



COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

RIN 3038-AE73

Financial Surveillance Examination Program Requirements for Self-Regulatory Organizations

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rule.

SUMMARY: The Commodity Futures Trading Commission (“Commission” or “CFTC”) is proposing to amend its regulations governing the minimum standards for a self-regulatory organization’s (“SRO”) financial surveillance examination program of futures commission merchants (“FCMs”). The proposed amendments would revise the scope of a third-party expert’s evaluation of the SRO’s financial surveillance program to cover only the examination standards used by SRO staff in conducting FCM examinations. The proposed amendments also would revise the minimum timeframes between when an SRO must engage a third-party expert to evaluate its FCM examination standards.

DATES: Comments must be received on or before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by RIN 3038–AE73, by any of the following methods:

- CFTC Comments Portal: <https://comments.cftc.gov>. Select the “Submit Comments” link for this rulemaking and follow the instructions on the Public Comment Form.

- Mail: Send to Christopher Kirkpatrick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

- Hand Delivery/Courier: Follow the same instructions as for Mail, above.

Please submit your comments using only one of these methods. To avoid possible delays with mail or in-person deliveries, submissions through the CFTC Comments Portal are encouraged.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <https://comments.cftc.gov>. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that you believe is exempt from disclosure under the Freedom of Information Act (“FOIA”), a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the Commission’s regulations.¹

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from <https://comments.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and

¹ Regulation 145.9. Commission regulations referred to herein are found at 17 CFR chapter I.

will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the FOIA.

FOR FURTHER INFORMATION CONTACT: Matthew B. Kulkin, Director, 202-418-5213, mkulkin@cftc.gov; Thomas Smith, Deputy Director, 202-418-5495, tsmith@cftc.gov; Jennifer Bauer, Special Counsel, 202-418-5472, jbauer@cftc.gov; or Joshua Beale, Special Counsel, 202-418-5446, jbeale@cftc.gov, Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

SUPPLEMENTARY INFORMATION:

I. Background

A. *Commission Initiative to Simplify and Modernize Regulations*

In March of 2017, Commission staff initiated an agency-wide internal review of CFTC regulations and practices to identify those areas that could be simplified to make them less burdensome and costly.² The Commission subsequently published in the *Federal Register* on May 9, 2017 a Request for Information soliciting suggestions from the public regarding how the Commission's existing rules, regulations, or practices could be applied in a simpler, less burdensome, and costly manner.³

² See Remarks of Acting Chairman J. Christopher Giancarlo before the 42nd Annual International Futures Industry Conference in Boca Raton, FL, dated March 15, 2017. The remarks are available at the Commission's web site: <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-20>.

³ Project KISS, 82 FR 21494 (May 9, 2017); amended on May 24, 2017, 82 FR 23765 (May 24, 2017). The *Federal Register* Request for Information, and the suggestion letters filed by the public are available at the Commission's web site: <https://comments.cftc.gov/KISS/KissInitiative.aspx>.

The CME Group (“CME”) submitted suggestions on a variety of rules, regulations, and practices in responses to the Commission’s Request for Information.⁴ One area identified by CME for simplification and the reduction of regulatory burden was Regulation 1.52, which imposes an obligation on SROs⁵ to conduct periodic examinations of member FCMs⁶ for compliance with both SRO and Commission minimum capital and other financial and related reporting requirements. Specifically, the CME suggested that Regulation 1.52 should be amended to eliminate a requirement that a third-party public accounting firm perform periodic evaluations and assessments of the CME’s surveillance program to oversee its member FCMs compliance with Commission and CME financial and related reporting requirements.⁷

B. Statutory and Regulatory Background

FCMs perform critical functions to facilitate the efficient operation of Commission-regulated exchange-traded derivatives markets. In addition to trading for their own accounts and carrying the accounts of their affiliates, FCMs are market intermediaries, standing between customers trading futures and swaps transactions on one side and designated contract markets (“DCMs”) and derivatives clearing organizations

⁴ See Letter from Kathleen Cronin, Senior Managing Director, General Counsel and Corporate Secretary, CME Group, dated September 29, 2017. The CME’s letter is available at the Commission’s web site: [https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61395&SearchText=.](https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61395&SearchText=)

⁵ The term “self-regulatory organization” is defined in Regulation 1.52 to include a contract market (as defined in Regulation 1.3) or an RFA under section 17 of the Commodity Exchange Act (“Act”) (7 U.S.C. 1 *et seq.*), but the term as defined in Regulation 1.52 does not include a swap execution facility (as defined in Regulation 1.3). See Regulation 1.52(a)(2).

⁶ The term “futures commission merchant” is generally defined in Regulation 1.3 as (1) an entity that is engaged in soliciting or accepting orders for the purchase or sale of any commodity for future delivery or a swap and, in connection with the solicitation and acceptance of such orders, accepts money, securities or property (or extends credit in lieu thereof) to margin, guarantee or secure futures or swaps transactions, or (2) an entity registered as an FCM.

⁷ CME Letter, pp. 13-14.

(“DCOs”) on the other side. As part of their role as market intermediaries, FCMs carry customer accounts and hold customer funds to margin futures and cleared swap transactions. FCMs also fulfill daily settlement obligations on behalf of customers by posting sufficient funds to DCOs to support their customers’ futures and swap positions, including paying mark-to-market losses associated with such positions. FCMs also are essential to the efficient operation of Commission-regulated markets in that they guarantee each customer’s financial performance for futures and swap positions to DCOs by agreeing to use their own financial resources to cover any shortfall resulting from a customer default.⁸

The Act acknowledges the critical role performed by FCMs. Section 4f(b) of the Act authorizes the Commission to adopt regulations imposing minimum capital and financial reporting requirements on FCMs to help ensure that they maintain adequate financial resources to meet their obligations.⁹ Under this statutory authorization, the Commission adopted regulations requiring FCMs, among other requirements, to maintain a minimum level of regulatory capital,¹⁰ to segregate customer funds from their own funds in specially designated customer accounts,¹¹ and to maintain appropriate risk

⁸ See Regulation 39.16.

⁹ Section 4f(b) of the Act authorizes the Commission to adopt FCM minimum financial and related reporting requirements. Section 4f(b) provides, in relevant part, that no person shall be registered as an FCM unless such person meets the minimum financial requirements that the Commission may prescribe by regulation as necessary to insure such person meets its obligations as a registrant, and each person registered as an FCM shall at all times continue to meet such prescribed minimum financial requirements.

¹⁰ See Regulation 1.17 for FCM minimum capital requirements.

¹¹ See Regulations 1.20, 22.2, and 30.7 for FCM segregation requirements for customer accounts containing futures positions, swap positions, and foreign futures positions, respectively.

management programs to monitor and manage the risks associated with their activities as FCMs.¹²

The Commission also has adopted, under the authority granted by section 4f(b), regulations imposing periodic financial reporting requirements on FCMs that are intended to provide the Commission with information regarding their financial condition. The financial reporting requirements include daily statements demonstrating compliance with the segregation of customer funds requirements,¹³ monthly unaudited and annual audited financial statements,¹⁴ and regulatory notices upon the occurrence of specified events including failing to meet minimum capital requirements, failing to comply with segregation requirements, and failing to maintain current books and records.¹⁵

In addition to authorizing the Commission to adopt regulations imposing direct financial and related reporting requirements, the Act further establishes a regulatory oversight structure that imposes an obligation on DCMs and registered futures associations (“RFAs”),¹⁶ as SROs, to perform frontline regulatory oversight of market intermediaries, including FCMs.¹⁷ In 2000, Congress affirmed this regulatory structure of industry self-regulation by amending section 3 of the Act to state, in pertinent part, that it is the purpose of the Act to serve the public interests through a system of effective self-

¹² See Regulation 1.11 for FCM risk management requirements.

¹³ See Regulations 1.32, 22.2 and 30.7 for FCM requirements to prepare and to submit to the Commission daily segregation computations and schedules for customer futures, cleared swaps and foreign futures accounts, respectively.

¹⁴ See Regulation 1.10 for FCM requirements to file unaudited monthly financial statements and annual audited financial statements.

¹⁵ See Regulation 1.12.

¹⁶ The National Futures Association (“NFA”) is the only registered RFA. NFA’s financial requirements for FCMs are available at its web site, www.nfa.futures.org.

¹⁷ Section 3(b) of the Act.

regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission.¹⁸

To achieve the objective of a self-regulatory structure, the Act and Commission regulations require RFAs and DCMs to adopt financial and related reporting requirements for member FCMs, and to periodically examine FCMs for compliance with such requirements. Section 17(p) of the Act requires an RFA to establish and submit for Commission approval rules imposing minimum capital, segregation and other financial requirements applicable to its members for which such requirements are imposed by the Commission. The RFA's financial requirements for its members must be at least as stringent as those set by the Act or Commission regulations.¹⁹ Section 17(p) further provides that the RFA must implement a program to audit and enforce compliance by its members with the RFA's minimum financial requirements.²⁰

With respect to DCMs, section 5(d)(11)(B) of the Act and Regulation 38.600 require, in relevant part, each DCM to implement rules to ensure the financial integrity of any member FCM and the protection of customer funds.²¹ DCMs also are required to monitor an FCM member's compliance with the DCM's minimum financial requirements

¹⁸ Section 108 of the Commodity Futures Modernization Act of 2000, Public Law 106-554, 114 Stat. 2763 (Dec. 21, 2000).

¹⁹ See section 17(p)(2) of the Act.

²⁰ *Id.*

²¹ See also, Regulation 38.602 which provides that a DCM must provide for the financial integrity of its transactions by establishing and maintaining appropriate minimum financial standards for its members and non-intermediated market participants, and Regulation 38.603 which requires a DCM to have rules concerning the protection of customer funds.

by reviewing financial information filed with the DCM and by conducting periodic examinations of the FCM.²²

The Commission's and SRO's minimum financial requirements for member FCMs are intended to help ensure that FCMs can continue to meet their financial and operational obligations to both customers and DCOs, which is necessary in order for the Commission-regulated markets to operate efficiently and effectively.

C. Current Commission Regulation 1.52

As noted in section I.B., above, the Act and Commission regulations establish SROs (*i.e.*, DCMs and NFA) as frontline regulators for FCMs. Commission Regulation 1.52 establishes the minimum standards that the Commission requires of an SRO oversight program, and includes an explicit requirement that each SRO must adopt rules prescribing minimum financial and related reporting requirements for member FCMs that are the same as, or more stringent than, the requirements imposed by the Commission.²³ Consistent with the requirements of Regulation 1.52, SROs have adopted rules imposing FCM capital and financial reporting requirements that are at least as stringent as the FCM capital and financial reporting requirements set forth in applicable Commission regulations.²⁴

²² See Regulations 38.600 through 38.605.

²³ See Regulation 1.52(b)(1).

²⁴ For example, CME Rule 970 imposes capital and financial reporting requirements on member FCMs that are at least as stringent as the Commission's capital and financial reporting requirements. CME rules may be accessed via the CME's web site: <http://www.cmegroup.com/rulebook/CME/1/9/9.pdf>.

NFA FCM capital and financial reporting requirements are set forth in Section 1 of the NFA's Financial Requirements section of its rulebook and may be accessed at NFA's web site: <https://www.nfa.futures.org/rulebook/index.aspx>.

In 2013, the Commission adopted new rules and rule amendments to comprehensively enhance customer protections.²⁵ As part of the 2013 Customer Protection Rulemaking, the Commission amended Regulation 1.52 to impose several additional obligations on SROs with respect to the oversight of FCMs. Amended Regulation 1.52 requires each SRO to establish and operate a supervisory program that includes written policies and procedures concerning the application of the supervisory program in the examination of its member registrants (including FCMs) for the purpose of assessing whether each member registrant is in compliance with applicable SRO and Commission regulations governing net capital and related financial requirements, the obligations to segregate customer funds, risk management requirements, financial reporting requirements, recordkeeping requirements, and sales practices and other compliance requirements. The supervisory program also must adequately address the following elements: (1) The level, training, and independence of SRO examination staff; (2) The SRO's ongoing surveillance of member FCMs, including the review and analysis of financial reports and regulatory notices received; (3) The SRO's procedures for identifying and monitoring FCMs that are deemed to pose a high degree of financial risk; (4) The SRO's conduct of on-site examination of FCMs by SRO staff at least once every 18 months; and (5) The documentation of all aspects of the SRO's operation of its supervisory program.

The supervisory program also must, at a minimum, incorporate FCM examination standards addressing: (1) The ethics of an SRO examiner; (2) The independence of an

²⁵ Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 FR 68506 (Nov. 14, 2013) (the "2013 Customer Protection Rulemaking").

SRO examiner; (3) The supervision, review, and quality control of an SRO examiner's work product; (4) The evidence and documentation to be reviewed and retained in connection with an examination; (5) The examination planning process; (6) Materiality assessment; (7) Quality control procedures to ensure that the SRO examinations maintain the level of quality expected; (8) Communications between an SRO examiner and the regulatory oversight committee, or the functional equivalent of the regulatory oversight committee, of the SRO of which the FCM is a member; (9) Communications between an SRO examiner and an FCM's audit committee of the board of directors or similar governing body; (10) Analytical review procedures; (11) Record retention; and (12) Required items for inclusion in the SRO's examination report, such as repeat violations, material items, and high risk issues.²⁶ Regulation 1.52 further provides that all aspects of an SRO's supervisory program, including the FCM examination standards, must conform to auditing standards issued by the Public Company Accounting Oversight Board ("PCAOB") as such PCAOB standards would apply to a non-financial statement audit.²⁷

Regulation 1.52 also requires each SRO to engage an "examinations expert" to evaluate its supervisory program prior to its initial use, and to evaluate the SRO's application of the supervisory program at least once every three years after its initial use.²⁸ For each evaluation, the SRO is required to obtain from the examinations expert a

²⁶ Regulation 1.52(c) and (d).

²⁷ The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of brokers and dealers registered with the Securities and Exchange Commission. The PCAOB was not, however, vested with the authority to oversee the audits of FCMs.

²⁸ An "examinations expert" is defined in Regulation 1.52(a) as an accounting and auditing firm with substantial expertise in the audits of FCMs, risk assessment, and internal control reviews, and is an accounting and auditing firm that is acceptable to the Commission.

written report on findings and recommendations issued under the consulting services standards of the American Institute of Certified Public Accountants (“AICPA”) that includes: (1) A statement that the examinations expert has evaluated the supervisory program (including its design to detect material weaknesses in an FCM’s system of internal controls), including any comments and recommendations regarding such evaluation; (2) A statement that the examinations expert has evaluated the application of the supervisory program by the SRO, including any comments and recommendations in connection with such evaluation; and, (3) A discussion and recommendations of any new or best practices as prescribed by industry sources, including the AICPA and PCAOB.

II. Proposed Amendments to Regulation 1.52

A. Response to Request for Information

The CME stated in its response to the Commission’s Request for Information that it fully supported the Commission’s objective of strengthening and enhancing SRO oversight programs for FCMs as set forth in the 2013 Customer Protection Rulemaking. CME further stated that it expended significant resources revising the FCM supervisory program to address the enhanced requirements of Regulation 1.52 that were imposed by the 2013 Customer Protection Rulemaking. In this regard, CME stated that it and NFA jointly engaged a public accounting firm as a consultant during the development of the FCM examination standards, and that the public accounting firm’s expertise was extremely beneficial in drafting the initial FCM examination standards and revising its supervisory program to address such standards.

The CME, however, also suggested that the Commission should eliminate the requirement for an SRO to engage an examinations expert once every three years to

evaluate the SRO's supervisory program. The CME expressed its view that the engagement of an examinations expert at least once every three years does not provide any meaningful regulatory benefit. The CME noted that under the current regulatory framework, staff of the Commission's Division of Swap Dealer and Intermediary Oversight ("DSIO") provides effective oversight of the SRO FCM examination programs through the conduct of its SRO rule enforcement reviews. The CME noted that it revises the FCM examinations programs to incorporate any regulatory changes adopted by the Commission or SROs, and provides the actual FCM examination programs, with the revisions, to DSIO staff for review at least once each year.

Based upon the CME's response to the Commission's Request for Information, and Commission staff's firsthand experience in the CME's and NFA's implementation of their initial supervisory program,²⁹ the Commission is proposing several amendments to Regulation 1.52 to revise the time interval between mandatory examinations expert evaluations of the SRO supervisory program, and to amend the scope of the examinations expert's evaluation to focus on changes to auditing standards adopted by the PCAOB since the last examinations expert's evaluation. The Commission also is proposing several technical amendments to eliminate redundancies in the rule text.

²⁹ Since adoption of the amendments to Regulation 1.52 resulting from the 2013 Customer Protection Rulemaking, Commission staff has participated in several meetings with the CME, NFA, and their examinations expert to address issues and questions arising during the drafting of the initial examination standards and programs. In 2015, Commission staff, through delegated authority, approved the initial FCM examination standards, and in 2017 approved the CME's and NFA's examination programs. The examination standards and programs are now fully implemented and are used in each DSRO examination of an FCM.

B. Scope of the Examinations Expert's Evaluation

The examinations expert is currently required to evaluate, at least once every three years, (1) the supervisory program of an SRO or a Joint Audit Committee (“JAC”)³⁰, and (2) the SRO's or JAC's application of its supervisory program.³¹ The SRO or JAC also is required to obtain from the examinations expert a written report on finding and recommendations issued under the consulting services standards of the AICPA that includes statements that the examinations expert has evaluated the supervisory program and the SRO's or JAC's application of the supervisory program, and an analysis of the supervisory program's design to detect material weaknesses in internal controls.

The Commission is proposing to amend Regulations 1.52(c)(2)(iv) and (d)(2)(ii)(I) to remove from the scope of the examinations expert's evaluation the SRO's or JAC's application of its supervisory program during periodic reviews and the analysis of the supervisory program's design to detect material weaknesses in internal controls during both periodic reviews and the initial review prior to the programs' initial use. The Commission initially adopted in 2013 the requirement that the examinations expert issue a written report on its findings and recommendations of the SRO's application of its

³⁰ As many FCMs are members of more than one SRO, Regulation 1.52 provides a permissive system that allows SROs to enter into agreements allocating primary, but not exclusive, financial oversight and examination responsibilities of FCMs that are members of two or more SROs to one of the SROs, which is termed the “designated self-regulatory organization” (“DSRO”). The term “designated self-regulatory organization” is generally defined in Regulation 1.3 to mean the SRO delegated the primary responsibility to monitor and exam registrants that are subject to oversight by more than one SRO for compliance with minimum financial and related reporting requirements, and for receiving financial reports from such registrants. SROs that agree to participate in a plan to allocate common members to a DSRO are referred to as JAC members under Regulation 1.52. The examination requirements proposed to be amended are effectively identical for SROs and JACs, and the Commission's proposed amendments would revise the examination requirements for both the SROs and JACs.

³¹ Regulation 1.52(c)(2)(iv).

supervisory program, including its internal controls, due to concerns that a third-party assessment was necessary due to limited Commission resources and expertise to perform a comparable periodic assessment.³² Since 2013, however, Commission staff has been actively involved with the NFA, CME, and their examinations expert in the development of a revised supervisory program that meets the requirements of Regulation 1.52, including the development of FCM examinations standards that are consistent with PCAOB auditing standards. Commission staff also has reviewed the detailed FCM examination programs, including several programs designed to assess the adequacy of an FCM's internal controls that were developed by the NFA and CME, for compliance with Regulation 1.52. Commission staff also has been performing scheduled oversight reviews of NFA's and CME's execution of its revised supervisory program, including its implementation and execution of programs designed to assess the FCM's internal controls.

Accordingly, following the adoption of the examination standards, the Commission believes that the scope of the examinations expert's review should be limited to the area of its expertise – auditing standards – and that engaging an independent third-party to review the entire program involves additional cost, but results only in a small, incremental benefit. Having assessed the implementation of the revised supervisory program, Commission staff has determined that it has adequate resources and expertise in the application of CFTC regulations to the operations of FCMs, and is appropriately situated to assess whether SRO and JAC staff are accurately and properly applying Commission requirements to FCMs in their execution of the examination

³² Customer Protection Rulemaking, 78 FR 65506, 68562.

programs. Commission staff's review of SRO and JAC supervisory programs includes detailed assessments of whether SRO or JAC staff complied with their respective FCM examination standards, including internal control testing and assessment, in the performance of FCM examinations. In this regard, Commission staff generally review, based on a risk-based approach, the most significant areas of an SRO's or JAC's FCM examination program during a review, including: (1) The staffing levels and adequate training and qualification of SRO or JAC staff members; (2) The detailed testing performed by SRO or JAC staff in each examination area (*e.g.*, segregation of customer funds, capital compliance, and recordkeeping); (3) The timeliness and effectiveness of the SRO's or JAC's review of FCM financial reporting, including FCM daily segregation computations, monthly unaudited and annual audited financial statements, periodic reporting of customer investments, and periodic regulatory notices; and (4) The effectiveness of the SRO's or JAC's disciplinary program. Accordingly, the Commission believes that a more efficient balance of oversight can be achieved by focusing the examinations expert's evaluation on the SRO's or JAC's examination standards, which is an area of the examinations expert's particular expertise. While the Commission still notes that it has limited resources to perform a holistic review of the SRO's or JAC's examination program, covering both the design of the standards and the effectiveness of the audit program, the Commission believes, as noted above, that the proposed amendments strike a reasoned balance between the Commission's expertise and that of the examinations expert.

The proposed amendments would continue to require an examinations expert to provide the SRO or JAC with a written report on the examinations expert's findings and

recommendations. The Commission, however, is not mandating the form and content of the written report, other than that the report must accurately reflect the extent of the examinations expert's evaluation, and include any findings and recommendations resulting from its evaluation. The Commission is also proposing that the written report will be provided to the Director of the Division of Swap Dealer and Intermediary Oversight with the understanding that the report will be shared with the Commission.

C. Frequency of the Examinations Expert's Evaluation of an SRO's Supervisory Program

Regulations 1.52(c)(2)(iv) and (d)(2)(ii)(I) require an SRO and JAC, respectively, to engage an examinations expert to evaluate their FCM supervisory programs prior to the initiation of the programs, and at least once every three years thereafter. The Commission believes that an examinations expert's evaluation provides important oversight of the SRO FCM examination standards by an independent third-party that is an expert in the understanding and application of the auditing standards issued by the PCAOB. Accordingly, the Commission is not proposing to eliminate the requirement in Regulation 1.52 for an SRO or JAC to engage an examinations expert at the initiation of the development of its supervisory program, or at different periods of time after the initial evaluation.

The Commission, however, further believes that the frequency of an examinations expert's evaluation of an SRO's or JAC's FCM examination standards should not be based upon a fixed timeframe of once every three years and is therefore proposing amendments that provide for flexibility dependent upon changes in auditing standards issued by the PCAOB.

Accordingly, the Commission is proposing that SROs and JACs must review and revise their respective FCM examination standards promptly after the issuance of new or amended auditing standards by the PCAOB that have an impact on the FCM examination standards. The SRO or JAC also must engage an examinations expert to evaluate the consistency of the revised FCM examination standards with the PCAOB auditing standards whenever the SRO or JAC adopts material amendments to their respective FCM examination standards.³³ The proposal would further provide the DSIO Director with the authority to direct an SRO or JAC to engage an examinations expert. This will address cases where DSIO staff believes that new or amended PCAOB audit standards have a material impact on FCM examinations standards, when an SRO or JAC has not otherwise engaged an examinations expert.³⁴

The proposal would also set a requirement that an SRO or JAC must engage an examinations expert at least once every five years to address situations where the SRO or

³³ The purpose of the proposal is for an SRO or JAC to promptly amend their respective FCM examination standards whenever the PCAOB issues new or revised auditing standards that are relevant to the SRO's or JAC's examinations of member FCMs. The SRO or JAC would further be required to engage an examinations expert to evaluate the consistency of any material amendments to the FCM examination standards with the PCAOB new or revised auditing standards. However, the Commission would not expect an SRO or JAC to engage an examinations expert if the amendments to the FCM examination standards are not material. The Commission also would not expect an SRO or JAC to engage an examinations expert more frequently than once every 12 months.

In the context of the JAC, the annual JAC meeting required by Regulation 1.52(d) may serve as the appropriate forum for discussing amendments to the FCM examination standards, and if necessary, a vote of JAC members could determine that engagement of the examinations expert to more fully assess the supervisory program standards in the context of a non-financial statement audit is warranted.

³⁴ The Commission also notes that proposal does not prescribe a specific timeframe for which the SRO or JAC should implement any revised examination standards, but only that the adoption must occur "promptly." This is because the time needed to comport the newly adopted auditing standard into a newly adopted examination standard may vary depending on the complexity of the standard and whether the examinations expert has been engaged. For avoidance of any doubt, the Commission expects "promptly" adoption to occur within a reasonable amount of time under the circumstances. In the event that the adoption should take longer than one year from the time a PCAOB auditing standard is made effective, the SRO or JAC may petition the Director of the Division of Swap Dealer and Intermediary Oversight for a longer permitted adoption timeframe.

JAC have not considered any new or amended PCAOB auditing standards issued during the preceding five years to be material to the FCM examination standards. The Commission is proposing this five-year limit based upon the importance of the FCM examination process by SROs and JACs and its belief that third-party experts should evaluate the FCM examination standards at least once every five years to ensure that they are consistent with PCAOB auditing standards. The Commission requests specific comment on whether the amended timeframe of five years is appropriate, or whether a different timeframe would be more appropriate.

In proposing the amendment to revise the FCM examination standards, the Commission is intending to limit the examinations expert's evaluation to those FCM examination standards that are new or revised since the last examinations expert's review or assessment. The Commission does not expect the examinations expert to re-assess each examination standard each time an evaluation is performed, but only those standards that may be susceptible to change based on the examinations expert's opinion, auditing standards adopted or amended by the PCAOB, and the examinations expert's understanding of the CFTC regulatory requirements in consultation with SRO or JAC.

D. Technical Amendments to Regulation 1.52

The Commission is proposing several technical amendments to Regulation 1.52 which eliminate redundancies and simplify the intent of the rule. Specifically, the Commission is consolidating the FCM examination standards listed in paragraphs (c)(2)(ii) and (iii) of Regulation 1.52 governing SROs into a single revised Regulation

1.52(c)(2)(ii).³⁵ The Commission also is proposing to amend paragraph (d)(2)(ii)(F) to reflect the consolidation of the FCM examination standards in revised Regulation 1.52(c)(2)(ii).

III. Cost-Benefit Considerations

A. Introduction

Section 15(a) of the Act requires the CFTC to consider the costs and benefits of its actions before promulgating a regulation under the Act or issuing certain orders.³⁶

Section 15(a) of the Act further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The CFTC considers the costs and benefits resulting from its discretionary determinations with respect to the section 15(a) factors below.

Where reasonably feasible, the CFTC endeavors to estimate quantifiable costs and benefits. Where quantification is not feasible, the CFTC identifies and describes costs and benefits qualitatively.

The CFTC requests comment on the costs and benefits associated with the proposed rule amendments. In particular, the CFTC requests that commenters provide data and any other information or statistics that the commenters relied on to reach any conclusions regarding the CFTC's proposed considerations of costs and benefits.

³⁵ The Commission notes that current paragraphs (c)(2)(ii) and (d)(2)(ii)(F) both contain an explanatory sentence of what topics within PCAOB auditing standards should be used in order to conform the examination standards. The Commission reads paragraph (c)(2)(iii), and by cross-reference (d)(2)(ii)(G), to already include each of these topics. Moreover, paragraph (c)(2)(iii) more appropriately uses in this context the term "examination," as opposed to "audit" to articulate this construction.

³⁶ 7 U.S.C. 19(a).

B. Economic Baseline

The CFTC's economic baseline for this proposed rule amendment analysis is the requirements of Regulation 1.52 that exist today. Specifically, current Regulation 1.52 requires an SRO or a JAC to engage an examinations expert to evaluate its supervisory program prior to its initial use, and to evaluate the SRO's application of the supervisory program at least once every three years after its initial use.

The Commission's proposal would not alter the requirement for an SRO or JAC to engage an examinations expert to evaluate its supervisory program prior to the initial use of the supervisory program. The Commission is proposing, however, to eliminate the requirement that the examinations expert must review the SRO's or JAC's ongoing application of its supervisory program during periodic reviews and the analysis of the supervisory program's design to detect material weaknesses in internal controls during both periodic reviews and the initial review prior to the program's initial use. The Commission also is proposing to revise the frequency of when an SRO or JAC must engage an examinations expert, as discussed below.

The Commission's proposal to eliminate the requirement that an examinations expert evaluate an SRO's or JAC's application of its supervisory program and the program's design to detect material weaknesses in internal controls will reduce costs to the SROs and JACs. The proposal, however, would not substantially reduce the benefits obtained from an evaluation of the SROs' and JACs' supervisory program, including internal controls, as such reviews are performed by Commission staff on a routine basis. Commission staff evaluates the SRO's or JAC's execution of its supervisory program, including performing detailed reviews of SRO and JAC examination work papers, to

assess the scope of the work performed by SRO and JAC staff members and to determine whether the conclusions reached by SRO and JAC staff members are supported by the work performed. Commission staff also reviews all SRO and JAC examination programs for conducting examinations of FCMs to assess the completeness of such programs and to determine that such programs properly reflect any regulatory updates, including rule amendments, adopted since the Commission staff's previous review of the examination programs. Reviews of execution and completeness of supervisory programs for FCMs occur no less frequently than annually. Commission staff has a particular expertise in determining whether registrants are in compliance with Commission regulatory requirements that makes a third-party review redundant.

The Commission proposes to continue to require that an examinations expert review the FCM examination standards contained in the supervisory program for consistency with PCAOB auditing standards, but is proposing to revise the timeframe for such reviews. Currently, Regulation 1.52 requires an SRO or JAC to engage an examinations expert at least once every three years to perform such a review. The Commission is proposing to amend Regulation 1.52 to require an SRO or JAC to engage an examinations expert if the PCAOB issued new or revised auditing standards that are material to the SRO's or JAC's examination of member FCMs.

The examinations expert's review, however, would be limited to only the new or revised PCAOB auditing standards that are applicable to the SRO's or JAC's examination of FCMs. Accordingly, the examinations expert would not have to review all of the SRO's or JAC's FCM examination standards for consistency with PCAOB audit standards. The proposal would further require an SRO or JAC to engage an

examinations expert at least once every five years even if the SRO or JAC determined that the PCAOB did not issue new or revised auditing standards during the previous five-year period that are material to its examinations of member FCMs. Based on past experience, the Commission anticipates that the adoption of new or revised auditing standards that are material to examination standards applicable to FCMs will be infrequent, and therefore the triggering of an examinations expert review will also likely be an infrequent event.³⁷ Finally, the proposal would provide that an SRO or JAC must engage an examinations expert if directed to by the Director of the Division of Swap Dealer and Intermediary Oversight.³⁸

The proposed amendments to Regulation 1.52 are intended to streamline the process under which examinations experts conduct their reviews and the time period between those reviews. The Commission believes that these amendments will make conducting the reviews more efficient and less costly, while still balancing the importance of having an independent third-party examinations expert in auditing standards evaluating the examination standards used by SROs and the JAC.

The Commission does not anticipate that there will be any significant increased costs associated with the proposed amendments. By narrowing the intended scope of examination reviews from an evaluation of the supervisory program to an assessment of the examinations standards for conformity with auditing standards established by the PCAOB as they apply to examinations, the Commission is purposely limiting the scope

³⁷ Since 2016 PCAOB has adopted approximately two new standards, neither of which had a significant impact on the examination standards applicable to FCMs. See PCAOB website available at: https://pcaobus.org/Standards/Pages/Current_Activities_Related_to_Standards.aspx.

³⁸ For example, in circumstances where an SRO or JAC has not engaged an examination expert yet DSIO staff believes a material change to PCAOB auditing standards warrants such engagement.

of the examinations expert's review. The Commission anticipates that this limitation, coupled with extending the time period between expert examiner reviews, will significantly limit the costs associated with engaging and hiring an examinations expert.³⁹ Nonetheless, the Commission believes that these amendments appropriately balance the integrity of the examination program with its costs while continuing to ensure that there is sufficient oversight over the minimum financial requirements at FCMs. As noted, Commission staff reviews no less frequently than annually all SRO and JAC examination programs and anticipates that it will continue to do so. These Commission staff reviews will continue to provide the benefits that have been associated with the examinations experts' reviews.

C. CEA Section 15(a) Factors

i. Protection of Market Participants and the Public

The Commission preliminarily believes that this proposal maintains the protection of market participants and the public provided by the current regulation. The proposal will continue to protect market participants and the public by ensuring that there is sufficient oversight over the minimum financial requirements at FCMs. As noted, the Commission believes that Commission staff is well-equipped to provide reviews that, under the proposal, would no longer be provided by outside examinations experts and Commission staff intends to continue to conduct such reviews.

ii. Efficiency, Competitiveness, and Financial Integrity of Markets

³⁹ In the 2013 Customer Protection Rulemaking, the Commission found that it was not feasible to quantify any costs associated with utilizing an examinations expert, largely because several nationally recognized accounting firms expressed their reluctance to provide such information. While it is likely not feasible to quantify such costs for the use of an examinations expert under the proposed amendments, such costs are likely much less than the costs under the existing rule. *See*, 2013 Customer Protection Rulemaking at 68605.

The Commission preliminarily believes that Regulation 1.52 as amended will continue to help ensure that FCMs can meet their financial and operational obligations to both customers and DCOs, which, along with the Commission's ongoing reviews, will continue to foster the efficiency and financial integrity of markets. The Commission has not identified any effect of Regulation 1.52 on the competitiveness of derivatives markets.

iii. Price Discovery

The Commission has not identified any material effect of the proposed amendments on the price discovery process in futures and swap markets.

iv. Sound Risk Management Practices

The Commission preliminarily believes that Regulation 1.52 as amended, along with the Commission's ongoing reviews, will continue to help ensure that FCMs can meet their financial and operational obligations to both customers and DCOs, which should continue to foster sound risk management practices.

v. Other Public Interest Considerations

The Commission has not identified any additional public interest considerations associated with the proposal.

D. Consideration of Alternatives

The Commission considered adopting the CME's suggestion to fully eliminate the requirement that a third-party public accounting firm perform periodic evaluations and assessments of an SRO's program to oversee its member FCMs' compliance with financial and related reporting requirements. The Commission determined instead to eliminate the requirement that the examinations expert must periodically review the

SRO's or JAC's ongoing application of its supervisory program, while maintaining reviews of an FCM's examinations standards at a modified interval. The Commission preliminarily believes that there are significant benefits associated with having an outside auditor performing evaluations of examination standards at least every five years (and also when there are material and relevant changes in PCAOB auditing standards) as required by the proposed amendments. While, as noted, Commission staff is well-equipped to review the ongoing application of SRO and JAC supervisory programs and intends to continue to do so at least annually, the Commission believes that third-party public accounting firms are best equipped to perform evaluations of examination standards for conformity with auditing standards established by the PCAOB as they apply to examinations.

The Commission also considered maintaining the current rule, but the Commission anticipates that the proposal will significantly reduce costs to SROs and JACs without materially impacting benefits.

The CFTC requests comment on these alternatives as well as any other alternatives that commenters believe would present a superior cost-benefit profile to the proposal.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA")⁴⁰ requires Federal agencies, in promulgating regulations, to consider the impact of those regulations on small entities. The Commission has previously established certain definitions of "small entities" to be

⁴⁰ 5 U.S.C. 601 *et seq.*

used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA.⁴¹ The proposed regulations would affect designated contract markets.

The Commission has previously determined that designated contract markets are not small entities for purposes of the RFA, and, thus, the requirements of the RFA do not apply to designated contract markets.⁴² Accordingly, the Chairman, on behalf of the Commission, certifies pursuant to 5 U.S.C. 605(b) that the proposed regulations would not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

This proposed rulemaking does not amend existing information collection requirements. The Paperwork Reduction Act (“PRA”) provides that a federal agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number issued by the Office of Management and Budget (“OMB”).⁴³ The Commission is proposing amendments to rules that have previously identified collections of information under a pre-existing collection 3038-0052. The proposed amendments, however, only increase the respondents permitted time to file required information and reduce the requirements of review contained therein. As such, the previously identified response hours in collection 3038-0052 remain a reasonable burden hour estimate.

The collections contained in this rulemaking are mandatory collections. In formulating burden estimates for the collections in this rulemaking, to avoid double

⁴¹ 47 FR 18618 (Apr. 30, 1982).

⁴² *Id.* at 18619.

⁴³ 44 U.S.C. 3501 *et seq.*

accounting of information collections that already have been assigned control numbers by OMB, or are covered as burden hours in collections of information pending before OMB, the PRA analysis provided in the proposed rulemaking, along with the information collection request (“ICR”) with burden estimates that were incorporated into the rulemaking by reference and submitted to OMB, accounted only burden estimates for collections of information that have not previously been submitted to OMB. The Commission invites comment on the collections of information contained in the proposed rulemaking only to the extent that the collections in the proposed rulemaking would increase the burden hours contained with respect to each of the related currently valid or proposed collections.

List of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

For the reasons stated in the preamble, the Commodity Futures Trading Commission proposes to amend 17 CFR part 1 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 6s, 7, 7a-1, 7a-2, 7b, 7b-3, 8, 9, 10a, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 19, 21, 23, and 24 (2012).

2. Amend § 1.52 as follows:

- a. Revise paragraphs (c)(2)(ii), (iii), (iv), and (v);
- b. Remove paragraphs (c)(2)(vi) and (vii);

- c. Revise paragraphs (d)(2)(ii)(F), (G), (H), and (I);
- d. Remove paragraphs (d)(2)(ii)(J) and (K); and
- e. Revise paragraph (d)(2)(iii).

The revisions read as follows:

§ 1.52 Self-regulatory organization adoption and surveillance of minimum financial requirements.

* * * * *

(c) * * *

(2) * * *

(ii) The supervisory program must, at a minimum, have examination standards addressing the following:

(A) The ethics of an examiner;

(B) The independence of an examiner;

(C) The supervision, review, and quality control of an examiner's work product;

(D) The evidence and documentation to be reviewed and retained in connection with an examination;

(E) The sampling size and techniques used in an examination;

(F) The examination risk assessment process;

(G) The examination planning process;

(H) Materiality assessment;

(I) Quality control procedures to ensure that the examinations maintain the level of quality expected;

(J) Communications between an examiner and the regulatory oversight committee, or the functional equivalent of the regulatory oversight committee, of the self-regulatory organization of which the futures commission merchant is a member;

(K) Communications between an examiner and a futures commission merchant's audit committee of the board of directors or other similar governing body;

(L) Analytical review procedures;

(M) Record retention; and

(N) Required items for inclusion in the examination report, such as repeat violations, material items, and high risk issues. The examination report is intended solely for the information and use of the self-regulatory organizations and the Commission, and is not intended to be and should not be used by any other person or entity.

(iii)(A) Prior to the initial implementation of the supervisory program, a self-regulatory organization must engage an examinations expert to evaluate the examination standards for consistency with auditing standards issued by the Public Company Accounting Oversight Board as such auditing standards are applicable in the context of the self-regulatory organization's examination of its futures commission merchant members. At least once every five years after the initial implementation of the supervisory program, a self-regulatory organization must engage an examinations expert to evaluate the examination standards for consistency with any new or amended auditing standards issued by the Public Company Accounting Oversight Board since the previous review performed by the examinations expert. At the conclusion of each evaluation, a self-regulatory organization must obtain a written report from the examinations expert in accordance with paragraph (c)(2)(iii)(C) of this section.

(B) Notwithstanding paragraph (c)(2)(iii)(A) of this section, a self-regulatory organization must review any new or amended auditing standards issued by the Public Company Accounting Oversight Board, and must revise its examination standards promptly to reflect any changes in such auditing standards that are applicable in the context of the self-regulatory organization's examination of its futures commission merchant members. A self-regulatory organization must engage an examinations expert to evaluate any material revisions that the self-regulatory organization makes to the examination standards to conform such standards with the Public Company Accounting Oversight Board's auditing standards, or if directed to engage an examinations expert by the Director of the Division of Swap Dealer and Intermediary Oversight. At the conclusion of each review, a self-regulatory organization must obtain a written report from the examinations expert in accordance with paragraph (c)(2)(iii)(C) of this section.

(C) At the conclusion of the examinations expert's engagement pursuant to paragraph (c)(2)(iii)(A) or (B) of this section, the self-regulatory organization must obtain from the examinations expert a written report on findings and recommendations issued under the consulting services standards of the American Institute of Certified Public Accountants. The self-regulatory organization must provide the Director of the Division of Swap Dealer and Intermediary Oversight with a copy of the examinations expert's written report, and the self-regulatory organization's written responses to any of the examinations expert's findings and recommendations, within thirty days of the receipt thereof. Upon resolution of any questions or comments raised by the Division of Swap Dealer and Intermediary Oversight, and upon written notice from the Division of Swap Dealer and Intermediary Oversight that it has no further comments or questions on the

examinations standards as amended (by reason of the examinations expert's proposals, consideration of the Division of Swap Dealer and Intermediary Oversight's questions or comments, or otherwise), the self-regulatory organization shall commence applying such examinations standards for examining its registered futures commission merchant members for all examinations conducted with an "as of" date later than the date of the Division of Swap Dealer and Intermediary's written notification.

(iv) The supervisory program must require the self-regulatory organization to report to its risk and/or audit committee of the board of directors, or a functional equivalent committee, with timely reports of the activities and findings of the supervisory program to assist the risk and/or audit committee of the board of directors, or a functional equivalent committee, to fulfill its responsibility of overseeing the examination function.

(v) The examinations expert's written report, the self-regulatory organization's response, if any, as well as any information concerning the supervisory program is confidential.

(d) * * *

(2) * * *

(ii) * * *

(F) The Joint Audit Program must include examination standards addressing the items listed in paragraph (c)(2)(ii) of this section.

(G)(I) Prior to the initial implementation of the Joint Audit Program, the Joint Audit Committee must engage an examinations expert to evaluate the examination standards for consistency with auditing standards issued by the Public Company Accounting Oversight Board as such auditing standards are applicable in the context of

the Joint Audit Committee's examination of its futures commission merchant members. At least once every five years after the initial implementation of the Joint Audit Program, the Joint Audit Committee must engage an examinations expert to evaluate the examination standards for consistency with any new or amended auditing standards issued by the Public Company Accounting Oversight Board since the previous review performed by the examinations expert. At the conclusion of each review, the Joint Audit Committee must obtain a written report from the examinations expert in accordance with paragraph (d)(2)(ii)(G)(3) of this section.

(2) Notwithstanding paragraph (d)(2)(ii)(G)(1) of this section, the Joint Audit Committee must review any new or amended auditing standards issued by the Public Company Accounting Oversight Board, and must revise its examination standards promptly to reflect any changes in such auditing standards that are applicable in the context of the Joint Audit Committee's examination of its futures commission merchant members. The Joint Audit Committee must engage an examinations expert to evaluate any material revisions that the Joint Audit Committee makes to the examination standards to conform such standards with the Public Company Accounting Oversight Board's auditing standards, or if directed to engage an examinations expert by the Director of the Division of Swap Dealer and Intermediary Oversight. The Joint Audit Committee must obtain a written report from the examinations expert in accordance with paragraph (d)(2)(ii)(G)(3) of this section.

(3) At the conclusion of the examinations expert's engagement pursuant to paragraph (d)(2)(ii)(G)(1) or (2) of this section, the Joint Audit Committee must obtain from the examinations expert a written report on findings and recommendations issued

under the consulting services standards of the American Institute of Certified Public Accountants. The Joint Audit Committee must provide the Director of the Division of Swap Dealer and Intermediary Oversight with a copy of the examinations expert's written report, and the Joint Audit Committee's written responses to any of the examinations expert's findings and recommendations, within thirty days of the receipt thereof. Upon resolution of any questions or comments raised by the Division of Swap Dealer and Intermediary Oversight, and upon written notice from the Division of Swap Dealer and Intermediary Oversight that it has no further comments or questions on the examinations standards as amended (by reason of the examinations expert's proposals, consideration of the Division of Swap Dealer and Intermediary Oversight's questions or comments, or otherwise), the Joint Audit Committee shall commence applying such examinations standards for examining its registered futures commission merchant members for all examinations conducted with an "as of" date later than the date of the Division of Swap Dealer and Intermediary's written notification.

(H) The Joint Audit Program must require the Joint Audit Committee members to report to their respective risk and/or audit committee of their respective board of directors, or a functional equivalent committee, with timely reports of the activities and findings of the Joint Audit Program to assist the risk and/or audit committee of the board of directors, or a functional equivalent committee, to fulfill its responsibility of overseeing the examination function.

(I) The examinations expert's written report, the Joint Audit Committee's response, if any, as well as any information concerning the supervisory program is confidential.

(iii) *Meetings of the Joint Audit Committee.* (A) The Joint Audit Committee members must meet at least once each year. During such meetings, the Joint Audit Committee members shall consider revisions to the Joint Audit Program as a result of regulatory changes, revisions to the examination standards resulting from new or amended auditing standards issued by the Public Company Accounting Oversight Board, or the results of an examinations expert's review.

(B) In addition to the items considered in paragraph (d)(2)(iii)(A) of this section, the Joint Audit Committee members must consider the following items during the meetings:

(1) Coordinating and sharing information between the Joint Audit Committee members, including issues and industry concerns in connection with examinations of futures commission merchants;

(2) Identifying industry regulatory reporting issues and financial and operational internal control issues and modifying the Joint Audit Program accordingly;

(3) Issuing risk alerts for futures commission merchants and/or designated self-regulatory organization examiners on an as-needed basis;

(4) Responding to industry issues; and

(5) Providing industry feedback to Commission proposals.

(C) Minutes must be taken of all meetings and distributed to all members on a timely basis.

(D) The Director of the Division of Swap Dealer and Intermediary Oversight must receive timely prior notice of each meeting, have the right to attend and participate in

each meeting and receive written copies of the minutes required pursuant to paragraph (d)(2)(iii)(C) of this section, respectively.

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Issued in Washington, DC, on June 28, 2018, by the Commission.

Christopher Kirkpatrick,
Secretary of the Commission.

NOTE: The following appendix will not appear in the Code of Federal Regulations.

Appendix to Financial Surveillance Examination Program Requirements for Self-Regulatory Organizations – Commission Voting Summary

On this matter, Chairman Giancarlo and Commissioners Quintenz and Behnam voted in the affirmative. No Commissioner voted in the negative.

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