Schulte Roth&Zabel

Alert

CFTC Updates — and Modernizes — Electronic Recordkeeping Rules for Hedge Fund Managers and Other Registrants

June 8, 2017

On May 23, 2017, the U.S. Commodity Futures Trading Commission approved amendments to CFTC Rule 1.31, which sets forth recordkeeping obligations for, among others, commodity pool operators and commodity trading advisors (and for other registrants and commodity interest traders).

It is important to note that the Rule 1.31 changes do not modify the types and categories of records that are required to be inspected, produced or maintained under CFTC regulations; Rule 1.31 merely addresses *how* to comply with CFTC recordkeeping requirements, not *what* must be retained.

These long-awaited changes to Rule 1.31 bring the CFTC's electronic recordkeeping requirements into the 21st century by eliminating outdated requirements such as the mandatory usage of "WORM" ("write-once, read-many") media and the much-ignored "third party technical consultant" requirement. These changes to Rule 1.31 will bring the electronic recordkeeping systems and processes utilized by many private fund managers into compliance with CFTC requirements. In addition, registered CPOs and CTAs that postponed claiming third-party recordkeeping exemptions (because the required filing required a representation of compliance with Rule 1.31) should now consider doing so.

Impact of the Rule 1.31 Amendments

The new Rule 1.31 does away with the narrow (and dated) prescriptive approach of the old rule and establishes a more flexible principles-based requirement for retention technology. Specifically, the new rule mandates that registered CPOs and CTAs (and others subject to Rule 1.31):

- Preserve required records "in a form and manner that ensures the authenticity and reliability of such regulatory records"; and
- "Establish appropriate systems and controls that ensure the authenticity and reliability of electronic regulatory records."

While the amended rule provides greater flexibility on retention and preservation, it does so at a (modest) price; i.e., a new, affirmative requirement to make a determination that a manager's electronic recordkeeping systems and controls are "appropriate," the documentation of which may become part of future examinations by the National Futures Association or by the CFTC itself. Private fund managers that transact in commodity interests, therefore, should: (i) review their existing regulatory compliance policies and procedures to determine whether amendments will be needed to satisfy this "systems and controls" standard; and (ii) stay abreast of technological developments to ensure that their practices stay within the generally-accepted definition of "appropriate."

In addition to the new principles-based approach to storage technology, the CFTC made two additional (and welcome) changes:

- Removing the requirement that firms using electronic recordkeeping employ a "third party technical consultant" to review its retention measures and make a filing with the CFTC;[1] and
- For swap dealers (and major swap participants), fixing the starting point for the five-year retention period for swap-related pre-execution communication records at the date on which the communication was created (instead of at the termination of the swap).

The CFTC was also persuaded to drop certain elements of the proposed rule, such as a requirement to have specific written policies that would require training of certain officers and personnel regarding recordkeeping requirements that the industry felt were overly burdensome or unnecessary.[2]

Impact on Third-Party Recordkeeper Notice Filings

CFTC registrants have historically been prohibited from engaging third parties to maintain their records; however, beginning in 2013 (with further revisions in 2014 and 2017), the CFTC bowed to reality and permitted the use of third-party recordkeepers by registered CPOs and CTAs; provided that the registrant make certain notice filings with the CFTC.[3] Because this notice filing would have included inaccurate representations of compliance with Rule 1.31,[4] many fund managers have elected to defer actually making the filing. Now that Rule 1.31 has been modernized, registrants who have delayed making such filings should consider doing so once the amended Rule 1.31 becomes effective (on Aug. 28, 2017).

Authored by Brian T. Daly and Jacob Preiserowicz.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] The previous incarnation of Rule 1.31 contained the following third-party technical consultant requirement:

> "Any person who uses only electronic storage media to preserve some or all of its required records ("Electronic Recordkeeper") shall, prior to the media's use, enter into an arrangement with at least one third party technical consultant ("Technical Consultant") who has the technical and financial capability to perform the undertakings described in this paragraph (b)(4). The arrangement shall provide that the Technical Consultant will have access to, and the ability to download, information from the Electronic Recordkeeper's electronic storage media to any medium acceptable under this regulation."

[2] The CFTC also declined to insert a specific "metadata" retention requirement, which the commissioners felt would be inconsistent with a goal of less prescriptive regulation.

[3] A CPO would make notice filings with the NFA under Rule 4.23 (with respect to firm records) and Rule 4.7(b)(4) (with respect to each pool's records). Pursuant to an April 2017 no-action letter, CTAs may also utilize third-party recordkeepers, provided that they make notice filings directly with the CFTC.

[4] *See SRZ Client Alert,* "New Commodity Futures Trading Commission Rule Requires Registered CPOs to File Additional Exemption" (Aug. 15, 2013).

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com