

FS Regulatory Brief

Good faith – What’s your story?

New derivatives reports will put it to the test

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On December 31, 2012, registration requirements for swap dealers¹ finally became a reality. Provisionally² registered swap dealers became subject to various requirements under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), and other requirements will roll into effect over the coming months. During this period of phased-in implementation, as provisionally registered swap dealers struggle with their compliance obligations, the notion of how to fulfill and document good faith compliance efforts is of particular importance.

In a number of no-action letters, exemptive orders³ and final rules under Dodd-Frank, the Commodity Futures Trading Commission (CFTC) signaled that good faith compliance will be a relevant consideration when it exercises its discretion in assessing

compliance under the new rules. Thus, good faith efforts to comply with new swap dealer regulatory requirements, particularly in this interim period of phased implementation, will be the key to mitigating compliance risk.

The notion of good faith compliance may get its first test with the first round of required report filings. For certain swap dealers, the first Quarterly Risk Exposure Reports to the CFTC are due March 31, 2013, and the first Chief Compliance Officer Annual Reports will be due later in the year (90 days after the firm’s fiscal year-end). While the compliance dates for many of the requirements have been delayed until the second and third quarters of 2013, now is the time to document your story of good faith compliance with the applicable rules.

This **FS Reg Brief** addresses the CFTC’s essential elements of good faith and provides guidance for translating them into a robust swap dealer compliance program.

What is good faith and when is it relevant?

Dodd-Frank elevated the compliance, risk management and supervision functions for all CFTC registrants in both the futures and swaps markets. With this new focus comes added compliance risk, with potential enforcement and private actions. The CFTC has recognized this reality and has indicated its intent to consider a firm’s good faith in managing its compliance obligations. Critical to this analysis is a firm’s allocation of sufficient resources to implement requirements and remediate problems as they arise. Maintaining a robust compliance focus to mitigate risk will be important over the near-term and long-term and should be a central consideration as firms build out their compliance programs.

¹ Major swap participants will not have to register until March 1, 2013 earliest.

² Swap dealer registration with the CFTC is considered “provisional” until all implementing regulations are completed and the dealer can demonstrate compliance with these regulations to the National Futures Association.

³ In the lead up to the registration deadline there was a flurry of CFTC no-action letters and exemptive orders delaying the compliance dates of many requirements for new registrants. Our December FS Reg Briefs highlighted the implications of some of the more significant regulatory delays. *Cross-Border Clarity: CFTC provides guidance and additional time for industry to address cross-border swaps*, December 2012; *Certain foreign-owned US banks may avoid registration under swap dealer aggregation rule*, December 2012; *CFTC delivers holiday gift to Wall Street – Delays EBC and Documentation Requirements*, December 2012; and *Is Your Counterparty Documented? ISDA Protocol adherence slower than expected*, December 2012.

We first addressed the topic of good faith compliance in our FS Reg Brief last month discussing the CFTC's December 21, 2012 final Exemptive Order and Further Proposed Guidance clarifying its approach to regulating cross-border swaps activities under Title VII of Dodd-Frank.⁴ In the release, the CFTC indicated the critical importance of good faith, stating that when a swap dealer or major swap participant "is making diligent, good faith implementation efforts ... [the CFTC] does not intend to bring an enforcement action ... for failing to fully comply with applicable Dodd-Frank requirements prior to July 12, 2013."

The CFTC also recognized the compliance concerns of market participants in the release. The CFTC stated that "despite their best efforts at compliance, there could be 'practical or technical limitations or interpretive uncertainty' that might need to be resolved" before full compliance is "practically feasible."

In assessing a swap dealer's or major swap participant's good faith the CFTC indicated that, at a minimum, it would look for:

- Material progress toward timely implementation and compliance;
- Identification of any implementation or interpretive issue as soon as reasonably possible;
- Timely elevation of such issues to the swap dealer's or major swap participant's senior management for consideration and resolution; and
- Timely consultation with other industry participants and the Commission as necessary to seek resolution of any such issues.

These principles are rooted in CFTC practice and can be applied more generally to all swap dealer and major swap participant requirements under Title VII. As a result, swap dealers should actively begin managing their compliance strategy as soon as they register.

⁴ See FS Reg Brief: *CFTC delivers holiday gift to Wall Street – Delays EBC and Documentation Requirements*, December 2012.

Demonstrating “material progress toward timely implementation and compliance”

Policies and procedures

Swap dealers with provisional registration already have taken significant steps toward documenting their compliance journey as part of the application process through their filings. Most of the CFTC rules require the adoption of policies and procedures reasonably designed to ensure compliance. To ensure *ongoing* compliance, these policies and procedures should reflect the nature of the business conducted by the entity and be sufficiently robust, dynamic and flexible to remain relevant to changing business environments.

Governance and reporting

Effective implementation of policies and procedures requires good governance. Firms should document ownership and responsibility for monitoring the implementation of all requirements and ensure that timely reporting mechanisms are in place. Effective communication is important here. Information flows must be designed to reach all relevant staff to ensure consistent approaches in real time.

Remediation of non-compliance

Despite best efforts, there are likely to be growing pains and “practical or technical” difficulties in achieving acceptable levels of compliance. Firms should document that they have tested their systems and programs, generated exception reports, and recorded remediation of non-compliance. Over time, the ability to demonstrate improved rates of compliance and corrective action will be important.

Firms should look both forward and backward to anticipate challenges for Day-One functionality and benefit from lessons learned for Day-Two performance. Again, documenting the process is key to demonstrating good faith retrospectively.

Compliance culture – elevating issues to senior management

Regulators consider corporate culture and the message from the top in assessing the value placed on compliance by a firm. This view will be particularly true going forward considering the sea change in compliance focus that is central to Dodd-Frank and CFTC rules. Regulators will look for a commitment of resources appropriate to the business of the enterprise. Also, timely elevation of implementation and interpretive issues to senior management for consideration and resolution will demonstrate the firm's commitment to compliance.

Consulting with other industry participants and the CFTC

Some compliance challenges can best be addressed through industry wide solutions or CFTC action. The CFTC has been receptive to industry approaches that can create efficiencies, lower costs and reduce the lead time to implementation. The CFTC has acknowledged certain industry initiatives and provided relief to enable those solutions to become fully operational, like the efforts of ISDA and Markit to provide standard documentation through the ISDA Dodd-Frank Protocol. Where issues arise that are susceptible to industry wide solutions, the CFTC has indicated that it will consider firms to be demonstrating good faith in pursuing those initiatives.

The CFTC continues to listen to the merit based arguments of the industry in developing a workable compliance schedule. Chairman Gensler and various Commissioners, in testimony and other statements, have expressed their intent to smooth the compliance process for firms operating in good faith.

Upcoming reports to demonstrate compliance

The Quarterly Risk Exposure Reports are due March 31st for certain swap dealers, so will therefore provide registrants with the first opportunity to demonstrate their record of good faith on an entity wide basis. The Risk Management Program rules require swap

dealers and major swap participants to prepare quarterly written reports – with distribution to senior management and the CFTC – setting forth their market, credit, liquidity, foreign currency, legal, operational, settlement, and other risk exposures. These reports must include recommended or completed changes to the Risk Management Program and a schedule for implementing recommended changes.

The next key due date will be the Chief Compliance Officer Annual Reports which must be filed with the CFTC within 90 days of the firm's fiscal year-end. The reports will include a description of the firm's written policies and procedures, including code of ethics and conflicts of interest policies, and identification of the policies and procedures that are reasonably designed to ensure compliance with the requirements under the Commodity Exchange Act (CEA) and CFTC rules. The Annual Reports also will assess the effectiveness of the firm's policies and procedures, recommend changes or improvements and describe the financial, managerial, operational, and staffing resources committed to compliance with the CEA and CFTC rules. Good faith efforts will be particularly important in the section of the report describing any "material non-compliance issues" and the efforts taken to remediate them.

Firms facing compliance challenges during the startup phase and later should be proactive in documenting their good faith efforts using the best practice suggestions described in this brief.

Good faith compliance to mitigate the risk and consequences of enforcement action

The CFTC historically has considered good faith compliance in assessing diligent supervision. CFTC precedent considers the adequacy of policies and procedures and the governance systems in place to ensure compliance. In addition, in particular Dodd-Frank rulemakings such as the external business conduct rules, the CFTC has expressly stated that, absent fraud, it will consider good

faith compliance with policies and procedures reasonably designed to comply with the rules as a mitigating factor when exercising its prosecutorial discretion.

Nevertheless, good faith is not an impenetrable shield to an enforcement action or private actions in cases of non-compliance. Firms should consult counsel to assess litigation risk in particular circumstances.

Good faith compliance: the antidote to claims of evasion

The flip side of the CFTC's consideration of good faith compliance is the CFTC's concern about evasion. Indeed, the external business conduct rules require policies and procedures to prevent a swap dealer or major swap participant from evading, or participating in or facilitating an evasion, of Dodd-Frank and CFTC rules. Documenting good faith compliance and due diligence will be highly relevant to dispel such evasion concerns.

Documenting your compliance journey

With the increased focus on compliance under Dodd-Frank and CFTC rules, documenting efforts to meet requirements will be critical in the startup phase and beyond. Firms should spend time now sketching the outline of the story they plan to tell in their upcoming reports to senior management and to the CFTC. Be sure that you are generating the data you will need to demonstrate good faith, particularly where you are facing implementation challenges. For the narrative to be effective, it should emphasize the firm's compliance culture and diligence in remediating challenges.

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