

First Swap Dealer Exams Expected To Probe Compliance Chiefs

By **Ed Beeson**

Law360, New York (June 12, 2014, 4:45 PM ET) -- The National Futures Association plans to launch its first examinations of swap dealers and major swap participants this summer, and while regulations for these entities are still being hatched, attorneys say the inspections will target how well firms are meeting the rules so far and put pressure on those that have fallen behind.

Much of the focus is expected to fall on the chief compliance officers of these firms, the work they do and the resources they have to get it done, attorneys said.

Once a lesser-known player, the NFA has emerged since the passage of the Dodd-Frank Act as a frontline regulator for the swaps industry. Swap dealers and major swap participants have been required to provisionally register with the NFA and submit documents and reports showing their compliance with U.S. Commodity Futures Trading Commission provisions known as the Section 4s rules, which cover things like designation of a chief compliance officer, business conduct standards and business continuity plans.

Now the self-regulatory organization has announced the next step in its oversight of swaps firms. Starting in July, it will begin on-site examinations of swap dealers and major swap participants in a process that will continue through June 2015, NFA officials said on a recent conference call with representatives from firms.

After giving 30 days notice, a team of four or five NFA examiners will show up at a firm to review paperwork, interview the CCO and other key personnel, and take a look at how the firm abides by its policies and legal requirements, officials said.

"Our approach is to essentially understand the process you have and the infrastructure you have that supports your compliance with the rules and regulations," said Shuna Awong, the NFA's director of OTC derivatives, according to a transcript of the call released this week.

"At this time, there's no plan to do a technical review of the systems, but we would focus on controls surrounding the systems, such as whether a critical system has been independently reviewed, for example, by your internal audit department," she added.

Attorneys and former regulatory officials say it remains to be seen how deep a dive NFA examiners will take during these initial looks at swap operations, but one former CFTC official says he expects close attention to be paid, given the level of scrutiny the regulator has put into its reviews of 4s submissions so far.

"This isn't going to be a pro forma review. They plan to spend three weeks on-site," said Dan Berkovitz,

a WilmerHale partner who was the CFTC's general counsel under former Chairman Gary Gensler.

He said the exam likely would focus on how well the compliance function and written policies and procedures have been integrated into a firm's operations.

"Rather than simply saying, 'Thou shall do this, thou shall do that,' they want a greater level of specificity of who shall do what," Berkovitz said. "They want to make sure that dealers get it, that this is being implemented, that it's not just paper procedures."

NFA officials declined to say how many of the 100 or so registered swap dealers would be inspected, but they said exams would be limited for the moment to U.S.-based swap dealers and major swap participants.

The officials also revealed plans to develop more ongoing monitoring of firms and said they would launch investigations after certain events at firms or as issues emerge within the industry.

Julian Hammar, a former assistant general counsel with the CFTC who is now of counsel at Morrison & Foerster LLP, said he expected NFA examiners to train their sights on areas such as whether reporting lines have been established between the CCO and the firm's board of directors or senior management and whether the two sides have consulted on anything.

Examiners also will want to review areas of noncompliance with an eye to how these issues were handled or resolved, he said. They also may want to look at documents the firm used to support its recent annual reports to the NFA, and whether there are inconsistencies between them, Hammar added.

On the conference call, NFA officials told industry representatives that the CFTC will receive a copy of their exam reports and may audit them. Attorneys, however, say they don't expect NFA examiners will be on hunt for violations that could lead to enforcement actions. The rules governing the swaps industry are still new for both firms and the regulator, and both recognize the learning curve ahead.

"Swap dealers all doing their best to cope with these complex rules," said Guy Dempsey, a partner with Katten Muchin Rosenman LLP. "It probably wouldn't send the right message to start hauling people out and shooting them to encourage the others."

The NFA's typical approach to exams has been to bring issues spotted during inspection to the registrant's attention and then work with them to find a solution before the exam is over, said Michael Philipp, a partner with Morgan Lewis & Bockius LLP. "It would not surprise me to see the same approach being taken here," he said.

Attorneys say that while they expect the NFA will be lenient on its first sweep through the industry, given the newness of the rules and the lack of formal guidance in many areas, that does not mean firms can slouch on fixing problems.

"Initially, there may be some level of forgiveness but, as time goes on, folks shouldn't rest easy," said Rita Molesworth, a partner at Willkie Farr & Gallagher LLP and a former NFA staffer. "Everybody needs to be moving towards full compliance."

--Editing by Kat Laskowski and Katherine Rautenberg.

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