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CFTC Provides Asset Managers Temporary Reprieve from Rule 1.35 Oral Recordkeeping Requirements; Other Issues Remain

by Kevin P. Kundra and Daniel C. Knox

Rule 1.35 under the Commodity Exchange Act requires that each member of a swap execution facility (SEF) or designated contract market (DCM), including asset managers that enter into participant agreements with SEFs or DCMs in order to execute transactions for their clients on such facilities, maintain records of all relevant data, memoranda, communications and documentation of all transactions related to their business of dealing in commodity interests and related cash or forward transactions. Among other items, these records are required to include customer orders (whether filled, unfilled or canceled), copies of confirmations and post-trade allocations of bunched orders involving multiple clients. More significantly, the records must include "all oral and written communications concerning quotes, solicitations, bids, offers, instructions, trading and prices that lead to the execution of a transaction in a commodity interest and related cash or forward transactions, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device or other digital or electronic media."

Although all asset managers that are members of a SEF or DCM must comply with the Rule 1.35 written recordkeeping requirements, the rule provides an exemption from the oral communications recordkeeping requirements for commodity pool operators (CPOs) and members of a SEF or DCM that are not registered or required to be registered with the CFTC in any capacity. This will exempt many asset managers from the oral recordkeeping requirements, but, notably, registered commodity trading advisors (CTAs) who are members of a SEF or DCM are not exempted.

The Rule 1.35 recordkeeping requirements, and particularly their oral recordkeeping aspects, pose significant burdens to asset managers, and may require that additional policies, procedures or technology infrastructure be put in place in order to ensure compliance. SIFMA's Asset Management Group (SIFMA AMG) outlined these burdens in a letter to the CFTC dated Dec. 10, 2013. As a result, the CFTC initially provided time-limited no-action relief from the Rule 1.35 oral recordkeeping requirements to registered CTAs that were members of SEFs or the truEX DCM, extending the compliance date for oral recordkeeping to May 1, 2014 from the original date of Dec. 21, 2013.

Subsequently, on April 3, 2014 the CFTC hosted an End-User Roundtable which focused in part on Rule 1.35 recordkeeping requirements. At the Roundtable, participants expressed concern that Rule 1.35 as currently constituted potentially requires that every conversation involving trading personnel be captured because their job functions involve cash commodity or forward contracts. Participants also complained that the rule's requirements that mobile phone conversations and text messages be maintained were overly burdensome. Asset manager participants complained that they should not be subject to the rule at all just because they were members of SEFs or DCMs, since they were not the type of market makers or liquidity providers such as futures commission merchants and introducing brokers

typically captured by these types of requirements.

Following the End-User Roundtable, SIFMA AMG sent a second letter dated April 17, 2014 to the CFTC requesting that asset managers that were members of SEFs or DCMs be exempted from the recordkeeping requirements of Rule 1.35. As a result, on April 25, 2014 the CFTC provided time-limited no-action relief extending the Rule 1.35 oral recordkeeping requirements compliance date for registered CTAs who are members of any SEF or DCM from May 1, 2014 until **Jan. 1, 2015.**[1] It is anticipated that during this additional time the CFTC will further consider industry concerns and the costs and benefits of the rule, although it cannot be determined at this time whether further relief will be granted.

Rule 1.35 remains a significant concern for asset managers that are members of a SEF or DCM. Although compliance with the oral recordkeeping requirements for registered CTAs has been delayed, unless further relief is granted by the CFTC registered CTAs ultimately will need to ensure that their policies, practices and technology infrastructure can comply with these requirements. In addition, the written recordkeeping requirements of Rule 1.35 to which all asset managers that are members of a SEF or DCM (not just registered CTAs) are subject include maintenance of documents and information beyond those required by either the Investment Advisers Act or other provisions of the Commodity Exchange Act. The required retention periods for these records under Rule 1.35 are also lengthier in some cases than those under other statutory recordkeeping requirements. Accordingly, all asset managers that are members of a SEF or DCM should review their existing recordkeeping policies and procedures against the requirements of Rule 1.35 in order to ensure compliance.

Some asset managers have attempted to avoid becoming subject to the additional recordkeeping requirements of Rule 1.35 by not signing up as members of SEFs or DCMs themselves. One approach has been to have SEF documentation executed in the name of an asset manager's advisory clients rather than in the name of the asset manager, thereby making the clients members of the SEF rather than the asset manager. Another approach has been to engage a swap dealer that is already a member of the SEF or DCM the asset manager wishes to use (sometimes referred to as a "SEF/DCM aggregator") to act as an intermediary in executing transactions on the SEF or DCM on behalf of the advisory clients of such asset manager, thereby providing indirect access to the SEF or DCM and alleviating the additional recordkeeping requirements. While these are options that an asset manager may consider, they may result in other issues of which asset managers should be cognizant. Asset managers signing up advisory clients as members of SEFs or DCMs should consider whether they have client authority for doing so, as well as whether this imposes additional regulatory requirements on such clients under Rule 1.35. Signing up advisory clients as members of a SEF or DCM may also make it more difficult for asset managers to execute aggregated or bunched orders involving multiple clients on SEFs or DCMs. Asset managers engaging SEF/DCM aggregators should consider whether the additional costs of doing so outweigh the benefits of lessened recordkeeping requirements. In addition, as a general matter asset managers should be mindful of any conflicts of interest that may arise in choosing one structure over another and any attendant disclosure or other obligations. ■

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[1] *The CFTC indicated that despite SIFMA AMG's request for asset managers to receive relief from Rule 1.35's written recordkeeping requirements as well, it was appropriate to restrict the relief granted in the no-action letter to compliance with the oral recordkeeping requirements.*