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# Part IV

# Commodity Futures Trading Commission

## 17 CFR Part 38

## Conflict of Interest in Self-Regulation and Self-Regulatory Organizations; Proposed Rule

**COMMODITY FUTURES TRADING COMMISSION**

**17 CFR Part 38**

**RIN 3038–AC28**

## Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations

**AGENCY:** Commodity Futures Trading Commission (''Commission'').

**ACTION:** Proposed Acceptable Practices for compliance with section 5(d)(15) of the Commodity Exchange Act (''CEA'' or ''Act'').[1]

**SUMMARY:** The Commission hereby proposes Acceptable Practices for section 5(d)(15) of the Act (''Core Principle 15'').[2] The proposed Acceptable Practices would provide designated contract markets (''DCMs'') with a safe harbor for compliance with selected aspects of Core Principle 15's requirement that they minimize conflicts of interest in their decisionmaking. The proposed Acceptable Practices are summarized as follows.

First, the Board Composition Acceptable Practice proposes that exchanges minimize potential conflicts of interest by maintaining governing boards composed of at least fifty percent ''public'' directors, as defined below. Second, the proposed Regulatory Oversight Committee Acceptable Practice calls upon exchanges to establish a board-level Regulatory Oversight Committee, composed solely of public directors, to oversee regulatory functions. Third, the Disciplinary Panel Acceptable Practice proposes that each disciplinary panel at all exchanges include at least one public participant, and that no panel be dominated by any group or class of exchange members.[3] Finally, the proposed Acceptable Practices provide a definition of ''public'' for exchange directors and for members of disciplinary panels.

Collectively, the proposed Acceptable Practices promote independence in decisionmaking by self-regulatory organizations (''SROs''),[4] and constitute a proactive yet measured step toward ensuring that SROs maintain fair, vigorous, and effective self-regulation in a rapidly evolving futures industry. The Commission welcomes comment on the proposed Acceptable Practices.[5]

**DATES:** Comments should be submitted on or before August 7, 2006.

**ADDRESSES:** Comments should be sent to Eileen Donovan, Acting Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Comments may be submitted via e-mail at *secretary@cftc.gov.* ''Regulatory Governance'' must be in the subject field of responses submitted via e-mail, and clearly indicated in written submissions. Comments may also be submitted at *http://www.regulations.gov.*

**FOR FURTHER INFORMATION CONTACT:** Rachel F. Berdansky, Acting Deputy Director for Market Compliance, (202) 418–5429; or Sebastian Pujol Schott, Special Counsel, (202) 418–5641, Division of Market Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

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## I. Introduction

Exchanges are ''affected with a national public interest'' in that they ''provid[e] a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities.''[6] Exchanges are also the front-line regulators in the U.S. futures industry.[7] There are potential conflicts of interest inherent in an exchange's responsibilities as a regulator of its market and members, and the commercial interests embedded in its market operation. Nevertheless, with proper checks and balances to address such conflicts, coupled with vigilant Commission oversight, self-regulation can continue to serve as an effective and efficient means of promoting market integrity.

Increasing competition,[8] changing ownership structures,[9] and evolving

[1] Acceptable Practices for the Core Principles reside in Appendix B to Part 38 of the Commission's Regulations, 17 CFR part 38, App. B.

[2] Core Principle 15 for designated contract markets provides as follows: ''CONFLICTS OF INTEREST—The board of trade shall establish and enforce rules to minimize conflicts of interest in the decisionmaking process of the contract market and establish a process for resolving such conflicts of interest.'' CEA § 5(d)(15), 7 U.S.C. § 7(d)(15).

[3] *See* CEA Section 1a(24), 7 U.S.C. 1a(24) (defining the term ''member'' to include both exchange members and non-member market participants with trading privileges); *see also* 17 CFR 1.3(q).

[4] For purposes of these Acceptable Practices, the term ''SROs'' refers to DCMs and is used interchangeably with the terms ''exchanges,'' ''boards of trade'' and ''contract markets.'' As part of its SRO study, the CFTC considered whether the current level of ''public'' representation on boards of registered futures associations (''RFAs'') is still sufficient. That question and related issues concerning RFAs remain under review and will be addressed separately.

[5] This Release is the latest development in the Commission's SRO review that commenced in May 2003. The Acceptable Practices proposed herein are based on comments received in response to prior requests for comments published in the **Federal Register**, interviews with industry participants, testimony given at a February 15, 2006 public hearing before the Commission, and other sources identified herein as part of the basis for the instant proposals. Prior **Federal Register** releases, responses thereto, the hearing transcript, and a summary of interview comments, described with greater specificity elsewhere herein, are available on the Commission's Web site at *www.cftc.gov,* or are available through the Acting Secretary of the Commission, whose name and address are listed above.

[6] CEA Section 3(a), 7 U.S.C. § 5(a).

[7] CEA Section 3(b), 7 U.S.C. § 5(b).

[8] Increasing competition exists between U.S. and foreign exchanges, and between domestic exchanges. The New York Mercantile Exchange (''NYMEX'') and the IntercontinentalExchange offer competing contracts in Brent and WTI crude futures. Euronext.liffe, a subsidiary of Euronext, and the Chicago Mercantile Exchange (''CME'') offer competing Eurodollar contracts. Within the U.S., the Chicago Board of Trade (''CBOT'') and NYMEX offer several competing gold and silver contracts.

New exchanges comprise a further source of new competition. Since 2002, the Commission has designated six new contract markets, all of which entered the marketplace as non-mutual, for-profit entities. There is also competition between trading formats—open outcry and electronic. NYMEX gold and silver contracts, for example, trade primarily on the floor of the exchange, while CBOT offers its gold and silver contracts only electronically. In addition, the new contract markets referred to above trade only electronically, and electronic trading now accounts for over 60% of all trading volume on U.S. futures exchanges.

Finally, enhanced competition is evident between exchanges and their large, institutional futures commission merchant (''FCM'') members. They may compete directly, with FCMs internalizing order flow or exchanges disintermediating FCMs. They may also compete indirectly, as occurs, for example, when FCMs establish or invest in new exchanges offering substitutable contracts. Examples include the Cantor Financial Futures Exchange (no longer trading), designated in 1998; BrokerTec Futures Exchange, designated in 2001; and U.S. Futures Exchange, designated in 2004. The FCM-owners of new exchanges may both compete against, and be subject to the regulation of, the established SROs of which they are members.

[9] The principal change in ownership structure is the demutualization of member-owned exchanges and their conversion to publicly traded stock corporations. In December 2002, CME became the

business models are dramatically transforming the U.S. futures industry. Today U.S. futures exchanges must compete vigorously with other exchanges, electronic trading facilities and foreign markets to attract order flow, and also must meet customer demand for twenty-four hour trading, immediate order execution, lower transaction costs, and access to global markets. This heightened competition places strain on exchanges' dual roles as regulators and as markets, and raises questions about their ability to deal with pressures to subordinate regulatory responsibilities to commercial imperatives. The trend towards demutualization represents an additional challenge to exchanges' performance of self-regulatory duties. Traditional SRO conflicts have been joined by the possibility that self-regulatory functions may be marginalized by potentially conflicting commercial interests.[10]

In view of these developments, the Commission conducted a review of self-regulation in the futures industry to consider whether, and how, SROs can continue to fulfill their statutorily-mandated responsibilities as regulators.[11] Three key principles emerged from this review. First, self-regulation continues to be the most effective and efficient regulatory model available to the futures industry; the self-regulatory system nevertheless must be updated and enhanced, as appropriate and necessary, to keep pace with the changing marketplace. Second, market forces, driven by global competition and changing ownership structures, pose a heightened risk that SROs may fail to fairly and vigorously carry out their regulatory responsibilities; such conflicts, whether actual or perceived, must be addressed proactively in the first instance by the SROs themselves. Third, the current market environment mandates enhanced and transparent governance as an essential business practice for maintaining market integrity and the public trust.[12]

The Acceptable Practices proposed today constitute the Commission's considered view of best practices relating to SRO governance and administration in order to address the concerns raised by SROs' dual roles in light of increasing competition and demutualization. The Acceptable Practices promote an optimal SRO governance structure, which would minimize the potential for conflicts with the SRO's regulatory duties. Specifically, the Acceptable Practices would ensure that there is adequate independence within the SRO's board to insulate regulatory functions from the interests of the exchange's management, members, and other business interests of the market itself. An SRO is not simply a corporation, but a corporation charged with the public trust. As such, the board—the governing body of the SRO—must be structured in a way that best fosters public confidence in the integrity of its organization, and further, ensures that SRO functions take no less preeminence than that accorded to the exchange's commercial interests.

The Acceptable Practices also would enhance the role of outside impartiality in other key SRO functions, including a board-level Regulatory Oversight Committee (''ROC'') and disciplinary panels, to further enhance the transparency and accountability of SRO decisions impacting self-regulation. Finally, the proposed Acceptable Practices carefully define ''public'' directors to identify those who can help ensure that SRO regulatory programs remain effective, yet unburdened by potential conflicts or pressures from the exchange's commercial or member interests.

In summary, the Acceptable Practices proposed today are measured steps—in the form of carefully-tailored internal safeguards and checks and balances—to promote the independence of SRO functions. At the same time, they ensure that industry expertise, experience, and

first U.S. futures exchange to transform from a membership mutual organization to a publicly traded, for-profit entity. Class A shares of its parent company, CME Holdings, Inc., are now listed on the New York Stock Exchange (''NYSE''). In October 2005, after undergoing a similar restructuring, the CBOT became the second U.S. futures exchange to demutualize and offer its parent's stock for trading on the NYSE.

While demutualization has been an important development for the largest and most well-established futures exchanges, the advent of exchanges structured as for-profit limited liability companies (''LLCs'') is another significant trend.

[10] Five domestic and international studies reviewed by the Commission address this issue, and are noteworthy for the extent to which they parallel concerns raised by futures industry participants. Although the studies focus primarily on the securities industry, some include futures markets as well, and the Commission believes that the concerns raised by demutualization and competition may be similar for both the futures and securities industries and exchanges.

The Securities Industry Association's (''SIA'') *White Paper on Reinventing Self-Regulation,* (Jan. 5, 2000, updated Oct. 14, 2003), observed, ''the combined roles of SROs as market overseers and as competitors may affect SROs'' ability and willingness to perform all their regulatory functions adequately, fairly, and efficiently'' (SIA 2003 at 3).

The International Organization of Securities Commissions'' (''IOSCO'') *Issues Paper on Exchange Demutualization,* (June 2001), determined that although many concerns with respect to self-regulation are not new, ''demutualization and increased competition may exacerbate them'' (IOSCO at 5).

A U.S. Government Accountability Office's (''GAO'') report to Congress entitled ''*Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation* (May 2002) found that some securities SRO members were ''concerned that SROs could adopt rules that unfairly impeded the ability of members to compete against the SROs.'' Others were concerned that ''an SRO, in its regulatory capacity, could obtain proprietary information from a member and, in its capacity as a market operator, inappropriately use the information'' (GAO at 7). Some securities SRO members also expressed concern that ''a demutualized, for-profit market operator might be more likely to misuse its regulatory authority or be less diligent in fulfilling its regulatory responsibilities in a desire to increase profits'' (GAO at 8). Abuse of authority could be manifested, for example, through ''rules that unfairly disadvantage members or other markets or inappropriately sanction or otherwise discipline members against which the SROs compete.'' (*Id.*)

A discussion paper prepared for the World Bank's (''WB'') Financial Sector Strategy Department by an independent consultant, Implications of *Demutualization for the Self-Regulatory and Public Interest Roles of Securities Exchanges* (John W. Carson, January 2003) (not necessarily representing the views or policies of the World Bank), identified four ''widely accepted'' propositions with respect to conflicts of interest and demutualization: (1) Conflicts of interest in self-regulation have always existed; (2) demutualization may increase the degree of those conflicts; (3) demutualization introduces new conflicts of interest; and (4) demutualization may reduce old conflicts (WB at 8). The World Bank Study offered several recommendations with respect to self-regulation: (1) ''At a minimum, the threat of increased conflict in exercising regulatory authority demands that new safeguards be put in place to reduce the possibility of either the business units or customers attempting to influence regulatory decisions;'' (2) it is imperative that decisions on opening investigations, when to expand or close investigations, when to pursue disciplinary action, and what penalty to seek are all made in an independent and unbiased manner, without regard to business considerations and impact on important customer relationships;'' and (3) ''strong measures are required to ensure that the integrity of an exchange's regulatory program is maintained and that it handles regulatory issues and decisions in a neutral and unbiased mnaner'' (WB at 42–43).

Finally, an International Monetary Fund (''IMF'') Working Paper, *Demutualization of Securities Exchanges: A Regulatory Perspective* (Jennifer Elliott, September 2002) (not necessarily representing the views of the IMF) identified two broad conflicts of interest associated with demutualization. According to the Working Paper, ''the forces that have generated pressure on exchanges to demutualize have also created new conflicts of interest and forced regulators and exchanges to reconsider what and how regulatory functions are delivered by the exchanges'' (IMF at 7). One new conflict of interest is that ''shareholders, who are interested in profit, may under fund the exchange's regulatory function. While in theory, the exchange should only benefit from an adequate regulatory standards [sic], exchanges may succumb to competitive pressure.'' (IMF at 16). ''The second conflict of interest is the disincentive to regulate market participants (who represent order flow and are a direct source of revenue for the exchange)'' (Id).

[11] *See* Section II.A., *infra.*

[12] In recent years, the U.S. financial industry has undertaken major initiatives to strengthen corporate governance structures. These initiatives respond, for the most part, to a perceived lack of effective board oversight and emphasize board independence and accountability. *See* Section II.B., *infra.*

knowledge continue to play a vital role in SRO governance and administration and thus, preserve the ''self'' in self-regulation. In this manner, these proposed Acceptable Practices keep pace with changing market dynamics and proactively ensure that the self-regulatory model remains as vigorous, as fair, and as effective as required to protect the integrity of U.S. futures markets and the public confidence in them for years to come.

## II. The SRO Review

### *A. Procedural History of the SRO Review*

The Commission's Acceptable Practices are based on a comprehensive review of self-regulation and SROs in the U.S. futures industry (''SRO Review''). Phase I of the SRO Review explored the roles, responsibilities, and capabilities of SROs in the context of industry changes. Staff examined the designated self-regulatory organization (''DSRO'') system of financial surveillance, the treatment of confidential information, the composition of exchanges' disciplinary committees and panels, and other aspects of the self-regulatory process. At the conclusion of Phase I, the Commission identified two issues for immediate attention: (1) An examination of the cooperative regulatory agreement by which DSROs coordinate compliance examinations of FCMs; and (2) ensuring the confidentiality of certain information obtained by SROs and DSROs in the course of their regulatory activities. Measures with respect to both issues were announced by the Commission in February 2004. These issues are not addressed in this release.[13]

After detailed interviews with an array of industry participants, the Commission initiated Phase II of the SRO Review and broadened its inquiry to address SRO governance and the interplay between exchanges' self-regulatory responsibilities and their commercial interests.

In June 2004, the Commission issued a **Federal Register** Request for Comments (''Request'') on the governance of futures industry SROs.[14] The Request sought input on the proper composition of exchange boards, optimal regulatory structures, the impact of different business and ownership models on self-regulation, the proper composition of exchange disciplinary committees and panels, and other issues.

In November 2005, the Commission updated its previous findings through a second **Federal Register** Request for Comments (''Second Request'') that focused on the most recent industry developments.[15] The Second Request examined the board-level ROCs recently established at some SROs in the futures and securities industries. It considered the impact of the listing standards of the New York Stock Exchange (''NYSE'') on publicly-traded futures exchanges; whether the standards were relevant to self-regulation; and how the standards might inform the Commission's own regulations. The Second Request also explored the role of outside regulatory service providers, including RFAs, and SRO governance and the composition of boards and disciplinary committees.

Phase II of the SRO Review concluded with a public Commission hearing on ''Self-Regulation and Self-Regulatory Organizations in the U.S. Futures Industry'' (''Hearing''). The day-long Hearing, held at Commission headquarters in Washington, DC on February 15, 2006, included senior executives and compliance officials from a wide range of U.S. futures exchanges, representatives of small and large FCMs, academics and other outside experts, and an industry trade group. The Hearing afforded the Commission an opportunity to question panelists on four broad subject areas: (1) board composition; (2) alternative regulatory structures, including ROCs and third-party regulatory service providers; (3) transparency and disclosure; and (4) disciplinary committees.[16]

### *B. Issues Raised by the SRO Review*

The SRO Review provided the Commission staff and industry participants and observers a unique opportunity to comment on the present state of self-regulation in the U.S. futures industry. Through interviews with over 100 industry participants and observers, comments received in response to **Federal Register** notices, and the Hearing, the Commission gathered a wide range of views on the successes and challenges facing self-regulation now and into the future.

In general, commenters and interview participants saw continuing vitality in the central premise of self-regulation: that regulation works best when conducted close to the markets by individuals with market-specific expertise. At the same time, though, throughout the course of the SRO Review and in the surrounding public debate on the merits of self-regulation in the financial sector generally, many identified increased competition, evolving business models, and new ownership structures as critical changes capable of adversely impacting exchanges' regulatory behavior.[17]

Specifically, some interview and Hearing participants and commenters expressed concern that for-profit, publicly traded exchanges may under-invest in regulatory personnel or technology to control costs and thereby meet the short-term expectations of stock holders and analysts.[18] The

[13] The most recent amendments to the DSROs' cooperative agreement were submitted to the Commission and published for comment. Futures Market Self-Regulation, 69 FR 19166 (Apr. 12, 2004). *See also* Press Release, Commodity Futures Trading Commission, Commission Progresses with Study of Self-Regulation (Feb. 6, 2004), available at: *http://www.cftc.gov/opa/press04/opa4890-04.htm.*

[14] Governance of Self-Regulatory Organizations, 69 FR 32326 (June 9, 2004). In this release, comment letters (''CLs'') in response to the SRO Governance Request for Comments are referred to by the name of the party submitting the letter and page number. These letters are available at: *http://www.cftc.gov/foia/comment04/foi04-005_1.htm.* A summary of interview comments (with names of persons interviewed redacted) also is available at this Web site.

[15] Self-Regulation and Self-Regulatory Organizations in the Futures Industry, 70 FR 71090 (Nov. 25, 2005). Comment letters received in response to this release are available at *http://www.cftc.gov/foia/comments05/foi05-007_1.htm.*

[16] The Hearing Transcript (''Hearing Tr.'') is available at *http://www.cftc.gov/files/opa/opapublichearing021506.final.pdf.*

[17] *See e.g.*, Futures Industry Association (''FIA''), CL at 2 (Jan. 23, 2006); Comments of Professor Roberta S. Karmel, Centennial Professor of Law, Brooklyn Law School (''Karmel''), Hearing Tr. at 32 (''[T]echnology and competition are creating more serious conflicts and, in fact, it is these forces that propel demutualization in the first place''); Comments of Christopher K. Hehmeyer, Co-Chairman, Goldenberg Hehmeyer & Co., *id.* at 151 (''[E]xchanges have done very well. But it would only take a couple of bad quarters, God forbid, on the part of the exchanges, for there to be pressures on some of the conflicts that haven't revealed themselves in the past.''); Comments of Susan M. Phillips, Dean, George Washington University School of Business (''Phillips''), *id.* at 116 (''Obviously, the whole exchange environment is changing dramatically, probably more so now than at any time in history. There are a lot of pressures on exchanges.'').

*See also* IOSCO at 4. (''[A]s competition increases and exchanges move from mutual or cooperative entities to for-profit enterprises, new elements enter the environment. The commercial nature of the exchange becomes more evident: maximizing profits becomes an explicit objective.''). Others have noted that, even absent demutualization or for-profit exchanges, ''intense competition alone will * * * increase conflicts due to the need to reduce costs, be more responsive to customers, and ensure that competing markets do not gain advantage by imposing a lighter regulatory burden.'' WB at 31.

[18] *See, e.g.*, FIA CL (Jan. 23, 2006) at 1 (observing that SROs may use their regulatory authority for anti-competitive purposes or to adopt rules that benefit parochial interests at the expense of the public interest); and Citigroup CL (Jan. 23, 2006) at 1–2 (echoing support for the views expressed in FIA's comment letter); *see also* Comments of Jeffrey Jennings, Managing Director and Global Head of Futures, Lehman Brothers (''Jennings''), Hearing Tr. at 53 (''[A]s the exchanges become for-profit * * * we have to recognize the issues that that raises, and

exchanges' growing conflicts may also manifest themselves in under-regulation of those market participants who generate significant income or liquidity for the exchange—for example, FCMs that bring significant customer volume, market makers that provide significant liquidity, or high-volume locals. Conversely, concerns were raised that exchange participants who are not favored by, or compete with, the exchange may suffer from discriminatory or over-regulation.[19]

Exchanges, in turn, have argued that increased competition, demutualization, and other industry developments will strengthen self-regulation, not weaken it.[20] They stated that their competitive advantage rests in offering fair and transparent markets that are free from fraud, manipulation, and other abusive practices. Exchanges also noted that demutualization and public listing create a new class of exchange owners whose long-term interests are aligned with effective self-regulation and fair markets.

Against this backdrop of market changes raising implications for the SROs'' performance of their regulatory functions, the U.S. financial industry has seen the emergence of governance ''best practices'' and standards designed to enhance corporate responsibility. These best practices and standards are found in a wide spectrum of the U.S. business community, ranging from securities self-regulatory organizations to major corporations and financial participants. All of these initiatives emphasize corporate governance as the key tool for the fulfillment of corporate responsibilities.[21]

The cumulative impact of an evolving industry, operating in an ever more competitive, global environment, and the growing attention to the need for enhanced corporate governance, provide the basis for the Commission's review of self-regulation in the futures industry and the Acceptable Practices proposed herein.[22]

## III. Description of Proposed Acceptable Practices

Section 5(d)(15) of the CEA (''Core Principle 15'') requires that exchanges ''minimize conflicts of interest in the decision making process.''[23] Underlying the Core Principle's mandate is the recognition that management of conflicts of interest, which could potentially compromise the independence of an exchange's decision making, is fundamental to the effective operations of the exchange—no less than customer protection and market integrity mandated by other Core Principles. Core Principle 15 requires the exchanges to have systems in place to address not only an individual's personal conflicts of interest, but also the broader potential conflicts of interest inherent in self-regulation.

As discussed earlier, with respect to SROs that operate as both markets and front-line regulators, these conflicts may be further exacerbated by emerging market trends. At present, however, there are no Acceptable Practices for Core Principle 15. The Commission's core mission is to promote and protect the integrity of the U.S. futures markets and to promote public confidence and trust in those markets. Now, as the futures industry undergoes one of the most significant transformations in its long history, self-regulation must keep pace. Accordingly, the Commission believes that it is appropriate and necessary to provide guidance to SROs in the form of Acceptable Practices for Core Principle 15.

Core Principle 15 is illustrative of the new regulatory approach ushered in by the Commodity Futures Modernization Act of 2000 (''CFMA''),[24] which replaced prescriptive rules governing futures exchanges with broad, flexible core principles. The core principles set standards of performance for the exchanges, and at the same time, allow exchanges considerable leeway in how to meet those standards. To facilitate compliance, the Commission has adopted Acceptable Practices for other core principles. Through its Acceptable Practices, the Commission provides exchanges with a safe harbor for complying with selected requirements of a core principle, but such Acceptable Practices, as stated in the Act, are not the exclusive means for compliance.[25] Once implemented, Acceptable Practices provide regulatory certainty that exchanges may rely upon when seeking designation as contract markets or when subject to periodic Rule Enforcement Reviews by the Commission.[26]

The Acceptable Practices proposed in this Release are designed to offer exchanges a roadmap for complying with selected requirements of Core Principle 15. The Acceptable Practices that we propose today would enable SROs to demonstrate that they are structurally capable of protecting their regulatory functions and decision making from conflicts of interest.[27]

As with Acceptable Practices generally, exchanges may choose not to comply with the proposed Acceptable Practices for Core Principle 15. They still will be required, however, to demonstrate that their policies and practices with respect to governance and decision making are in compliance with Core Principle 15 by other means.[28]

the risks of there being some sort of conflicts of interest. * * *'').

[19] Whether stemming from increased competition, demutualization, or for-profit structures, potential conflicts of interest in self-regulation may be all the more evident when exchanges regulate their competitors. For example, when firms operate their own market and also are users of an exchange, the exchange could discriminate in disciplinary matters, trading rules, fees, and other areas in which it has jurisdiction over the competitor. It has been suggested that, as with other conflicts of interest, ''the conflicts inherent in an exchange regulating its competitors, while not new, become more apparent where the exchange is also a for-profit enterprise.'' IOSCO at 5.

[20] *See, e.g.*, CME CL (Jan. 23, 2006) at 2 and NYMEX CL (Jan. 23, 2006) at 3.

[21] *See, e.g.*, Fair Administration and Governance of Self-Regulatory Organizations, 69 FR 71126 (Dec. 8, 2004) (''Fair Administration''); World Bank—Corporate Governance Principles of Best Practices, available at: *http://www.worldbank.org/html/fpd/privatesector/cg/codes.htm;* CalPERS Governance Principles, available at: *http://www.calpers-governance.org/principles/default.asp.*

[22] In the face of such developments, a Hearing participant observed that ''it is incumbent upon us all that the U.S. futures industry establish standards that recognize and are responsive to the realities of our changing industry and marketplace and are fair and without any appearance of conflicts.'' Jennings, Hearing Tr. at 28.

[23] Any board of trade that is registered with the Securities and Exchange Commission (''SEC'') as a national securities exchange, is a national securities association registered pursuant to section 15(A)(a) of the Securities Exchange Act of 1934, or is an alternative trading system, and that operates as a designated contract market in securities futures products under Section 5f of the Act and SEC Regulation 41.31, is exempt from the core principles enumerated in Section 5 of the Act, and the Acceptable Practices thereunder.

[24] Appendix E of Pub. L. No. 106–554, 114 Stat. 2763 (2000).

[25] *See* CEA Section 5c(a)(2), 7 U.S.C. § 7a–2(a)(2).

[26] The Commission has explained that ''boards of trade that follow the specific practices outlined under [the Acceptable Practices] * * * will meet the selected requirements of the applicable core principle.'' 17 CFR part 38, App. B, ¶ 2.

[27] In recent amendments to Appendix B of Part 38, the Commission has explained that ''the enumerated acceptable practices under each core principle are neither the complete nor the exclusive requirements for meeting that core principle. With respect to the completeness issue, the selected requirements in the acceptable practices section of a particular core principle may not address all the requirements necessary for compliance with the core principle.'' Technical and Clarifying Amendments to Rules for Exempt Markets, Derivatives Transaction Execution Facilities and Designated Contract Markets, and Procedural Changes for Derivatives Clearing Organization Registration Applications, 71 FR 1953, 1958 (Jan. 12, 2006). The Acceptable Practices that we propose today do not reach, and are not intended to reach, individual, personal conflicts of interest. A contract market must address these conflicts as well as the structural conflicts that are the subject of these proposed Acceptable Practices in order to demonstrate full compliance with Core Principle 15's requirements.

[28] In this regard, the CFTC will take into account the governance and regulatory conflicts of interests

Continued

The elements of the proposed Acceptable Practices under Core Principle 15 are summarized below. The Commission proposes as a new Acceptable Practice under Core Principle 15 that at least fifty percent of the board members of exchanges' boards of directors and executive committees (or similarly empowered bodies) be ''public'' directors, as defined below (''*Board Composition Acceptable Practice*''). Day-to-day regulatory operations should be supervised by a Chief Regulatory Officer (''CRO'') reporting directly to a ROC (''*Regulatory Oversight Committee Acceptable Practice*''). The Acceptable Practices define ''public director'' for persons serving on boards, ROCs, and disciplinary panels. An individual may qualify as a public director upon an affirmative determination by the board that the individual has no material relationship with the exchange.

In addition, the Acceptable Practices strengthen impartial adjudication by providing that SRO disciplinary panels should not be dominated by any group or class of SRO participants, and that each panel should include at least one public member (''*Disciplinary Panel Acceptable Practice*''). By increasing the public voice on governing boards and disciplinary committees and creating an independent board-level ROC, combined with Commission oversight, the Acceptable Practices seek to maintain the existing high standards of fair and effective self-regulation in the futures industry, while proactively adapting them to the market and business realities of a new era for the industry. Each of these Acceptable Practices is described below.

*A. Board Composition; ''Public'' Director Defined*

The Board Composition Acceptable Practice provides that exchanges should elect governing boards composed of at least fifty percent public directors. In addition, it provides that SROs' executive committees (or similarly empowered bodies) should be at least fifty percent public.

The Acceptable Practice offers guidance on the definition of ''public'' director. The proposed definition provides that a director is ''public'' only if the board of directors affirmatively determines that the director has no ''material relationship'' with the exchange. The nominating committee of the board of directors should affirmatively determine on the record that a director or nominee has no material relationship with the exchange, and should state on the record the basis for its determination and the scope of its scrutiny. The committee should reevaluate that determination at least on an annual basis.

''Material relationships'' are those that reasonably could affect the independent judgment or decision making of the director. Material relationships are not exclusively compensatory or financial. Any relationship between a director and the exchange that may interfere with a director's ability to deliberate objectively and impartially on any matter is a material relationship. In this regard, material relationships are not limited to those where a director has an immediate interest in a particular matter before him or her.

In addition to the general materiality test, the proposed definition of ''public'' director identifies specific circumstances or relationships that would preclude a determination that a person qualifies as a ''public'' director. Specifically, a director could not be ''public'' if any of the following circumstances existed: [29]

—The director is an officer or employee of the exchange or a director, officer or employee of its affiliate; [30]

—The director is a member of the exchange, or a person employed by or affiliated with a member. In this context, a director is affiliated with a member if the director is an officer or director of the member;

—The director receives more than $100,000 in payments from the exchange, any affiliate of the exchange, or a member or anyone affiliated with a member; [31]

—Any of the relationships above apply to a member of the director's immediate family, *i.e.*, spouse, parents, children, and siblings.

—All of the disqualifying circumstances described above are subject to a one-year look back. Thus, for example, a director who, within the past year, was a member of the exchange, would not qualify as a ''public'' director.

Comments are solicited on whether there are additional categories of circumstances which should automatically disqualify a person from consideration as a ''public'' director. Also, commenters have suggested that members should not be precluded from serving as a ''public'' director. They have offered as examples persons who engage in *de minimis* trading, or members who lease their seats to others. The Commission seeks the public's views on whether these or similar circumstances could rebut the presumption of member disqualification as a ''public'' director.

*B. Regulatory Oversight Committee*

The Regulatory Oversight Committee Acceptable Practice recognizes the importance of insulating core regulatory functions from improper influences and pressures stemming from the exchange's commercial affairs. To comply with the Regulatory Oversight Committee Acceptable Practice, every exchange should establish, as a standing committee of its board of directors, a ROC with oversight responsibility for all facets of the SRO's regulatory program. This includes broad authority to oversee: (1) Trade practice surveillance; (2) market surveillance; (3) audits, examinations, and other regulatory responsibilities with respect to member firms; [32] (4) the conduct of investigations; (5) the size and allocation of regulatory budgets and resources; (6) the number of regulatory officers and staff; (7) the compensation of regulatory officers and staff; (8) the hiring and termination of regulatory officers and staff; and (9) the oversight of disciplinary committees and panels.

The ROC's primary role is to assist the board in fulfilling its responsibility of ensuring the sufficiency, effectiveness, and independence of self-regulatory functions.[33] In this capacity, the ROC should have the authority, discretion and necessary resources to conduct its own inquiries; consult directly with regulatory staff; interview employees, officers, members, and others; review relevant documents; retain independent legal counsel, auditors, and other professional services; and otherwise exercise its independent analysis and

specific to the exchange and how they are being managed.

[29] These specific circumstances—or ''bright-line'' tests—are neither exclusive nor exhaustive. A director does not qualify as ''public'' unless the board affirmatively determines that the director has no material relationship with the exchange, including but not limited to, the bright-line tests identified herein.

[30] As used in this context, an affiliate includes parents or subsidiaries of the contract market or entities that share a common parent with the contract market.

[31] Compensation for services as a director will not be counted towards the $100,000 threshold test.

[32] SROs' regulatory responsibilities with respect to member firms include ensuring compliance with financial integrity, financial reporting, sales practice, recordkeeping, and other requirements. Commission Regulation 1.52 permits cooperative agreements among exchanges to coordinate compliance examinations of FCMs such that each FCM is assigned a primary examiner (its DSRO). ROCs should have authority over SROs self-regulatory functions, both when the SROs are fulfilling SRO responsibilities and when they are fulfilling DSRO responsibilities.

[33] In its review of exchanges for compliance with Core Principles, the Commission will look at board documentation of the reasons for its actions and its acceptance or rejection of recommendations by the ROC, as well as by other committees.

judgment to fulfill its regulatory obligations.[34]

ROCs would be expected to identify aspects of the regulatory scheme that work well and those that need improvement, and, as necessary, to make recommendations to the governing board for changes that would ensure fair, vigorous, and effective regulation. ROCs should also be given an opportunity to review and, if they wish, present formal opinions to management and the board on any proposed rule or programmatic changes originating outside of the ROCs, but which their CROs believe may have a significant regulatory impact.[35] Exchanges should provide their CROs and ROCs with sufficient time to consider such proposals before acting on them. In addition to periodic reports to the board, ROCs should prepare for the governing board and the Commission an annual report assessing the effectiveness, sufficiency, and independence of the SRO's regulatory program, including any proposals to remedy unresolved regulatory deficiencies. ROCs are also expected to keep thorough minutes and records of meetings, deliberations, and analyses, and make these available to Commission staff upon request.[36]

Finally, the proposed Acceptable Practice envisions that the CRO of the SRO will report directly to, and regularly consult with, the ROC. ROCs may delegate their day-to-day authority over self-regulatory functions and personnel to the CRO. Although ROCs remain responsible for ensuring the sufficiency, effectiveness, and independence of self-regulation within their SROs, they are not expected to assume managerial roles.

*C. Disciplinary Panels*

The proposed Disciplinary Panel Acceptable Practice would preclude any group or class of exchange members from dominating or exercising disproportionate influence on any disciplinary panel. In addition, the Commission proposes that all disciplinary panels include at least one ''public'' participant. To qualify as ''public,'' panel members should meet the same test as public directors.

For purposes of this Acceptable Practice, ''disciplinary panel'' means any person, panel of persons, or any subgroup thereof, which is authorized by an SRO to issue disciplinary charges, to conduct proceedings, to settle disciplinary charges, to impose disciplinary sanctions, or to hear appeals thereof, except in cases limited to decorum, attire, the timely submission of accurate records required for clearing or verifying each day's transactions or other similar activities. If an exchange's rules provide for an appeal to the board of directors, or a committee of the board, then that appellate body should include at least one person who meets the qualifications for membership on the board's ROC. ''Disciplinary panel'' does not include exchange regulatory staff authorized to issue warning letters or summary fines imposed pursuant to established schedules.

To take advantage of this safe harbor, and thereby comply with Core Principle 15's requirement to minimize conflicts of interest in decisionmaking, the Commission is proposing that exchanges amend their disciplinary panel composition rules and policies to incorporate the terms of the Disciplinary Panel Acceptable Practices. Finally, under this Acceptable Practice, disciplinary committees and panels would fall under the oversight of the ROC.

## IV. Analysis and Rationale for Proposed Acceptable Practices

*A. Board Composition; ''Public'' Director*

The Board Composition Acceptable Practice is designed to promote and safeguard the independence of the board of directors. It reaffirms the basic corporate principle that good governance is the cornerstone of a strong corporation and that a company's long-term success is best secured by enhancing the presence of independent participants at the highest level of corporate decisionmaking, the board of directors.

In any corporation, the paramount duty of the board of directors is to act, at all times, in the best interest of the corporation. It is the board that has the ultimate decisionmaking authority within a corporation and that must be accountable for any failure in the fulfillment of its corporate duties. In effect, the board represents the first line of defense against corporate misconduct. In the case of a corporation that also operates as an SRO, the board may have to make decisions in circumstances where its role as a fiduciary to the shareholders conflicts with its duty as a custodian of the public trust.[37] Increased competition and demutualization may further exacerbate these potentially competing claims and render the board susceptible to pressures that may impact its ability to carry out self-regulatory duties to their fullest extent.

The Commission's proposed Board Composition Acceptable Practice constitutes a strong, proactive approach to ensuring the continued success of self-regulation in the futures industry. With respect to exchange boards of directors, their dual regulatory and commercial roles suggest that a fifty percent ''public'' board is an appropriate balance and should best enable directors to carry out their responsibilities.[38]

The Commission notes that its proposed Board Composition

[34] Nevertheless, a ROC should not rely on outside professionals or firms that also provide services to the full board, other board committees, or other units of the exchange.

[35] ROCs' deliberations with respect to such proposed rule changes should be memorialized in thorough meeting minutes, and their formal opinions made available to Commission staff upon request.

[36] The Commission's review of Core Principle 15 compliance will include, inter alia, the ROC's records, annual reports, meeting minutes, analyses conducted or commissioned by the ROC, examinations of proposed and existing rules, and evaluations and recommendations concerning the effectiveness, sufficiency, and independence of the exchange's regulatory programs. *See* Section 8(a)(1) of the Act, 7 U.S.C. § 12(a)(1), authorizing the Commission to ''make such investigations as it deems necessary to ascertain the facts regarding the operations of boards of trade and other persons subject to the provisions of this Act.''

[37] Any decisions made by SROs' boards of directors, although not directly regulatory, implicate the public interest and the intersection between regulatory responsibilities and commercial imperatives. SROs' boards of directors determine transaction fees; market data fees; and membership criteria. They control the employment and compensation of senior executives, including the president of the exchange, and they are sometimes responsible for the appointment of public directors. Boards make fundamental governance decisions, including those made with respect to the strategic direction of the SRO and the oversight of self-regulation. In addition, SROs' public interest obligations are cited in the very purposes of the Act, which include ''to serve the public interest * * * through a system of effective self-regulation of trading facilities.'' CEA Section 3(b), 7 U.S.C. 5(b).

As noted at the Hearing, ''exchanges which also function as for-profit institutions as well as SROs are truly occupying an absolutely unique space in corporate America.'' Jennings, Hearing.Tr. at 79.

[38] Industry participants and observers noted that independence of an exchange's board of directors is key to effective and impartial self-regulation due to its role as the ultimate arbiter of decisions affecting both commercial and regulatory functions of the exchange. To address the conflicts of interest inherent in this dual role, most participants agreed on the benefits of including ''public'' directors on exchange boards. *See e.g.,* Jennings, Hearing Tr. at 29 (''[I]t is a fundamental requirement that exchange boards must have a significant representation of independent public directors. I believe it is appropriate that at least fifty percent of the exchange board must comprise this group.''); and Phillips, Hearing Tr. at 159 (addressing reviews of exchanges' rulemaking authority, ''* * * it comes back to the governance process and the independence of the board to really make those kinds of reviews meaningful.''). However, industry participants did not agree on what specifically constitutes an appropriate board composition, or whether existing exchange board compositions are adequate.

Acceptable Practice is consistent with the trend of major governance initiatives across the corporate and SRO communities in the United States. In November 2003, the New York Stock Exchange (''NYSE'') and NASDAQ both implemented new governance standards for their listed companies. Among the most important provisions is the requirement that listed companies' boards have a majority of independent directors. In addition, listed companies must have fully independent nominating, corporate governance, compensation, and audit committees. While the conflicts driving these governance initiatives may differ from those arising in the futures self-regulatory context, the NYSE and NASDAQ standards for listed companies reflect their recognition that good corporate governance is founded on strengthening the independence and accountability of the board.

Two futures exchanges, the CME and the CBOT are now subject to the NYSE listing standards outlined above, and others may join them as futures exchanges continue to demutualize and seek public listing of their shares. The Commission is satisfied that the listing standards provide a measure of shareholder protection for the owners of publicly-traded futures exchanges. However, the Commission is equally satisfied that these listing standards are not designed for public companies that also bear a special responsibility of public protection and fair and effective self-regulation. Although it may be true, as the publicly-traded futures SROs have determined, that SRO members are independent under the NYSE listing standards, the proposed Board Composition Acceptable Practice provides that members are not independent for purposes of protecting the public interest against conflicts of interest in self-regulation.

Finally, the fifty percent minimum standard strikes a favorable balance between inside expertise and ''outside'' impartiality and ensures that other exchange stakeholders, such as members and exchange management, are adequately represented. In this manner, the ''self'' in self-regulation is retained, along with its efficiencies and expertise, while the ultimate benefactors of the self-regulatory system—market participants and the public—are assured that their interests are well-represented at the highest level.

(i) Definition of ''Public'' Director

To facilitate compliance, the Commission has modeled aspects of its ''public'' director definition, and more specifically, the materiality test, on what have now become accepted standards for defining independent directors. For example, the NYSE governance standards, noted above, mandate that to qualify as independent, directors must meet both a series of bright-line tests capturing certain present and past employment, compensation, business, familial, and other relationships; and a categorical ''no material relationship'' test. Similarly, under the Commission's proposed definition, the determination of whether a person qualifies as a ''public'' director entails (1) proposed ''bright-line'' tests, such as membership, employment, and business and financial ties with the exchange, aimed at identifying many of the circumstances that necessarily impair independent decision making; and (2) a facts and circumstances analysis. As to the facts and circumstances analysis, the board, taking into account all of the relevant factors relating to the person's relationship with the exchange, must make a reasonable finding on the record that the person is capable of independent decision-making. This analysis is broader than the bright-line tests.

Similar standards have already been implemented in a variety of related contexts: by the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act of 2002) with respect to independent directors serving on the audit committees of public companies;[39] and by the NYSE for its own board of directors.[40] The SEC has also proposed similar standards for independent directors on the boards of securities exchanges.[41]

The Acceptable Practice addressing board qualifications is named the ''Public Director Acceptable Practice'' rather than the ''Independent Director Acceptable Practice'' to emphasize the national public interest in futures trading and the role that SROs play in serving and protecting that interest.[42] The appropriate definition of, and qualifications for, an unconflicted director were debated vigorously during the SRO Review.[43] The debate often centered on whether the NYSE listing standards are sufficient for self-regulatory purposes. Several commenters and Hearing participants noted that the NYSE independent director standard principally operates to protect shareholder interests against undue management influence, and that more is needed to protect the public interest in an institution that exercises regulatory duties.[44] The Commission generally agrees that the listing standards are not sufficient for public companies that also bear special responsibility to the public to self-regulate fairly and effectively. Simply stated, self-regulation and shareholder protection are two distinct missions: they may be complementary, but they are not substitutes.

*B. Regulatory Oversight Committee*

ROCs would provide independent oversight of core regulatory functions, including trade practice, market, and financial surveillance, for all exchanges. ROCs also would oversee the performance of disciplinary committees. Because these functions are fundamental manifestations of SROs' regulatory authority, the Commission believes that they should be overseen in the most impartial manner possible within the context of self-regulation—by public directors who are neither members of the SRO nor otherwise dependent upon the commercial enterprise.[45]

[39] Pub. L. No. 107–204, 116 Stat. 745 (2002).

[40] Constitution of the New York Stock Exchange, Art. IV, § 2.

[41] Fair Administration, *supra* note 21.

[42] *See* CEA Section 3(b), 7 U.S.C. § 5(b).

[43] FIA for example, commented that ''[i]ndependent SRO directors should be independent not only of management but also of all activity on the exchange'' because ''[t]he special nature of an SRO's powers and functions * * * makes it essential to have truly independent directors with no direct, current ties to the industry the SRO regulates.'' FIA CL (Jan. 23, 2006) at 3. NYMEX, on the other hand, was of the view that active industry participation did not impair impartiality so long as a director had no ties to the exchange itself. *See* NYMEX CL (Jan. 23, 2006) at 7: NYMEX stated that its ''Public Directors would qualify as independent directors'' under NYSE listing standards and noted that ''it is possible for markets subject to [NYSE] listing standards to conclude that exchange members qualify as independent directors.'' NYMEX noted the ''specialized'' nature of futures trading and emphasized the importance of board expertise. *Id.* The CME as well stated that independence should be determined on a case by case basis. CME CL (Jan. 23, 2006) at 7.

[44] *See, e.g.,* Karmel, Hearing Tr. at 33 (''The New York Stock Exchange and NASDAQ listing standards, as others have already said, do not squarely address the key issue of whether exchange members should be considered independent or not when they serve as directors of an exchange board or a regulatory subsidiary''; and FIA CL (Jan. 23. 2006) at 3.

[45] The Commission's proposed Regulatory Oversight Acceptable Practice is similar to measures already implemented or recommended by some exchanges in response to acknowledged self-regulatory concerns. The CME, for example, has formed an advisory board-level committee to ''ensure the independent exercise'' of self-regulatory obligations (''Market Regulation Oversight Committee'' or ''MROC''). Every member of the committee must be an independent director. The MROC reviews and reports to CME's board, on an annual basis, with respect to: (1) The independence of CME's regulatory functions from its business operations; (2) the independence of CME management and regulatory personnel from

The public directors on the ROC would be free to consider the unique responsibilities of the SRO to act in the public interest, to plan for effective self-regulation in the long-term, and to insulate regulatory decisions from short-term pressures that may be brought to bear in an increasingly competitive environment. The Commission believes that SROs generally stand to benefit from establishing ROCs.

ROCs' determinations with respect to their core competencies would be subject to review by the full board of directors, including member directors, and ROCs would be free to consult widely within the SRO throughout their deliberations, thus ensuring that member expertise remains central to self-regulation in the futures industry. At the same time, by placing initial oversight responsibility in the hands of public directors, arming them with the tools and resources necessary to make fully informed decisions, and providing an independent reporting line for senior regulatory officers, SROs would ensure that regulatory decisions are insulated from improper influences. The ROC structure, combined with careful Commission review of the interaction between the ROC and the board, fosters the continued integrity of futures self-regulation, effective management of conflicts of interest within SRO governance, and full consideration of the public interest in every decision of regulatory consequence.

*C. Disciplinary Panels*

Diversity in committee and panel composition has long been recognized as an effective tool for minimizing conflicts of interest in SRO disciplinary adjudication, a long-standing objective of the Commission. Prior to enactment of the CFMA, the Act set specific standards for the composition of SRO disciplinary committees, requiring that: (1) Exchanges provide for a diversity membership on all major disciplinary committees and (2) respondents in exchange disciplinary actions not be tried exclusively by their peers.

The CFMA continues the Act's commitment to fair disciplinary procedures. The Acceptable Practices for Core Principle 2, for example, require that exchanges discipline members and market participants pursuant to ''clear and fair standards.''[46] As stated earlier, Core Principle 15 requires exchanges to ''minimize conflicts of interest in the decision making process.'' This requirement extends to disciplinary committees and panels, which must be free of both individual and group (*e.g.*, floor versus FCM) conflicts of interest.

The Commission believes that fair disciplinary procedures with minimal conflicts of interest require unbiased disciplinary panels representing a diversity of opinions and experiences. At the very least, this presumes panels that are not weighted in favor of any single class of exchange participants. Also, including a public person provides an outside perspective and helps to ensure that the public's interests are represented and protected. The Commission is confident that proper composition can minimize potential conflicts of interest and promote fairness on disciplinary panels, as required by Regulation 170.3 and Core Principles 2 and 15.

The SRO Review has found no indication of widespread inadequacy in exchange disciplinary committees, as many FCMs suggested. To the contrary, some exchanges maintain very diverse committees, including nonmember representatives. For example, CME's seven-person Probable Cause and Business Conduct panels each include three non-members.[47] Furthermore, the Commission has found that, at most exchanges, FCMs are more likely to appear before clearing house risk committees or financial compliance/surveillance committees (where FCMs are typically well-represented) than on business conduct committees or similar committees (which may include broker, local, commercial, FCM, and public panelists).

In addition, periodic Rule Enforcement Reviews conducted by the Commission's Division of Market Oversight, which carefully examine disciplinary sanctions, typically find that they are fair and do not discriminate among different classes of exchange participants. Rule Enforcement Reviews also examine exchange disciplinary procedures, and consistently find that these are adequate.

The Commission is generally satisfied with the composition and performance of most SRO disciplinary committees and panels, and believes that significant new measures are not required at this time. The Commission has found that disciplinary committees typically have adequate diversity, sometimes including FCMs and nonmembers, and seek to balance expertise with impartiality. Accordingly, the Commission's proposed Disciplinary Panel Acceptable Practice acknowledges SROs' current practices and the requirements of the Act, and identifies minimal panel composition standards as a means of protecting the continued integrity of the disciplinary process. It helps to minimize conflicts of interest by ensuring a basic degree of diversity, and the inclusion of at least one public person on SRO disciplinary panels.

To take advantage of the safe harbor offered by the proposed Disciplinary Panel Acceptable Practice, and comply with Core Principle 15's requirement to minimize conflicts of interest in decision making, the Commission is proposing that SROs' amend their rules and policies to ensure that they preclude any group or class of exchange members from dominating or otherwise exercising disproportionate influence on any disciplinary panel. The Commission is also proposing that SROs ensure that their rules and policies provide for public persons on disciplinary panels, except in cases limited to decorum and attire.[48] Public panel members should meet the definition of ''public'' for directors serving on Regulatory Oversight Committees.

## V. Related Matters

*A. Cost-Benefit Analysis*

Section 15(a) of the Act, as amended by Section 119 of the CFMA, requires the Commission to consider the costs and benefits of its action before issuing a new regulation or order under the Act. By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of its action or to determine whether the benefits of the action outweigh its costs. Rather, Section 15(a) simply requires the Commission to ''consider the costs and benefits'' of the subject rule or order.

Section 15(a) further specifies that the costs and benefits of the proposed rule or order shall be evaluated in light of five broad areas of market and public

improper influence by industry directors regarding regulatory matters; (3) CME's compliance with its SRO responsibilities; (4) appropriate funding and resources to ensure effective performance of SRO responsibilities; and (5) appropriate compensation for CME employees involved in regulatory activities.

[46] 17 CFR Part 38, App. B, Core Principle 2, Acceptable Practices.

[47] CME Rules 402, 406.

[48] The proposed Disciplinary Panel Acceptable Practice is broader than Regulation 1.64, in that it requires a public member to participate in some categories of cases that, under Regulation 1.64, may be heard by a panel with no public members. The Commission believes the expansion of public participation is an appropriate response to the growth in the size and complexity of the futures markets, and the new profit element in exchange operations. Moreover, a public member's presence on disciplinary panels will enhance the appearance as well as the reality of fairness and impartiality in exchange disciplinary proceedings, and thus promote confidence in our markets among the public and market participants.

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 Commission may, in its discretion, give greater weight to any one of the five enumerated areas of concern and may, in its discretion, determine that, notwithstanding its costs, a particular rule or order is necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The Acceptable Practices proposed herein are safe harbors for compliance with Core Principle 15's conflict of interest provisions. They offer exchanges the opportunity to meet the requirements of the Core Principle through a regulatory governance structure that insulates their regulatory functions from their commercial interests. The Acceptable Practices propose that exchanges implement boards of directors that are at least fifty percent public. The Acceptable Practices further propose that all exchange-SROs place oversight of their core regulatory functions in the hands of board-level ROCs composed exclusively of ''public'' directors. They also offer guidance on what constitutes a ''public'' director. In addition, the Acceptable Practices suggest minimum composition standards for exchange disciplinary committees.

The proposed Acceptable Practices are consistent with legislative, regulatory, and voluntarily undertaken changes in governance requirements and practices in other financial sectors, such as the securities markets, and are intended to enhance protection of the public. The Commission has endeavored, in offering these Acceptable Practices to propose the least intrusive safe harbors and regulatory requirements that can reasonably be expected to meet the requirements of Core Principle 15 of the Act. These Acceptable Practices advance the Commission's mandate of assuring the continued existence of competitive and efficient markets and to protect the public interest in markets free of fraud and abuse.

They nevertheless may be expected to entail some costs, including, among the most foreseeable, those attendant to recruiting and appointing additional directors, amending corporate documents, making necessary rule changes and certifying them to the Commission, and appointing a CRO.

After considering these factors, the Commission has determined to propose the Acceptable Practices with respect to contract markets. The Commission specifically invites public comment on its application of the criteria contained in the Act. Commenters are also invited to submit any quantifiable data that they may have concerning the costs and benefits of the proposed Acceptable Practices with their comment letter.

*B. Regulatory Flexibility Act*

The Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.*, requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The proposed Acceptable Practices affect contract markets. The Commission has previously determined that contract markets are not small entities for purposes of the Regulatory Flexibility Act.[49] Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed Acceptable Practices will not have a significant economic impact on a substantial number of small entities.

*C. Paperwork Reduction Act of 1995*

The Acceptable Practices contain information collection requirements. As required by the Paperwork Reduction Act of 1995 (44 U.S.C. 3504(h)), the Commission has submitted a copy of this section to the Office of Management and Budget (''OMB'') for its review.

*Collection of Information:* Rules Relating to Part 38, Establishing Procedures for Entities to become designated as Contract Markets, OMB Control Number 3038–0052. The Acceptable Practices increase the burden previously approved by OMB.

*The estimated burden was calculated as follows:*

*Estimated number of respondents:* 12.

*Annual responses by each respondent:* 1.

*Total annual responses:* 12.

*Estimated average hours per response:* 70.

*Annual reporting burden:* 840.

Organizations and individuals desiring to submit comments on the information collection requirements should direct them to the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10202, New Executive Office Building, 725 17th Street, NW., Washington, DC 20503; Attention: Desk Officer for the Commodity Futures Trading Commission.

[49] Policy Statement and Establishment of Definitions of ''Small Entities'' for Purposes of the Regulatory Flexibility Act, 47 FR 18618, 18619 (Apr. 30, 1982).

The Commission considers comments by the public on this proposed collection of information in:

Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;
Evaluating the accuracy of the Commission's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
Enhancing the quality, usefulness, and clarity of the information to be collected; and
Minimizing the burden of collecting information on those who are to respond, including through the use of appropriate automated electronic, mechanical, or other technological collection techniques or other forms of information technology (*e.g.*, permitting electronic submission of responses).

OMB is required to make a decision concerning the collection of information contained in these Acceptable Practices between 30 and 60 days after publication of this document in the **Federal Register**. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the Commission on the Acceptable Practices.

Copies of the information collection submission to OMB are available from the Commission Clearance Officer, Three Lafayette Centre, 1155 21st Street, NW., Washington DC 20581, (202) 418–5160.

## VI. Text of Proposed Acceptable Practices

### List of Subjects in 17 CFR Part 38

Commodity futures, Reporting and recordkeeping requirements.

In light of the foregoing, and pursuant to the authority in the Act, and in particular, Sections 3, 5, 5c(a) and 8a(5) of the Act, the Commission proposes to amend Part 38 of Title 17 of the Code of Federal Regulations as follows:

## PART 38—DESIGNATED CONTRACT MARKETS

1. The authority citation for part 38 is revised to read as follows:

**Authority:** 7 U.S.C. 2, 5, 6, 6c, 7, 7a–2 and 12a, as amended by Appendix E of Pub. L. 106–554, 114 Stat. 2763A–365.

2. In Appendix B to Part 38 amend Core Principle 15 by adding paragraph (b) ''Acceptable Practices'' as follows:

### Appendix B to Part 38—Guidance on, and Acceptable Practices in, Compliance With Core Principles

* * * * *

Core Principle 15 of Section 5(d) of the Act: Conflicts of Interest

* * * * *

(b) *Acceptable Practices.* All designated contract markets (''DCMs'' or ''contract markets'') bear special responsibility to regulate effectively, impartially, and with due consideration of the public interest, as provided for in Section 3 of the Act. Under Core Principle 15, they are also required to minimize conflicts of interest in their decision making processes. To comply with this Core Principle, contract markets should be particularly vigilant for conflicts between their self-regulatory responsibilities, their commercial interests, and the interests of their management, members, owners, customers and market participants, other industry participants, and other constituencies.

Acceptable Practices for minimizing conflicts of interest shall include the following elements:

(1) *Board Composition for Contract Markets*

(A) At least fifty percent of the directors on a contract market's board of directors shall be public directors; and

(B) The executive committees (or similarly empowered bodies) shall be at least fifty percent public.

(2) *Public Director*

(A) To qualify as a public director of a contract market, an individual must first be found, by the board of directors on the record, to have no material relationship with the contract market. A ''material relationship'' is one that reasonably could affect the independent judgment or decision making of the director.

(B) In addition, a director shall not be considered ''public'' if any of the following circumstances exist:

(i) The director is an officer or employee of the contract market or a director, officer or employee of its affiliate;

(ii) The director is a member of the contract market, or a person employed by or affiliated with a member. ''Member'' is defined according to Section 1a(24) of the Commodity Exchange Act and Commission Regulation 1.3(q). In this context, a director is affiliated with a member if the director is an officer or director of the member;

(iii) The director receives more than $100,000 in payments from the contract market, any affiliate of the contract market or from a member or anyone affiliated with a member, provided that compensation for services as a director will not be counted towards the $100,000 threshold test;

(iv) A director shall be precluded from serving as a public director if any of the relationships above apply to a member of the director's ''immediate family,'' *i.e.*, spouse, parents, children, and siblings; and

(v) An affiliate includes parents or subsidiaries of the contract market or entities that share a common parent with the contract market.

(C) All of the disqualifying circumstances described in Subsection (2)(B) shall be subject to a one-year look back.

(D) A contract market shall disclose to the Commission which members of its board are public directors, and the basis for those determinations.

(3) *Regulatory Oversight Committee*

(A) A board of directors of any contract market shall establish a Regulatory Oversight Committee (''ROC'') as a standing committee, consisting of only public directors as defined in Section (2), to assist it in minimizing potential conflicts of interest. The ROC shall oversee the contract market's regulatory program on behalf of the board. The board shall delegate sufficient authority, dedicate sufficient resources, and allow sufficient time for the ROC to fulfill its mandate.

(B) The ROC shall:

(i) Monitor the contract market's regulatory program for sufficiency, effectiveness, and independence;

(ii) Oversee all facets of the program, including trade practice and market surveillance; audits, examinations, and other regulatory responsibilities with respect to member firms (including ensuring compliance with financial integrity, financial reporting, sales practice, recordkeeping, and other requirements); and the conduct of investigations;

(iii) Review the size and allocation of the regulatory budget and resources; and the number, hiring and termination, and compensation of regulatory personnel;

(iv) Supervise the contract market's chief regulatory officer, who will report directly to the ROC;

(v) Prepare periodic reports for the board of directors and an annual report assessing the contract market's self-regulatory program for the board of directors and the Commission, which sets forth the regulatory program's expenses, describes its staffing and structure, catalogues disciplinary actions taken during the year, and reviews the performance of disciplinary committees and panels;

(vi) Recommend changes that would ensure fair, vigorous, and effective regulation; and

(vii) Review regulatory proposals and advise the board as to whether and how such changes may impact regulation.

(4) *Disciplinary Panels*

All contract markets shall minimize conflicts of interest in their disciplinary processes through disciplinary panel composition rules that preclude any group or class of industry participants from dominating or exercising disproportionate influence on such panels. Contract markets can further minimize conflicts of interest by including at least one person who would qualify as a public director as defined in Section (2) above, on disciplinary panels, except in cases limited to decorum and attire. If contract market rules provide for appeal to the board of directors, or to a committee of the board, then that appellate body shall also include at least one person who would qualify as a public director as defined in Section (2) above.

* * * * *

Issued in Washington, DC, on June 28, 2006 by the Commission.

**Eileen A. Donovan,**

*Acting Secretary of the Commission.*

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

## APPENDIX—STATEMENTS OF COMMISSIONERS HATFIELD AND DUNN

*Commissioner Frederick W. Hatfield, writing separately.*

Since the passage of the Commodity Futures Modernization Act of 2000 (CFMA), the U.S. futures industry has experienced dynamic growth. With rapid growth comes new challenges. U.S. futures exchanges are today faced with increased competition, domestically and from abroad, changing ownership structures, and new business models. As regulators, it is incumbent upon us to ensure that regulatory guidelines continue to keep pace with the ever changing environment of the industry. Accordingly, I applaud Chairman Jeffery and Commission staff for their thoughtful and exhaustive pursuit of fair, vigorous and effective self-regulation in this evolving market landscape.

In this review, I have been guided by two questions: have the exchanges produced self-regulatory structures that are up to the challenges of the changing marketplace and if not, are we as regulators suggesting a better model? I look forward to receiving comments on the Board Composition Acceptable Practice proposal. However, in my view, establishing a board level Regulatory Oversight Committee (ROC) comprised of nonmember public directors and a disciplinary panel structure, as described in the proposal, goes a long way toward ensuring that an exchange's regulatory duties will not be compromised by conflicts emanating from commercial goals.

The primary function of the proposed ROCs is to ensure that regulatory programs and staff are free of improper influence from exchange owners, management, members, investors, customers, and commercial considerations. As the proposal recognizes, ''[t]he ROC structure, combined with careful Commission review of the interaction between the ROC and the board, fosters the continued integrity of futures self-regulation, effective management of conflicts of interest within SRO governance, and full consideration of the public interest in every decision of regulatory consequence.'' Section B. Regulatory Oversight Committee, last paragraph. Despite this recognition, the proposed safe harbor would require, in addition to public director ROCs, that at least fifty percent of the governing boards and exchange executive committees also be comprised of public directors.

Interest in SRO board composition has an established history in the Commodity Exchange Act (Act) and in the Commission's regulations. Prior to passage of the CFMA, Section 5a(14) of the Act mandated diversity of representation on exchanges' boards of directors.[1] With passage of the CFMA, the

[1] This provision of the Act was implemented by Commission Regulation 1.64, which required exchanges to establish meaningful representation for the following groups: (1) Futures commission merchants (FCMs); (2) floor brokers and traders; (3) independent non-members; (4) producers, consumers, processors, distributors, and merchandisers of commodities traded on the particular exchange (''commercials''); (5)

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requirements of Section 5a(14) were removed for exchanges, as Congress and the Commission moved to a more flexible, principles-based oversight regime that does not include specific composition targets for exchanges' boards of directors.[2] Mutually owned exchanges are still subject to mandatory board composition standards under Section 5(c)(16) of the Act (Core Principle 16), which requires ''that the composition of the governing board reflect market participants.'' The Application Guidance for Core Principle 16 identifies this as a ''diversity of interests'' requirement.

As part of the SRO Review, Commission staff examined the corporate documents of the major exchanges under CFTC authority and found that all require diversity of their boards of directors, including nonmember directors.[3] These diversity requirements are similar regardless of the exchanges' ownership structures, and they are present at all of the major exchanges. The Kansas City Board of Trade, for example, requires that nominating committees give ''special consideration to the desirability of having all interests of the Corporation represented on the Board of Directors.'' [4] The Chicago Mercantile Exchange (CME) requires that its board of directors have ''meaningful representation of a diversity of interests, including floor brokers, floor traders, futures commission merchants, [and commercials.].'' [5]

Some exchanges employ specific numerical targets for their various participant categories and public directors. For example, the New York Mercantile Exchange requires three public directors, one FCM, one floor broker, one commercial, and one local trader.[6] The New York Board of Trade requires five public directors.[7] The Minneapolis Grain Exchange requires four nonmember directors, and at least four commercials, two FCMs, two floor traders, and one floor broker.[8] The CME requires that independent, nonmember directors constitute twenty percent of its board and that commercials constitute ten percent of the board.[9] Moreover, the CME currently exceeds its own requirements, with seven of its twenty directors (thirty-five percent) being independent, nonindustry persons.

Most of those who commented or testified during the course of the SRO study generally agreed that diverse boards best serve the needs of exchanges and the public. Participants also agreed on the benefits of including public directors on exchange boards, and our review demonstrates that this is a model that most exchanges are following. In their comments and testimony, however, exchanges unanimously opposed having mandatory board composition requirements. CME argued, for example, that ''no one composition criteria can address the individual needs'' of the diverse exchanges and business models active in the industry.[10]

In my view, having a ROC that serves to insulate the regulatory functions of an exchange from its commercial interests, combined with a disciplinary panel structure that strengthens impartial adjudication and reduces potential conflicts of interest by including at least one public person on every panel and ensuring that such panels are not dominated by any group or class of exchange participants, may well be sufficient to ensure fair, vigorous, and effective self-regulation and should demonstrate compliance with Core Principle 15. Such an approach would be narrowly tailored to focus specifically on regulatory governance and functions, and would be in keeping with the flexibility the CFMA intended to afford exchanges to conduct business without undue interference from regulators.

I am concerned that the Board Composition proposal also would create an additional and perhaps unnecessary layer of regulation for publicly traded exchanges, which are already subject to myriad new and enhanced corporate governance requirements, including, among others, Securities and Exchange Commission registration requirements, the audit committee provisions of the Sarbanes-Oxley Act of 2002, and the listing standards of the New York Stock Exchange (NYSE). I agree that the dual function of exchanges as commercial enterprises and self-regulatory organizations sets them apart from corporations engaged in business for the sole purpose of earning profits for the benefit of shareholders. In my opinion, however, the foregoing corporate governance standards, combined with properly structured ROCs and disciplinary committees, and the Commission's continuing obligation to monitor exchanges through rule enforcement reviews and otherwise, have provided multiple levels of safeguards that should be sufficient to ensure that exchanges'' self-regulatory obligations are not compromised.

I recognize that what the Commission is contemplating is an acceptable practice rather than a mandatory requirement. In promulgating such guidance, however, the Commission should strive to establish standards that that are not overly broad and that are viewed as necessary, in most circumstances, to accomplish regulatory goals. Accordingly, I welcome comment on the advisability of adopting the proposed Board Composition Acceptable Practice, especially with respect to the following questions:

- Is there an existing problem that this proposal addresses?
- Will those exchanges that are not now subject to mandatory diversity requirements feel compelled to sacrifice voluntary diversity in order to increase the percentage of public directors and still maintain boards that are of manageable size, or will boards become larger? Is it feasible to comply with the acceptable practice and maintain the proper level of diversity? What are the relative costs and benefits of doing so?
- How would the acceptable practice affect mutually owned exchanges that are subject to the mandatory diversity requirements of Core Principle 16?
- How would the proposed requirement that exchange executive committees have at least fifty percent public representation affect the day-to-day operations of the exchanges?
- Is there any evidence that the proposed Board Composition Acceptable Practice will provide greater regulatory assurance than the proposed ROC and Disciplinary Panel Acceptable Practices?
- Do the corporate governance requirements currently applicable to publicly traded exchanges, combined with properly structured ROCs and disciplinary panels and continuing Commission oversight, provide sufficient assurance that conflicts of interests will be kept to a minimum in the decision making process of those exchanges?
- If the Commission adopts the Board Composition Acceptable Practice, should it be accompanied by a phase-in period and if so, what would be the appropriate length of time for exchanges to modify their boards?

I join with my Chairman and fellow Commissioners in requesting comment on this endeavor and look forward to reviewing the responses to these questions and any other views the Commission receives as we continue to consider the important issues raised in the proposal.

*Commissioner Michael V. Dunn, writing separately.*

The proposed acceptable practices published today represent an important step forward in ensuring the fairness and transparency of our commodity markets. I wish to comment on two aspects of the proposal.

First, the proposed rule notes that exchanges that elect to forgo the safe harbor of the best practices outlined in this proposal can still demonstrate compliance with Core Principle 15 through showing they have procedures and safeguards in place to address potential conflicts of interest. For these exchanges, the Commission will continue its current practice of reviewing the activities of these exchanges to ensure they are in compliance with Core Principle 15. Therefore, while the proposed acceptable practices offer a safe harbor for complying with Core Principle 15, they are not the only method of demonstrating compliance.

Second, efficient, transparent, and open markets bring great benefits to their

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participants in a variety of pits or principal groups of commodities traded on the exchange; and (6) other market users or participants. Specific composition targets existed only for commercials (ten percent) and nonmembers (twenty percent).

[2] Under Commission Regulation 38.2, exchanges are now exempt from Regulation 1.64.

[3] The corporate documents included the certificates of incorporation, bylaws, and rulebooks of the exchanges and their holding companies, if applicable.

[4] Kansas City Board of Trade Rulebook, Ch. II, § 210.01.

[5] Second Amended and Restated Bylaws of Chicago Mercantile Exchange Holdings, Inc., Art. III, § 3.5 (applicable to the board of trade through the Certificate of Incorporation of Chicago Mercantile Exchange, Inc., Art. V, § 3 (requiring that the board of directors of CME, Inc., be identical to that of CME Holdings, Inc.).

[6] Amended and Restated Certificate of Incorporation of NYMEX Holdings, Inc., Art. VI, § (c) (applicable to the board of trade through the Amended and Restated Certificate of Incorporation of New York Mercantile Exchange, Inc., Art. VII (the board of directors NYMEX Holdings, Inc., constitutes the board of NYMEX, Inc.).

[7] New York Board of Trade Bylaws, Art. II, § 302(c).

[8] Minneapolis Grain Exchange Rulebook, Ch. II, §§ 200.00 and 210.00.

[9] Note 5, *supra*.

[10] CME Comment Letter at 2.

participants and the public. The Commodity Futures Modernization Act of 2000 (CFMA), sought to safeguard these values by placing a much greater emphasis on industry self-regulation: setting out core principles registrants have to meet and giving industry flexibility in choosing how to comply.

While the Commission has final responsibility to ensure the fairness and transparency of the markets it regulates, its effectiveness in doing so relies heavily upon the presence of a robust self-regulatory system. Registered Futures Associations (RFAs) are provided for in the CEA to complement the Commission's oversight of commodities markets and to bring industry knowledge and experience to bear on regulatory issues affecting those markets.[1] In its June 2004 request for comments on SRO governance that led to this proposal, the Commission asked, ''Should registered futures associations that are functioning as SROs also be subject to governance standards?'' In its response, the National Futures Association (''NFA''), the sole RFA, wrote that ''registered futures associations should be subject to the same governance standards as the other SROs,'' as long as these standards are flexible.

As the sole RFA, NFA occupies a unique position in the futures markets' system of self-regulation. NFA is entrusted with overseeing a wide variety of futures market intermediaries, cutting across different segments of the futures industry, including futures commission merchants, commodity pool operators (''CPOs''), commodity trading advisers (''CTA''), and introducing broker-dealers (''IBs''). NFA's functions are as varied as the members it oversees. NFA performs registration and fitness screening functions, conducts audits and surveillance of its members to enforce compliance with financial requirements, establishes and enforces rules and standards for customer protection, and conducts arbitration of futures-related disputes. NFA also has taken certain functions delegated to it by the Commission and more recently, has assumed trade practice and market surveillance activities for a number of exchanges.[2]

In light of the concerns raised in this proposal regarding conflicts of interest and self-regulation, I believe the Commission needs to review the conflicts of RFAs as well as exchanges. In this proposal, the Commission indicates in footnote 4 that we will be considering this matter further, and I look forward to that consideration.

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[1] *See generally* Section 17 of the Act, 7 U.S.C. 21. An RFA must be determined by the Commission to be in the public interest. Id. at Section 17(b)(1), 7 U.S.C. 21(b)(1).

[2] When an RFA extends its sphere of operation beyond traditional, self-regulatory roles to include such ancillary activities, it appropriately should reexamine the methods it uses to manage and minimize conflicts of interests, to determine whether these methods remain adequate to meet changed circumstances.