employees and agents in the conduct of

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<sup>7</sup> Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20178.

<sup>8</sup> *Id.* at 20168.

<sup>9</sup> *Id.* at 20178.

<sup>10</sup> *Id.* at 20156.

their swap activities for or on behalf of the Member.”<sup>11</sup> As NFA explains, Compliance Rule 2-9(d) is broadly written to provide each firm with some degree of flexibility in determining what constitutes “diligent supervision” and to develop and implement supervisory procedures tailored to meet the Member's particular needs.<sup>12</sup> Although NFA does not dictate the specific supervisory procedures that a Member must implement, all swap dealer Members are required to develop and implement written supervisory procedures designed to achieve ongoing compliance with applicable NFA and CFTC requirements.<sup>13</sup>

### **III. Recent CFTC Swap Dealer Enforcement Cases Involving Inadequate Internal Controls**

The CFTC’s views on appropriate internal controls are only one factor that swap dealers must consider when developing or reviewing their compliance program. Additionally, swap dealers must remain apprised of the CFTC’s enforcement activity, and incorporate any takeaways from those cases into its operations.

In the last two years, the CFTC has brought a number of cases against registered swap dealers for various CEA noncompliance issues. While the alleged specific violations are different in each instance, one common theme is the CFTC’s discussion in each consent order related to the role of the swap dealer’s compliance program and the reliance on internal controls to facilitate compliance.

As CFTC Chairman Rostin Behnam recently noted, recent CFTC enforcement cases with significant civil monetary penalties “appear to be rooted in a lack of risk management or the absence of a structured compliance function.” In order to address such misconduct, Chairman Behnam added, “It may be that we need to assert our authority and regulatory oversight, tempered by the need to be clear in the boundaries of our authority, but firm enough to incite a culture of compliance.”<sup>14</sup>

This section summarizes each of those cases.

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<sup>11</sup> NFA Compliance Rule 2-9: Supervision (Sept. 30, 2019), <https://www.nfa.futures.org/rulebook/rules.aspx?RuleID=RULE%202-9&Section=4>.

In addition to swap dealers, NFA Compliance Rule 2-9 places a continuing responsibility on a futures commission merchant (“FCM”) to diligently supervise its employees and agents in the conduct of its commodity interest activities for or on behalf of the FCM. Each associate of an FCM who has supervisory duties must diligently exercise such duties in the conduct of that associate's commodity interest activities on behalf of the Member. FCMs must also, among other things, establish, maintain, and enforce a Risk Management Program designed to monitor and manage the risks associated with the activities of the FCM.

<sup>12</sup> NFA Interpretive Notice 9077, NFA Compliance Rule 2-9(D): Swap Dealer and Major Swap Participant Supervision of the Use of Marketing Materials (May 31, 2021), <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9077>.

<sup>13</sup> *Id.*

<sup>14</sup> Keynote of Chairman Rostin Behnam at the FIA Boca 2022 International Futures Industry Conference, Boca Raton, Florida (March 16, 2022), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam21>.

Most recently on March 15, 2022, the CFTC settled charges against ED&F Man Capital Markets, Ltd. (“ED&F Man”) for failing to accurately report certain data for hundreds of thousands of swaps transactions to a swap data repository . The CFTC found that ED&F Man exhibited a number of supervisory failures, including failing to disclose a conflict of interest and mid-market marks to counterparties.

Though ED&F Man’s internal compliance and training materials identified the relevant regulatory obligations, the CFTC found that ED&F Man did not implement those requirements or fulfill their obligations. Further, the CFTC found that ED&F Man “lacked both protocols on how to implement the requirements and adequate surveillance systems to alert it to compliance deficiencies,” which directly led to the violations of Parts 23, 43, and 45 of Commission Regulations. In its evaluation, the CFTC credited ED&F Man for its remedial measures upon discovering the above deficiencies, including enhancing certain surveillance and control protocols.<sup>15</sup>

On October 14, 2021, UBS AG settled a case related to failing to retain certain audio recordings. While the specific compliance charges relate to CEA Section 4s and CFTC Regulations 23.201, 23.202, and 23.203, the Commission’s Order found deficiencies in the swap dealer’s controls and the shortcomings in the scope of the internal control reviews. Specifically, while UBS conducted a monthly control to check the retention period for each individual recorded user’s records, the control did not check the retention periods for recordings generated without being associated with an individual recorded user.

Furthermore, in evaluating the swap dealer, the CFTC credited UBS with proactive engagement in remedial procedures and changes to its recordkeeping retention program. Specifically, the CFTC noted that UBS made meaningful changes to its monthly control testing to confirm that the retention period for user groups previously outside the scope of the control is now in-scope in a manner compliant with CFTC rules.<sup>16</sup>

In September 2021, Cargill Inc. agreed to pay a civil monetary penalty in connection with swap dealer reporting deficiencies as well as reporting obligation shortcomings. The Commission’s order found that Cargill failed to include new swaps in its large trader reports and Form 102S submissions. The CFTC also found that Cargill failed to supervise the carrying out of its reporting obligations, and that supervision failures resulted in the reporting failures. Specifically, the CFTC found that Cargill “did not have robust internal processes in place to determine the accuracy or the completeness of its Part 20 submissions, relying primarily on a Commission-generated error email that informed Respondent if a report was not successfully uploaded.” Cargill did not conduct analysis to evaluate the accuracy or completeness of its Part 20 submissions, which would have found errors in its reporting. Part of the settlement included a finding of a violation of CFTC Regulation 23.602, both by employing an inadequate supervisory system and failing to perform its supervisory duties diligently.<sup>17</sup>

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<sup>15</sup> In the Matter of: ED&F Man Capital Markets, Ltd. (March 15, 2022), <https://www.cftc.gov/PressRoom/PressReleases/8501-22>.

<sup>16</sup> In the Matter of: UBS AG, (Oct. 14, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8448-21>.

<sup>17</sup> In the Matter of: Cargill, Inc. (Sept. 30, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8442-21>.

Similarly, the CFTC settled a case around the same time with Société Générale for a failure to supervise its mid-market mark disclosure process diligently. The CFTC found that Société Générale failed to perform its supervisory obligations and that the failures went undetected for extended periods due to its inadequate supervision and controls over its mid-market mark disclosure process. The Commission identified a previously implemented control that included a quarterly supervisory review. The CFTC found that the swap dealer's staff failed to perform the control properly, rendering the measure ineffective, and Société Générale did not discover its control was ineffective until the end of 2018. Société Générale also failed to have sufficient oversight of its pre-trade mid-market mark disclosure process. For both deficiencies, the CFTC described remedial controls put into place to improve performance and ensure adequate supervision over the compliance validation process. These efforts include new and updating existing policies, procedures, and controls designed to ensure compliance with mid-market mark and swap valuation data reporting requirements, as well as creating new governance to oversee and monitor matters related to mid-market mark compliance requirements.<sup>18</sup>

In a September 2021 case with Mizuho Capital Markets LLC, the CFTC found failures in connection with certain requirements concerning swap counterparty portfolio reconciliation, providing disclosures to counterparties concerning the daily mid-market mark of swaps, and reporting swap transactions to a swap data repository. The Commission cited insufficient supervision, inadequate controls, lack of effective written procedures, testing failures, and insufficient processes and controls to ensure compliance in these areas. Specifically, the CFTC found inadequate controls to detect repeated errors and omissions in its swap data reporting. Remediation efforts identified by the Commission included new and enhancing existing policies and procedures, automated controls to test portfolio reconciliation, additional and new swap dealer compliance and supervisory resources, and enhanced compliance training.<sup>19</sup>

Finally, in a September 2021 case with Citibank, N.A. and Citigroup Global Markets Limited (collectively, "Citi"), which involved the reporting of legal entity identifiers ("LEIs") and supervision requirements, the CFTC identified several supervisory deficiencies, including the reliance on informal, ad hoc reporting instructions, failure to maintain an audit trail of these instructions, inconsistent use of a monthly control, an inadequate supervisory system and a failure to perform supervisory obligations diligently. The CFTC cites Citi's failure to detect, prevent, and remediate repeated LEI swap data reporting errors, even after a previous case in 2017.<sup>20</sup>

#### **IV. Key Takeaways**

The CFTC – in its rulemakings and enforcement cases – has made clear its high expectations for swap dealer compliance and supervision. As CFTC Acting Director of Enforcement Vincent

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<sup>18</sup> In the Matter of: Société Générale (Sept. 29, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8437-21>.

<sup>19</sup> In the Matter of: Mizuho Capital Markets LLC (Sept. 27, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8429-21>.

<sup>20</sup> In the Matter of: Citibank, N.A. and Citigroup Global Markets Limited (Sept. 27, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8428-21>.

McGonagle remarked last year, the CFTC continues to “highlight[] the need for swap dealer registrants to have an adequate supervisory system and controls in place.” Swap dealers “must also diligently perform their supervisory duties.”<sup>21</sup> Looking forward, to quote Acting Director McGonagle, we expect the CFTC will continue to investigate and penalize “swap dealer registrants who fail to meet their compliance, regulatory and supervisory obligations accountable for their failures.”<sup>22</sup>

Based on these statements, corresponding enforcement actions, and CFTC and NFA statements made in adopting rules and regulations, swap dealers should incorporate several functions to strengthen internal controls and ensure appropriate supervision:

- Consistent with CFTC Rule 3.3, the swap dealer chief compliance officer should assess the effectiveness of the swap dealer’s policies and procedures, particularly with respect to internal controls, supervision, testing, and escalation;
- The swap dealer chief compliance officer should identify areas for improvement with respect to internal controls, supervision, testing, and escalation, and recommend potential changes or improvements to its compliance program;
- Automated controls should be tested and validated to ensure that they cover the intended scope of review and provide accurate results;
- Governance forums should be evaluated regularly with respect to the stated mission or purpose for the committee or group, a clear list of required participants, documentation of meeting agendas and decisions made, and whether the forum appropriately receives information about the swap dealer’s operations;
- On an annual basis, the swap dealer should review its written supervisory procedures designed to achieve ongoing compliance with applicable NFA and CFTC requirements; and
- On an annual basis, the swap dealer should review its compliance training program, making sure that staff receives comprehensive annual “refresher” training on relevant topics and that subject-specific training is kept current to reflect the swap dealer’s operations and related regulations; and
- Ensure that supervisors are regularly reminded of their roles and responsibilities.

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<sup>21</sup> Press Release, CFTC, CFTC Orders Société Générale S.A. to Pay \$1.5 Million for Mid-Market Mark, Swap Valuation Data and Supervision Failures (Sept. 29, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8437-21>.

<sup>22</sup> Press Release, CFTC, CFTC Orders Mizuho Capital Markets LLC to Pay \$1.5 Million for Swap Portfolio Reconciliation, Other Compliance and Supervision Failures (Sept. 27, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8429-21>.