37°42′30″ N., long. 112°55′00″ W., to lat. 37°43′00″ N., long. 112°43′00″ W., thence to the point of beginning.

Issued in Seattle, Washington, on October 6, 2010.

John Warner,

Manager, Operations Support Group, Western Service Center.

[FR Doc. 2010–26096 Filed 10–15–10; 8:45 am]

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COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 37, 38, 39, and 40

RIN 3038–AD01

Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest

AGENCY: Commodity Futures Trading Commission.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Commodity Futures Trading Commission (the "Commission") hereby proposes rules to implement new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Specifically, the proposed rules contained herein impose new requirements on derivatives clearing organizations ("DCOs"), designated contract markets ("DCMs"), and swap execution facilities ("SEFs") with respect to mitigation of conflicts of interest.

DATES: Submit comments on or before November 17, 2010.

ADDRESSES: You may submit comments, identified by RIN number, by any of the following methods:

- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.
- *Agency Web Site: http://www.cftc.gov.* Follow the instructions for submitting comments on the Web site.
- *E-mail: dcodcmsefGovernance@cftc.gov.*
- *Fax:* 202–418–5521.
- *Mail:* David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.
- *Hand Delivery/Courier:* Same as mail above.

FOR FURTHER INFORMATION CONTACT: Nancy Liao Schnabel, Special Counsel, Division of Clearing and Intermediary Oversight (DCIO), at 202–418–5344 or *nschnabel@cftc.gov;* Lois Gregory, Assistant Deputy Director for Market Review, the Division of Market Oversight (DMO), at 202–418–5569 or *lgregory@cftc.gov;* Andrea Musalem, Special Counsel, DCIO, at 202–418–5167 or *amusalem@cftc.gov;* Jordan O'Regan, Attorney-Advisor, DCIO, at 202–418–5984 or *joregan@cftc.gov;* Cody Alvarez, Attorney-Advisor, DMO, at 202–418–5404 or *calvarez@cftc.gov;* Dana Brown, Law Clerk, DMO, at 202–418–5093 or *dbrown@cftc.gov;* Jolanta Sterbenz, Counsel, Office of the General Counsel, at 202–418–6639 or *jsterbenz@cftc.gov;* David Reiffen, Senior Economist, Office of the Chief Economist, at 202–418–5602 or *dreiffen@cftc.gov;* or Alicia Lewis, Attorney-Advisor, DCIO, at 202–418–5862 or *alewis@cftc.gov;* in each case, also at the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

SUPPLEMENTARY INFORMATION:

I. Background

On July 21, 2010, President Obama signed the Dodd-Frank Act.[1] Title VII of the Dodd-Frank Act [2] amended the Commodity Exchange Act ("CEA") [3] to establish a comprehensive new regulatory framework for swaps and certain security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (i) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; [4] (ii) imposing mandatory clearing and trade execution requirements on clearable swap contracts; (iii) creating robust recordkeeping and real-time reporting regimes; and (iv) enhancing the rulemaking and enforcement authorities of the Commission with respect to, among others, all registered entities and intermediaries subject to the oversight of the Commission.

In order to ensure the proper implementation of the comprehensive new regulatory framework, especially with respect to (ii) above, the Dodd-Frank Act requires [5] the Commission to promulgate rules to mitigate conflicts of interest in the operation of certain DCOs, DCMs, and SEFs. First, Section 726(a) of the Dodd-Frank Act specifically empowers the Commission to adopt "numerical limits * * * on control" or "voting rights" that enumerated entities [6] may hold with respect to such DCOs, DCMs, and SEFs. Second, Section 726(b) of the Dodd-Frank Act directs the Commission to determine the manner in which its rules may be deemed necessary or

[1] *See* Dodd-Frank Act, Pub. L. 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at *http://www.cftc.gov./LawRegulation/OTCDERIVATIVES/index.htm.*

[2] Pursuant to Section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

[3] 7 U.S.C. 1 *et seq.*

[4] In this release, the terms "swap dealer" and "major swap participant" shall have the meanings set forth in Section 721(a) of the Dodd-Frank Act, which added Sections 1a(49) and (33) of the CEA. However, Section 721(c) of the Dodd-Frank Act directs the Commission to promulgate rules to further define, among other terms, "swap dealer" and "major swap participant." The Commission is in the process of this rulemaking. *See, e.g., http://www.cftc.gov/LawRegulation/OTCDerivatives/OTC_2_Definitions.html.* The Commission anticipates that such rulemaking will be completed by the statutory deadline of July 15, 2011.

[5] *See* the following colloquy between Representative Stephen Lynch and Representative Barney Frank on the language that became Section 726 of the Dodd-Frank Act:

Madam Speaker, for the purpose of a colloquy, I would like to engage with the chairman of the committee and the drafter of this legislation. I congratulate him on the great work he has done on this reform bill.

Mr. Chairman, I want to call your attention to sections 726 and 765 of the bill. These two provisions require the CFTC and the SEC to conduct rulemakings to eliminate the conflicts of interest arising from the control of clearing and trading facilities by entities such as swap dealers and major swap participants.

This problem arises because, right now, 95 percent of all of the clearinghouses in this country are owned by just five banks. So, while we are relying on the clearinghouses to reduce systemic risk, we have the banks now owning the clearinghouses.

The question I have is regarding the intent of the conferees in retaining subsection B of these provisions. It could be loosely construed to leave it up to the agencies whether or not to adopt rules.

Mr. Chairman, do you agree that my reading of sections 726 and 765 affirmatively require these agencies to adopt strong conflict of interest rules on control and governance of clearing and trading facilities?

Mr. FRANK of Massachusetts. If the gentleman would yield to me, he has been a leader in this important area, and he is a careful lawyer and understands that just saving a principle isn't enough. You've got to make sure it is carried out. Dealing with a conflict of interest that he has been a leader in identifying is essential if this is going to work. So I completely agree with him. Yes, we mean both of those subsections, and it is a mandatory rulemaking.

I will say to my neighbor from Massachusetts that we will be monitoring this carefully. They can expect oversight hearings because, yes, this is definitely a mandate to them to adopt rules to deal with what would be a blatant conflict of interest in the efficacy rules, and we intend to follow that closely.

156 Cong. Rec. H5217 (2010).

[6] The "enumerated entities" include: (i) Bank holding companies with over $50,000,000,000 in total consolidated assets; (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; (iii) an affiliate of (i) or (ii); (iv) a swap dealer; (v) a major swap participant; or (vi) an associated person of (iv) or (v).

appropriate to improve the governance of certain DCOs, DCMs, or SEFs or to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with the interaction between swap dealers and major swap participants, on the one hand, and such DCOs, DCMs, and SEFs. Finally, Section 726(c) of the Dodd-Frank Act directs the Commission to consider the manner in which its rules address conflicts of interest in the abovementioned interaction arising from equity ownership, voting structure, or other governance arrangements of the relevant DCOs, DCMs, and SEFs. The Commission must complete a rulemaking under Section 726 of the Dodd-Frank Act within 180 days after enactment—*i.e.*, by January 14, 2011.[7]

In carrying out Section 726 of the Dodd-Frank Act,[8] the Commission identifies in Section II below the following potential conflicts of interest:

• Conflicts of interest that a DCO may confront when determining (i) whether a swap contract is capable of being cleared, (ii) the minimum criteria that an entity must meet in order to become a swap clearing member, and (iii) whether a particular entity satisfies such criteria; [9] and

• Conflicts of interest that a DCM or SEF may confront in balancing advancement of commercial interests and fulfillment of self-regulatory responsibilities.

The Commission proposes in Section III below (i) structural governance requirements and (ii) limits on the ownership of voting equity and the exercise of voting power, and describes, in each case, the manner in which such proposals may mitigate conflicts of interest in the operation of a DCO, DCM, or SEF.[10]

In general, the proposed rules include strengthened versions of the acceptable practices that the Commission previously adopted for the DCM core principle on conflicts of interest.[11] The proposed rules impose structural governance requirements and limits on the ownership of voting equity and the exercise of voting power. They impose specific composition requirements on DCO, DCM, or SEF Boards of Directors and require each DCO, DCM, or SEF to have a nominating committee and one or more disciplinary panels. Each DCO must have a risk management committee and each DCM or SEF must have a regulatory oversight committee and a membership or participation committee, subject to specific composition requirements.

The proposed rules limit DCM or SEF members (and related persons) from beneficially owning more than twenty (20) percent of any class of voting equity in the registered entity or from directly or indirectly voting an interest exceeding twenty (20) percent of the voting power of any class of equity interest in the registered entity. With respect to a DCO only, the proposed rules require a DCO to choose one of two alternative limits on the ownership of voting equity or the exercise of voting power. Under the first alternative, no individual member may beneficially own more than twenty (20) percent of any class of voting equity in the DCO or directly or indirectly vote an interest exceeding twenty (20) percent of the voting power of any class of equity interest in the DCO. In addition, the enumerated entities, whether or not they are DCO members, may not collectively own on a beneficial basis more than forty (40) percent of any class of voting equity in a DCO, or directly or indirectly vote an interest exceeding forty (40) percent of the voting power of any class of equity interest in the DCO.

Under the second alternative, no DCO member or enumerated entity, regardless of whether it is a DCO member, may own more than five (5) percent of any class of voting equity in the DCO or directly or indirectly vote an interest exceeding five (5) percent of the voting power of any class of equity interest in the DCO.

Notwithstanding the foregoing, the proposed rules recognize that circumstances may exist where neither alternative would be appropriate for a DCO. Consequently, the proposed rules provide a procedure for the DCO to apply for, and the Commission to grant, a waiver of the limits specified in the first and second alternative.

The proposed rules reflect consultation with staff of the following agencies: (i) The Securities and Exchange Commission (the "SEC"); [12] (ii) the Board of Governors of the Federal Reserve, (iii) the Office of the Comptroller of the Currency; (iv) the Federal Deposit Insurance Corporation; and (v) the Treasury Department. Staff from each of these agencies has provided verbal and/or written comments, and the proposed rules incorporate elements of the comments provided. The proposed rules have been further informed by (i) the joint roundtable that Commission and SEC staff conducted on August 20, 2010 (the "Roundtable") [13] and (ii) public comments posted to the Web site of the Commission.[14] Finally, mindful of the importance of international harmonization,[15] the proposed rules incorporate certain elements of: (i) The *Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties, and Trade Depositories* (the "European Commission Proposal"); [16] and (ii) the latest draft of the *Principles for Financial Market Infrastructures,* which would ultimately be reviewed by the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of the

[7] In adopting rules to implement Section 726 of the Dodd-Frank Act, the Commission is also implementing Section 725(d) of the Dodd-Frank Act. The latter states: "[t]he Commodity Futures Trading Commission shall adopt rules mitigating conflicts of interest in connection with the conduct of business by a swap dealer or a major swap participant with a derivatives clearing organization, board of trade, or a swap execution facility that clears or trades swaps in which the swap dealer or major swap participant has a material debt or material equity investment."

[8] Although the Commission is proposing the rules contained herein to specifically carry out Section 726 of the Dodd-Frank Act (as well as Section 725(d) of the Dodd-Frank Act), the Commission notes that it has additional authority to propose such rules under Sections 735(b), 735(c), and 733 of the Dodd-Frank Act. *See infra* note 17 for a more extensive description of Sections 735(b), 735(c), and 733 of the Dodd-Frank Act.

[9] The Commission requests comment as to whether DCOs, like DCMs and SEFs, have (or potentially may have) other conflicts of interest that implicate the balance between advancement of commercial interests and fulfillment of self-regulatory responsibilities.

[10] Commission regulations (the "Regulations") referred to herein are found at 17 CFR Ch. 1.

[11] *See, generally,* "Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations," 74 FR 18982 (April 27, 2009) (which defined "public director"); 72 FR 6936 (Feb. 14, 2007) (which adopted final acceptable practices for the DCM core principle) (the "DCM Conflicts of Interest Release"); 71 FR 38740 (July 7, 2006) (which proposed acceptable practices for the DCM core principle).

Currently, DCM core principle 15 addresses conflicts of interest. *See* 7 U.S.C. 7(d)(15). The Dodd-Frank Act has redesignated DCM core principle 15 as DCM core principle 16, but has left the actual language of the principle substantively unchanged.

[12] Section 765 of the Dodd-Frank Act requires the SEC to promulgate rules to mitigate conflicts of interest in the operation of (i) a clearing agency that clears security-based swaps, (ii) a security-based swap execution facility, or (iii) a national securities exchange that posts or makes available for trading security-based swaps.

[13] The transcript from the roundtable (the "Roundtable Tr.") is available at: *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/derivative9sub082010.pdf.*

[14] Such comments are available at: *http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_9_DCOGovernance.html.*

[15] Currently, the Commission regulates certain entities based outside of the United States (*e.g.*, LCH.Clearnet Limited and ICE Clear Europe Limited ("ICE Clear Europe"), each of which is based in the United Kingdom).

[16] COM(2010) 484/5.

International Organization of Securities Commissions.

The Commission anticipates conducting at least one other rulemaking that may impose requirements on DCOs, DCMs, and SEFs with respect to governance and mitigation of conflicts of interest.[17] The Commission expects to finish such rulemaking by the statutory deadline of July 15, 2011.

The Commission requests comment on all aspects of this release.

II. Conflicts of Interest

As mentioned above, Title VII of the Dodd-Frank Act amended the CEA to establish a comprehensive new framework for swaps and security-based swaps. This framework imposes mandatory clearing and trade execution requirements with respect to clearable swap contracts. Some market participants, investor advocates, and academics have expressed a concern that the enumerated entities have economic incentives to minimize the number of swap contracts subject to mandatory clearing and trading. They contend that control of a DCO by the enumerated entities, whether through ownership or otherwise, constitutes the primary means for keeping swap contracts out of the mandatory clearing requirement, and therefore also out of the trading requirement. The Commission addresses these arguments below. The Commission also examines the contention that sustained competition between DCMs or SEFs with respect to the same swap contracts may exacerbate certain structural conflicts of interest, as the DCM Conflicts of Interest Release defines such term.[18]

a. DCOs

In general, in the commodity futures and options markets, the DCM decides which contracts to list, whereas the DCO manages the risk of guaranteeing such contracts. Clearing members exercise significant control over the manner in which a DCO manages risk, whether the members own the DCO or not.[19] Based on Commission experience, such control has generally permitted the DCO to serve the purposes of the CEA, especially with respect to "ensur[ing] the financial integrity of all transactions subject to [the CEA] and the avoidance of systemic risk."[20] Clearing members contribute substantial financial resources to the DCO default or guarantee fund. If a clearing member defaults, and the DCO holds insufficient performance bond from such member to cover its losses, then the DCO would access the default or guarantee fund. Thus, the DCO spreads its losses across all clearing members. This mechanism creates an incentive for each clearing member to ensure that (i) other clearing members meet certain financial requirements and (ii) the DCO adopt a conservative approach towards risk management, especially in determining whether a particular contract would be acceptable for clearing.

This same mechanism also creates a disincentive for clearing members to act collectively (i) to exclude other entities from becoming clearing members or (ii) to bar a DCO from accepting new commodity futures or options contracts. After all, each new clearing member must contribute to the default or guarantee fund. Such contribution would result in a *pro rata* decrease in the potential exposure of each other clearing member to a default. Moreover, clearing members generally had little incentive to prevent the DCO from accepting a particular contract, absent a risk-based objection. In fact, the more different types of contracts that a DCO accepts, the more the intermediation services that such clearing member offers would likely be in demand.

The regulated market structure that the Dodd-Frank Act contemplates for swap contracts is, in many ways, the mirror image of the market structure for commodity futures and option contracts. Currently, most swap contracts are privately negotiated between two parties, and are generally not cleared.[21] Section 723 of the Dodd-Frank Act requires: (i) Swap contracts meeting certain criteria to be cleared with a DCO; and (ii) such contracts to be executed on a DCM or SEF (unless no DCM or SEF lists such contracts). Therefore, a DCO has unprecedented influence over the manner in which a swap contract can be executed.

Certain market participants and academics believe that Section 723 of the Dodd-Frank Act does not introduce any new incentives for clearing members to act collectively (i) to exclude other entities from becoming clearing members or (ii) to bar a DCO from accepting new contracts. First, they argue that clearing does not make a bilateral swap contract less profitable.[22] Second, they contend that, because clearing does not impact the profitability of a bilateral swap contract, swap clearing members that are

[17] Such rulemaking would implement Sections 735(b) and 725(c) of the Dodd-Frank Act, which amends Sections 5(d) and 5b(c) of the CEA to add new core principles, or to supplement existing core principles, regarding the governance of DCMs and DCOs, and the mitigation of conflicts of interest in the operation of such entities. Such core principles would apply to all DCMs and DCOs, regardless of whether they clear or list swap contracts or only commodity futures or options. Such rulemaking would also implement Section 733 of the Dodd-Frank Act, which inserts new Section 5h of the CEA to create a registration category for SEFs, and to impose core principles that include the mitigation of conflicts of interest. The Commission is considering the proposals set forth below, among others, with respect to the second rulemaking: (1) Requiring each DCO, DCM, or SEF to have a regulatory program to (i) identify, on an ongoing basis, existing and potential conflicts of interest, and (ii) to make decisions in the event of such conflict; (2) mandating that each DCO, DCM, or SEF (i) prescribe limits on use of non-public information, and (ii) afford transparency with respect to governance arrangements; (3) requiring each DCO, DCM, or SEF to report to the Commission whenever (i) the Board of Directors rejects a recommendation or supersedes an action of the DCM or SEF Regulatory Oversight Committee, DCM or SEF Membership or Participation Committee, or DCO Risk Management Committee, as applicable, or (ii) the DCO Risk Management Committee rejects or supersedes an action of the DCO Risk Management Subcommittee, if applicable; (4) mandating minimum governance fitness standards for DCO and DCM members and participants; and (5) prescribing minimum standards regarding (i) DCM consideration of market participant views and (ii) the diversity of DCM Board of Directors, if the DCM is publicly-listed.

[18] According to the DCM Conflicts of Interest Release, "[t]he presence of potentially conflicting demands within a single entity—regulatory authority coupled with commercial incentives to misuse such authority—constitutes the new structural conflict of interest addressed by the acceptable practices adopted herein." 72 FR at 6937.

[19] The CME Group, Inc. (the "CME Group"), a publicly-listed corporation, wholly owns the Chicago Mercantile Exchange, Inc. ("CME"). However, CME Clearing House, a division of CME, has a Risk Committee that is composed of: (i) Two members of the CME Board of Directors; (ii) five clearing member representatives; and (iii) two additional individuals, one of whom cannot be a clearing member representative. *See* CME Rule 403.A, available at: *http://www.cmegroup.com/rulebook/CME/I/4/03.html.*

[20] *See* Section 3(b) of the CEA, 7 U.S.C. 5(b).

[21] *See, e.g.,* Darrel Duffie, Ada Li, Theo Lubke, "Policy Perspectives on OTC Derivatives Market Infrastructure," Federal Reserve Bank of New York Staff Report No. 424, dated January 2010, as revised March 2010 (the "*FRBNY Staff Report*"). According to Section II of the FRBNY Staff Report, "[a]n over-the-counter trade is privately negotiated between the buyer and seller." According to Section VII(A)(i) of the FRBNY Staff Report, "[o]nly some types of OTC derivatives are now cleared. These include, for example, certain actively traded credit derivatives, some common forms of interest-rate swaps, and some energy derivatives. Of these 'eligible' types of OTC derivatives, those for which clearing has been set up, not all positions are actually cleared; the decision of which positions to clear has to this point been left to the discretion of market participants."

[22] *See, e.g.,* Comments from James Hill, Managing Director and Global Credit Derivatives Officer, Morgan Stanley, representing the Securities Industry and Financial Markets Association ("Hill") ("I think there's a bit of a misconception that somehow clearing makes trades less profitable. That's clearly not the case. In fact, I think most of the large systemically important participants in this market prefer clearing. And I think that's not just a statement; there is significant anecdotal evidence to support that perhaps the most important of which is LCH"), Roundtable Tr. at 21–22.

enumerated entities have specific, risk-based justifications for (i) setting membership criteria that exclude certain entities [23] and (ii) determining that certain swap contracts cannot be cleared.[24] Third, they assert that such swap clearing members must have the right to cause the DCO to act on such justifications, since ultimately, the capital of such clearing members (*i.e.,* their contributions to the default or guarantee fund) may be accessed if a fellow clearing member defaults.[25]

Others do not agree. They maintain that certain enumerated entities are active in the over-the-counter swap markets [26] and that they earn significant revenues from this line of business.[27] Such entities may experience substantial decreases in revenues if swap contracts were required to be (i) cleared with a DCO and (ii) executed on a DCM or SEF.[28] Therefore, some contend that such entities may have an incentive to represent that certain swap contracts do not meet the mandatory clearing criteria under Section 723 of the Dodd-Frank Act.[29] Such swap contracts would also not be subject to the trading requirement under Section 723 of the Dodd-Frank Act.

Although Section 723 of the Dodd-Frank Act grants the Commission ultimate authority to determine whether a swap contract must be cleared with a DCO, it also anticipates that the Commission would consider the risk assessment of DCOs. Currently, DCOs that clear large volumes of swap contracts tend to have swap clearing members that consist exclusively of enumerated entities.[30] Therefore, some argue that the risk assessment of such DCOs may be compromised.[31]

[23] *See, e.g.,* Comments from Hill ("as a general rule, the clearing member needs to be able to absorb losses, a default by another clearing member, number one; and, number two, they need to be able to absorb the economic transaction risk in the portfolio of a defaulting member * * * And so the way these clearinghouses set up their risk, you know, their admission or their membership criteria, is both of those things. So, A, they have to have a capital base sufficient to absorb losses and add in more capital to the clearinghouse if a member defaults. And B, they have to be able to in a situation where a clearing member has defaulted, which is probably the time of most economic stress, you know, in the economy, be able to take down the economic transaction risk of the swaps that were otherwise, the defaulting member was otherwise a party to, those trades need to be allocated among the surviving clearing members * * * And so the way these clearinghouses developed their criteria is they look at both of those prongs and they set thresholds to make sure that the members who are admitted can do those things. Because, remember, if you admit a member who can't do both of those things, then what happens is the clearinghouse will have insufficient capital in a situation where a member has defaulted, which is the time of the highest economic stress"), Roundtable Tr. at 28 to 29.

[24] *See, e.g.,* Comments from Hill ("In evaluating what trades should be cleared, there's a balance that needs to be struck between the goal of increasing clearing, obviously, but, B, you don't want to put trades in the clearinghouse that can't be appropriately risk-managed. So if you put trades in the clearinghouse that are illiquid and can't be valued properly, what will happen is when a clearing member defaults, there will be insufficient collateral with respect to that trade because it wasn't properly valued in the clearinghouse, and the surviving clearing members will be stressed from an economic perspective in taking positions the value of which cannot be readily ascertained. So it's critical that only trades that can be appropriately risk-managed be put into the clearinghouse. And I think what you'll see is that most of the clearinghouses look to their clearing members to help them valuate which trades are appropriate from a clearing perspective, and that is completely consistent with the economic incentives because the clearing members are the ones who have the overwhelming preponderance of the capital in the clearinghouse. So it's their capital that's at risk. They should certainly have a say in helping the clearinghouse evaluate which trades are acceptable for clearing and which trades are too risky or can't be valued, or are too illiquid or not standardized and, therefore, shouldn't be cleared"), Roundtable Tr. at 43 to 45.

[25] *Id. See, also, e.g.,* Comments from Lee Olesky, Chief Executive Officer and Co-Founder, TradeWeb ("*Olesky*") ("And I second Mr. Hill's comments. I think that it's very important that the people who bear the risk and supply the capital should have a substantial voice in how that risk gets managed, and that includes what contracts are accepted for clearing"), Roundtable Tr. at 46.

[26] For example, according to the Office of the Comptroller of the Currency ("OCC"), as of the second quarter of 2009, U.S. commercial banks held derivatives with $203.5 trillion in notional value. Of that $203.5 trillion, the top five commercial banks held approximately $197 trillion. The top five commercial banks were: (i) JPMorgan Chase Bank N.A.; (ii) Goldman Sachs Bank USA; (iii) Bank of America N.A.; (iv) Citibank N.A.; and (v) Wells Fargo Bank N.A. The sixth commercial bank, holding approximately $3 trillion, was HSBC Bank USA N.A. *See* OCC's Quarterly Report on Bank Trading and Derivatives Activities, Second Quarter 2009.

[27] *Id.* (stating that "U.S. commercial banks reported revenues of $5.2 billion trading cash and derivative instruments in the second quarter of 2009, compared to a record $9.8 billion in the first quarter").

[28] According to Section VI of the FRBNY Staff Report, "[e]ven after an OTC derivatives product has achieved relatively active trading, and would be suitable for exchange trading, dealers have an incentive to maintain the wider bid-ask spreads that they can obtain in the OTC market relative to the spreads that might apply to the same product on an exchange, where buyers and sellers can more directly compete for the same trade. Further, exchanges are more likely to match ultimate buyers to sellers, reducing the fraction of trades intermediated by dealers. Thus, from the viewpoint of their profits, dealers may prefer to reduce the migration of derivatives trading from the OTC market to central exchanges."

[29] *See, e.g.,* Comments of Heather Slavkin, Senior Legal and Policy Advisor, Office of Investment, AFL–CIO ("Slavkin") ("If there's an interest among the people who own the clearinghouse, or a conflict of interest that would create incentives for them to also favor, you know, [not] allowing certain types of swaps to clear because they may be more profitable for the institution generally if they remain over the counter, then that can create perverse incentives to maintain the OTC, nontransparent, systemically risky markets when the goal needs to be to prevent those conflicts of interest to ensure that anything that can be cleared does, in fact, clear"), Roundtable Tr. at 21; Comments of Darrell Duffie, Dean Witter Distinguished Professor of Finance at the Graduate School of Business, Stanford University ("Duffie") ("We talked earlier about how the members of the clearinghouse should determine what gets traded, and we also have conflicts of interest arising from the incentives of the dealers to profit from bid versus ask on products that are not traded on swap execution facilities. So the interaction effect here is effectively if one gets cleared as one gets traded on a swap execution facility, then we want to be very careful that the members of a central clearing counterparty that determine what gets cleared and, therefore, have control over what gets traded on swap execution facilities are the members that have, you know, the right social incentives to create competition"); Comments of Michael Greenberger, Professor, University of Maryland School of Law ("Greenberger") ("If you have one clearinghouse dominated by the major swaps dealers, they have several conflicting incentives. One is, I reject the idea that somehow they do not want to keep a large and vibrant over-the-counter market. We're told that clearing is very profitable. If it was that profitable, where were these people when we were aggressively arguing for mandatory clearing and exchange trading? They were on the opposite side of that. The transaction fees and the spreads still make an unregulated market very, very profitable, probably more profitable than the profits that would derive from clearing. So, if you have the swaps dealers in control of a clearing facility, they have that incentive"), Roundtable Tr. at 111.

[30] For example, as of July 2, 2010, ICE Clear Europe cleared approximately $3.3 trillion in European credit default swap ("*CDS*") indices and an additional $501 billion in European CDS single-name instruments. *See* "ICE Surpasses $10 Trillion Milestone in Global CDS Clearing," available at: *http://ir.theice.com/releasedetail.cfm?ReleaseID=485527.*

As of September 20, 2010, all CDS clearing members of ICE Clear Europe are banks, bank holding companies, or affiliates thereof. Such members are: (i) Banc of America N.A.; (ii) Barclays Bank PLC; (iii) BNP Paribas; (iv) Citigroup Global Markets Limited; (v) Credit Suisse International; (vi) Deutsche Bank AG; (vii) Goldman Sachs International; (viii) HSBC Bank PLC; (ix) JPMorgan Chase Bank, N.A.; (x) Morgan Stanley Capital Services, Inc.; (xi) Nomura International PLC; (xii) Société Générale; (xiii) The Royal Bank of Scotland PLC; (xiv) UBS AG, London Branch; and (xv) UniCredit Bank AG. *See* ICE Clear Europe, Clearing Members, available at: *https://www.theice.com/publicdocs/clear_europe/ICE_Clear_Europe_Clearing_Member_List.pdf,* and the release updating such list, available at *https://www.theice.com/publicdocs/clear_europe/circulars/C10080.pdf.*

ICE Trust U.S. LLC ("ICE Trust"), an affiliate of ICE Clear Europe, cleared approximately $6 billion in North American CDS indices and $272 billion in North American single-name indices. The CDS clearing members of ICE Clear Europe and ICE Trust generally overlap (counting affiliated entities), except that Merrill Lynch International is a clearing member of ICE Trust and Société Générale and UniCredit Bank AG are not. *See* ICE Trust, Participant List, available at: *https://www.theice.com/publicdocs/ice_trust/ICE_Trust_Participant_List.pdf.* ICE Trust is currently not a DCO.

[31] *See* note 29 above. *See, also,* Comments from Slavkin ("I think that there's the risk that anything that could be made to appear to be something that is a bilateral * * * contract, you could have the spurious customization issues, if there's the opportunity to get additional profits within the big dealer banks, and those same dealer banks are

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Moreover, some contend that the swap clearing members of such DCOs may exclude non-enumerated entities from becoming clearing members, because non-enumerated entities may influence risk assessments of DCOs in favor of clearing more swap contracts.[32] Some market participants maintain that such practices may have systemic implications.[33]

The framers of the Dodd-Frank Act observe that the clearing of swap contracts constitutes a key means for managing systemic risk, because clearing removes the type of interconnectedness between financial institutions that contributed to the financial crisis resulting from the failure and bankruptcy of firms such as Bear Stearns, Lehman Brothers, and AIG.[34] Therefore, it is important to mitigate potential conflicts of interest that may prevent clearable swap contracts from becoming subject to mandatory clearing. At the same time, the Commission recognizes that the safety and soundness of a DCO should not be compromised. A DCO must not only have the ability to appropriately manage the risk associated with each and every contract that it guarantees, it must be able to decline accepting contracts for clearing if they pose unacceptable risks. In addition, DCO members must have input in setting membership criteria, because they bear the risk of loss in the event of member default. Nevertheless, the Commission does not believe that (i) subjecting more swap contracts to mandatory clearing is incompatible with (ii) DCO safety and soundness.[35] Rather, the Commission intends to ensure, through the proposed rules below, that a DCO takes action to achieve both (i) and (ii), and that the private, competitive interests of certain DCO members do not capture DCO risk assessments.

b. DCMs and SEFs

The main function of a DCM, as well as a SEF, is to provide a facility for: (i) The discovery of prices; and (ii) the execution of transactions. However, in order to obtain and maintain a license to perform such a function, each DCM and SEF must fulfill self-regulatory obligations under the CEA and the Dodd-Frank Act.[36] Therefore, although each DCM or SEF[37] is a commercial enterprise, the fact that each entity has self-regulatory obligations means that each entity "is not simply a corporation, but a corporation charged with the public trust."[38] Section 3(b) of the CEA confers on the Commission the responsibility for ensuring that each DCM or SEF appropriately prioritizes its self-regulatory obligations. Such obligations include appropriately implementing the comprehensive new framework that the Dodd-Frank Act sets forth, as well as meeting existing requirements under the CEA.

As the DCM Conflicts of Interest Release notes, increased competition may exacerbate conflicts of interest, causing a DCM to (i) prioritize commercial interests over self-regulatory responsibilities;[39] and (ii) restrict access or impose burdens on access in a discriminatory manner.[40]

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running and controlling the clearinghouses, then, you know, the potential for spurious customization becomes a real issue and becomes a possibility"), Roundtable Tr. at 40.

In addition to noting that the enumerated entities may have incentives to influence DCO risk assessments in favor of considering fewer contracts to be suitable for mandatory clearing, certain academics have observed that, for those contracts that nonetheless are cleared, the enumerated entities may have incentives to lower risk management standards. *See, e.g.,* Comments from Greenberger ("* * * yes, certain products will be cleared because they are profitable and [the enumerated entities] may over calculate and be over enthused about clearing things that are too risky"), Roundtable Tr. at 112. For example, the enumerated entities may not accurately calculate the amount of performance bond and/or guarantee or default fund contributions necessary to clear a particular swap contract.

[32] *See, e.g.,* Comments from Jason Kastner, Vice Chairman, Swaps and Derivatives Markets ("Kastner") ("Let me give you a specific example. One of the members of this SDMA currently clears 13 percent of the business at a large exchange in Chicago. That large, independent FCM is clearly qualified to become a swap clearing member. But because of various conflicts of interest, the risk committee of said exchange is precluding that firm, which is clearly qualified and has the capital, from becoming a swap clearing member * * * this goes back to the governance point and transparency about who's making that decision and why, because a lot of times what happens is people will swallow themselves in the cloak of risk management or financial stability or whatever really to make an anti-competitive stand. In other words, you can never say that you don't want to let somebody in. But you could probably find an excuse or a reason in the interest of systematic—you know, systemic stability and the rest of it to put an asterisk on the application or just delay it for awhile"), Roundtable Tr. at 90–91.

See, also, infra note 67 on the potential non-availability of arrangements whereby a non-clearing futures commission merchant may present a customer trade to a swap clearing member for clearing with a DCO.

[33] In *Lessening Systemic Risk: Removing Final Hurdles to Clearing OTC Derivatives,* the Swaps and Derivatives Market Association states: "[r]estricted access leads to reduced clearing which leads to systemic risk."

[34] *See, e.g.,* the letter from Senators Christopher Dodd and Blanche Lincoln, respective chairs of the Senate Banking and Agriculture Committee, to Representatives Barney Frank and Collin Peterson, respective chairs of the House Financial Services and Agriculture Committees, dated June 30, 2010 (stating that "Congress determined that clearing is at the heart of reform—bringing transactions and counterparties into a robust, conservative and transparent risk management framework").

[35] Certain Roundtable participants agree. *See* Comments from Duffie ("I don't think there's a conflict between the incentives for competition, increasing competition in this market on the one hand and the incentives for improving financial stability on the other, or I don't think there's a problem between those two. You can * * * have both. The incentives to watch for on competition are that we've got enough access by multiple market * * * participants, and that the oligopolistic nature of the market is, to some extent, watched carefully by regulators"), Roundtable Tr. at 104.

[36] Section 3(a) of the CEA defines the "national public interest" that transactions in commodity futures and options and swaps serve. It states, "[t]he transactions subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities." 7 U.S.C. 5(a). The importance of transactions in commodity futures and options, as well as swaps, forms the basis for Commission regulation of DCMs and SEFs.

Section 3(b) of the CEA describes the system of regulation that Congress has directed the Commission to implement to achieve the abovementioned purposes. It states: "[i]t is the purpose of this chapter to serve the public interests * * * through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission." 7 U.S.C. 5(a). The Commission has interpreted the "self-regulation" referenced in Section 3(b) of the CEA as encompassing both (i) the registered entity ensuring that members meet applicable statutory requirements, and (ii) the registered entity having systems to ensure that it continues to meet applicable statutory requirements. For example, as the Commission previously stated in the DCM Conflicts of Interest Release, "Core Principle 15 requires DCMs to maintain systems to minimize structural conflicts of interest inherent in self-regulation, as well as individual conflicts of interest faced by particular persons. The acceptable practices are rationally related to the purposes of Core Principle 15." 72 FR at 6937, 6940.

[37] As mentioned above, the SEF is a new registration category that the Dodd-Frank Act created. Therefore, the Commission has never opined as to whether a SEF is a "self-regulatory organization" within the meaning of Regulation 1.3(ee). However, a SEF has self-regulatory obligations under the Dodd-Frank Act, as the Commission has interpreted such obligations in the DCM Conflicts of Interest Release. For example, to the extent that a SEF determines that it must impose requirements on members in order to comport with a core principle (*e.g.,* with respect to position limits), a SEF must monitor member compliance with such requirement, and must have the authority and ability to enforce such requirement. *See* Section 5h(f)(2)(A) of the CEA, as added by Section 733 of the Dodd-Frank Act.

[38] Preamble to proposed acceptable practices on "Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations," 71 FR 38740, 38741 (July 7, 2006).

[39] *See, generally,* the DCM Conflicts of Interest Release.

[40] *See, infra* note 67 for a specific example of DCM or SEF restrictions or burdens on access. Also, clauses (i) and (ii) are not mutually exclusive. As the DCM Conflicts of Interest Release notes, "[s]elf-regulation's traditional conflict—that members will fail to police their peers with sufficient zeal—has been joined by the possibility that competing DCMs could abuse their regulatory authority to gain competitive advantage or to satisfy commercial imperatives." 72 FR at 6938. In its *Concept Release Concerning Self-Regulation,* the SEC identified one method that national securities exchanges have used to gain a competitive advantage: "abus[ing]

The Dodd-Frank Act attempts to create conditions favorable to sustained competition between DCMs and SEFs with respect to the same swap contract. For example, the Dodd-Frank Act contemplates that either a DCM or a SEF may list swap contracts.[41] It also contemplates that multiple DCMs or SEFs may list the same swap contract, and that such swap contracts may be offset at the same DCO.[42] Also, in requiring certain swap contracts to be listed on a DCM or SEF,[43] the Dodd-Frank Act may encourage competition between standardized swap contracts and commodity futures and options.[44]

Such sustained competition, if it occurs,[45] would constitute an increase to the competition that most DCMs currently face with respect to commodity futures and options. As described below, the Commission intends to ensure through the proposed rules that each DCM or SEF implements appropriate systems to manage such conflicts.

c. Questions on Conflicts of Interest

The Commission seeks comment on the questions set forth below on potential conflicts of interest.

- Has the release correctly identified the conflicts of interest that a DCO, DCM, or SEF may confront?
- Has the release accurately specified the possible effects of such conflicts of interest on DCO, DCM, or SEF operations? What are other possible effects?
- What other conflicts of interest may exist? What are the effects of such conflicts?

III. Mitigation of Conflicts of Interest

To mitigate, on a prophylactic basis, the conflicts of interest identified above, the Commission sets forth below proposed (i) structural governance requirements and (ii) limits on the ownership of voting equity and the exercise of voting power. As explained in greater detail below, the Commission views (ii) as a method of enhancing (i), in that (ii) limits the influence that certain shareholders may exert over the DCO, DCM, or SEF Board of Directors. The Commission believes that such influence may affect, among other things, the independent perspective of public directors. The Commission does not believe that stricter structural governance requirements (*e.g.,* a higher percentage of public directors) justify more lenient limits on the ownership of voting equity and the exercise of voting power, or *vice versa.* However, the Commission requests comment on the proper relationship between such requirements and limits. The Commission also requests comment on whether both (i) structural governance requirements and (ii) limits on the ownership of voting equity and the exercise of voting power are necessary or appropriate to mitigate the conflicts of interest described in Section II, or whether one or the other (or neither) would be effective.

In applying such requirements and limits, the Commission does not propose to distinguish between DCMs and SEFs listing swap contracts. As mentioned above, such DCMs and SEFs may experience sustained competition with respect to the same swap contract, and therefore would face the same pressures on self-regulation. Additionally, the Commission does not propose to distinguish between (i) DCMs listing swap contracts and (ii) DCMs listing only commodity futures and options. As mentioned above, clearable swap contracts may share sufficiently similar characteristics with certain commodity futures and options as to compete with respect to execution. Therefore, a DCM listing only commodity futures and options may face competition from a SEF with fewer self-regulatory requirements, in the same manner as a DCM listing swap contracts. Given that the same conflicts of interest[46] may concern both types of DCM, it would appear that the same (i) structural governance requirements and (ii) limits on the ownership of voting equity and the exercise of voting power should apply.

In addition, the Commission does not propose to distinguish between (i) DCOs clearing swap contracts and (ii) DCOs clearing only commodity futures and options. Certain standardized swap contracts have sufficiently similar risk profiles to commodity futures and options that the Commission has, on occasion, permitted such products to be commingled and margined within the segregated customer account under Section 4d of the CEA.[47] If the Commission applied differential (i) structural governance requirements and (ii) limits on the ownership of voting equity and the exercise of voting power, the Commission risks creating an incentive for regulatory arbitrage between the two types of DCO.

The Commission requests comment on holding the two types of (i) DCMs and (ii) DCOs to the same requirements regarding the mitigation of conflicts of interest. The Commission also requests comment on holding DCMs and SEFs listing swap contracts to the same requirements. The Commission is specifically interested in the costs and benefits of its approach.

a. Structural Governance Requirements

i. Independence

In general, the structural governance requirements mitigate conflicts of interest at a DCO, DCM, or SEF by introducing a perspective independent of competitive, commercial, or industry considerations to the deliberations of governing bodies (*i.e.,* the Board of Directors and committees). Such independent perspective would more likely encompass regulatory considerations, and to accord such considerations proper weight. Such independent perspective also would more likely contemplate the manner in which a decision might affect all constituencies, as opposed to concentrating on the manner in which a decision affects the interests of one constituency.[48]

SRO status by overregulating members that operate markets that compete with the SROs." Release No. 34–50700 (Nov. 18, 2004), 69 FR 71256 (Dec. 8, 2004).

Also, similar to the incentives that the enumerated entities may have with respect to the mandatory clearing requirement, if the enumerated entities control a DCM or SEF, they may cause such DCM or SEF to not list a swap contract for trading, if it would be more profitable to keep such contract bilaterally negotiated. However, the Commission notes that nothing would prevent another DCM or SEF from listing such contract, and that Section 723 of the Dodd-Frank Act would require that a DCO clearing such contract provide non-discriminatory access to such DCM or SEF.

[41] *See* Section 2(h)(8) of the CEA, as added by Section 723 of the Dodd-Frank Act.

[42] *See* Section 2(h)(1)(B) of the CEA, as added by Section 733 of the Dodd-Frank Act. Whereas DCMs have competed in the past, and are currently competing, to list commodity futures and options contracts with the same economic terms and conditions, such contracts have not been, and currently are not, fungible. In other words, such contracts cannot be offset in the same DCO.

[43] *See* Section 2(h)(8) of the CEA, as added by Section 723 of the Dodd-Frank Act.

[44] For example, two DCMs (*i.e.,* the NASDAQ OMX Futures Exchange and CME), as well as one exempt board of trade (*i.e.,* Eris Exchange), offer interest rate futures products. Currently, interest rate swap contracts constitute a large percentage of the bilateral swaps market. *See, e.g.,* OCC's Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2010, Executive Summary, available at: *http://www.occ.treas.gov/ftp/release/2010-71a.pdf.* (stating that "[d]erivative contracts remain concentrated in interest rate products, which comprise 84% of total derivative notional values").

[45] As discussed above, whether such competition occurs depends in part on the manner in which Section 723 of the Dodd-Frank Act is implemented.

[46] Namely, (i) prioritizing commercial interests over self-regulatory responsibilities and (ii) restricting access or imposing burdens on access in a discriminatory manner, in each case, because of increased competition.

[47] 7 U.S.C. 6d.

[48] *See, e.g.,* the DCM Conflicts of Interest Release (stating that "the public interest will be furthered if the boards and executive committees of all DCMs

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In the DCM Conflicts of Interest Release, the Commission emphasized the importance of independent decision-makers in protecting DCM self-regulatory functions from DCM commercial interests and that of its constituencies. However, the Commission notes that participants in the Roundtable raised the possibility that conflicts of interest may also be mitigated by providing for fair representation of all constituencies in the governance of a DCO, DCM, or SEF.[49] Theoretically, all constituencies would act in their own commercial, competitive, or industry interests, but no one interest would dominate. The Commission specifically requests comment regarding whether fair representation would be preferable to, or would complement, director independence in mitigating the DCO, DCM, and SEF conflicts of interest described in Section II. The Commission would particularly welcome factual examples. The Commission also requests comment on how the proposed structural governance requirements should change if the Commission adopts a fair representation standard as either an alternative to, or a complement of, rules emphasizing an independent perspective.

ii. Board Requirements

1. Composition

As the DCM Conflicts of Interest Release states, "the governing board * * * is [the] ultimate decision maker and therefore the logical place to begin to address conflicts." [50] The Commission proposes (i) maintaining the requirement that DCM Boards of Directors be composed of at least 35 percent "public directors" [51] and (ii) extending this requirement to SEF and DCO Boards of Directors. In the DCM Conflicts of Interest Release, the Commission stated that the 35 percent requirement struck an appropriate balance between (i) the need to minimize conflicts of interest in DCM decision-making processes with (ii) the need for expertise and efficiency in such processes. Such rationale would appear to apply to SEF and DCO Boards of Directors as well.[52]

In addition to the 35 percent composition requirement, the Commission proposes specifying that DCO, DCM, and SEF Boards of Directors may not have less than two public directors. Such a requirement is also contained in the European Commission Proposal.[53] As the Commission has observed that most DCO and DCM Boards of Directors contain more than three members, the Commission does not believe that such a requirement imposes additional burden. However, the Commission welcomes comment on this proposal.

In order to prevent evasion of the abovementioned composition requirements through corporate structuring or internal reorganization, the Commission proposes extending the composition requirements to any committee of the Board of Directors that may exercise delegated authority with respect to the management of a DCO, DCM, or SEF. Further, the Commission proposes prohibiting a DCO, DCM, or SEF from permitting itself to be operated [54] by another entity, unless such entity agrees to comport with such requirements in the same manner as the DCO, DCM, or SEF.

The Commission would like to clarify that it does not intend to extend the abovementioned composition requirements to an entity that does not exert active and recurrent control over the operations of a DCO, DCM, or SEF. Consequently, the Commission proposes to deem an entity to "operate" a DCO, DCM, or SEF only if it engages in "the direct exercise of control (including through the exercise of veto power) over the day-to-day business operations" of the registered entity.

In addition to the abovementioned composition requirements, the Commission proposes prohibiting a DCO, DCM, or SEF from permitting itself to be operated by an entity unless such entity agrees to subject (i) its officers, directors, employees, and agents to Commission authority, and (ii) its books and records to Commission inspection and copying. The Commission believes that such proposals are necessary to ensure effective audits of DCO, DCM, or SEF operations, given the corporate structure of the DCO, DCM, or SEF.

2. Questions on Composition

The Commission seeks comment on the questions set forth below on DCO, DCM, and SEF Boards of Directors composition requirements:

• Would such composition requirements be equally valid in mitigating conflicts of interest concerning a privately-held DCO, DCM, and SEF, as opposed to a publicly-held DCO, DCM, and SEF?

• As mentioned above, would providing for fair representation on DCO, DCM, or SEF Boards of Directors be preferable to, or complementary to, mandating specific percentages of

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are at least 35% public. Such boards and committees will gain an independent perspective that is best provided by directors with no current industry ties or other relationships which may pose a conflict of interest. These public directors, representing over one-third of their boards, will approach their responsibilities without the conflicting demands faced by industry insiders. They will be free to consider both the needs of the DCM and of its regulatory mission, and may best appreciate the manner in which vigorous, impartial, and effective self-regulation will serve the interests of the DCM and the public at large. Furthermore, boards of directors that are at least 35% public will help to promote widespread confidence in the integrity of U.S. futures markets and self-regulation"). 72 FR 6946.

[49] *See, e.g.,* Comment from Hal Scott, Nomura Professor of International Financial Systems and Director of Program on International Financial Systems, Harvard Law School ("Scott") ("When I spoke, I was saying I opposed ownership restrictions, I was not talking about voting restrictions which I think is a different issue, and the way I would put it is not a voting restriction. I would turn it around to a duty of fair representation, which the SEC is quite familiar with, and is applied to their regulated entities which ensures that the users, more broadly defined of the exchange. And maybe if you translated this into the clearinghouse, the users, but not necessarily the members of the clearinghouse, would have representation in terms of governance * * * Independent directors, to me, are most needed with public companies as under SOX when there was a broad duty to shareholders. But I think what's needed in this context is more the expert, and we heard before that it's very important that people that know what they're doing have input into those, and clearly major users of these clearinghouses, that is customers who clear through a member. Major hedge funds, for instance, have a lot of expertise, okay, in these areas, they're big traders * * *"), Roundtable Tr. at 130–131; Richard Prager, Managing Director, Global Head of Fixed Income Trading, Blackrock ("as the [sole] fiduciary on this panel * * * we would be in support of a very inclusive participation and governance with teeth"), Roundtable Tr. at 131–132; Lynn Martin, Chief Operating Officer, NYSE Liffe U.S. ("You may be aware that NYSE Euronext's U.S. Future Exchange—NYSE Life U.S., is a semi-neutralized structure whereby we balance the views of both the independence criteria as required by core principle 15 in the CFTC–DCM requirements, as well as the views of NYSE Euronext and our external investor firms' views, such that no one board action may be enacted based on the views of any one of those constituents * * * So, it's our belief that a more balanced board structure, a more balanced governance structure, is the proper way to handle or potentially mitigate conflicts of interest"), Roundtable Tr. at 121.

[50] 72 FR at 6940.

[51] *See* Section III(a)(iv) of this release for more detail regarding the definition of "public director."

The Commission notes that such percentage harmonizes with Article 25(2) of the European Commission Proposal, which requires a central counterparty ("CCP") to have "a board of which at least one third, but no less than two, of its members are independent."

[52] 72 FR at 6946.

[53] *See* Article 25(2) of the European Commission Proposal.

[54] The proposed rule defines "operate" as "the direct exercise of control (including through the exercise of veto power) over the day-to-day business operations of" a DCO, DCM, or SEF "by the sole or majority shareholder of such registered entity, either through the ownership of voting equity, by contract, or otherwise. The term 'operate' shall not prohibit an entity, acting as the sole or majority shareholder of such registered entity, from exercising its rights as a shareholder under any contract, agreement, or other legal obligation."

public directors? Also, if the main purpose of the 35 percent composition requirement is to introduce an independent perspective into DCO, DCM, and SEF governance, would requiring one or two public directors be sufficient, regardless of the size of the DCO, DCM, or SEF Board of Directors?

• As mentioned above, the Commission is seeking to mitigate potential conflicts of interest that may influence a DCO regarding (i) whether a swap contract is capable of being cleared, (ii) the minimum criteria that an entity must meet in order to become a swap clearing member, and (iii) whether a particular entity satisfies such criteria. Because the DCO Board of Directors would make ultimate decisions implicating (i), (ii), and (iii), is the 35 percent composition requirement sufficient to ensure that the private, competitive interests of certain DCO members do not capture DCO risk assessments with respect to both products and membership? Or should the Commission increase the required percentage of public directors to 51 percent? Or is there a number less than 51 percent but greater than 35 percent that would be more appropriate?

• As described above, the Dodd-Frank Act envisions (i) a DCM competing with a SEF to list the same swap contract, and (ii) a DCM listing a commodity futures or options contract that competes with a swap contract listed on a SEF. In both cases, a DCM would be competing against an entity with lesser self-regulatory obligations. Such competition may place increased stress on the manner in which the DCM aims to satisfy its self-regulatory responsibilities. In light of such stress, is the 35 percent composition requirement still sufficient to protect the DCM self-regulatory function?

• As referenced above, the Dodd-Frank Act anticipates that a SEF would face a more competitive environment at inception than a DCM currently listing commodity futures and options. As the DCM Conflicts of Interest Release notes, increased competition may be detrimental to self-regulation. Therefore, is the 35 percent composition requirement appropriate to ensure that a SEF discharges its self-regulatory functions in the first instance?

3. Substantive Requirements

In addition to the abovementioned composition requirements, the Commission proposes the substantive requirements set forth below, which aim to enhance the accountability of the DCO, DCM, or SEF Board of Directors to the Commission regarding the manner in which such Board of Directors causes the DCO, DCM, or SEF to discharge all statutory, regulatory, or self-regulatory responsibilities under the Dodd-Frank Act and the existing CEA.

• The roles and responsibilities of a DCO, DCM, or SEF Board of Directors must be clearly articulated, especially in respect of the manner in which such Board of Directors ensures that the DCO, DCM, or SEF complies with all statutory, regulatory, and self-regulatory responsibilities under the Dodd-Frank Act and the existing CEA.

• A DCO, DCM, or SEF Board of Directors shall review its performance and that of its individual members annually. It should consider periodically using external faciliators for such reviews.

• A DCO, DCM, or SEF must have procedures to remove a member from the Board of Directors, where the conduct of such member is likely to be prejudicial to the sound and prudent management of the DCO, DCM, or SEF.

Because of the highly specialized nature of DCO, DCM, or SEF operation, the Commission proposes requiring that each member of a DCO, DCM, or SEF Board of Directors have sufficient expertise, where applicable, in financial services, risk management, and clearing services. Roundtable participants generally agreed that a DCO, DCM, or SEF Board of Directors must have sufficient expertise.[55]

To ensure that members of a DCO, DCM, or SEF Board of Directors are not incented to accord undue consideration to the commercial interests of a DCO, DCM, or SEF in relation to regulatory interests, the Commission proposes to prohibit linking the compensation of public directors and other non-executive members of the Board of Directors to the business performance of the DCO, DCM, or SEF.

The abovementioned substantive requirements are in accord with certain provisions in the European Commission Proposal.[56]

4. Questions on Substantive Requirements

The Commission seeks comment on the questions set forth below on the substantive requirements applicable to a DCO, DCM, or SEF Board of Directors:

• What substantive requirements, other than those identified above, should the Commission consider imposing on a DCO, DCM, or SEF Board of Directors to mitigate the potential conflicts of interest described in Section II, as well as any potential conflicts of interest not specified herein? For example, should the Commission consider any additional requirements related to (i) the fiduciary duties that a DCO, DCM, or SEF Board of Directors may owe or (ii) policies or charters that the DCO, DCM, or SEF Board of Directors may adopt?

iii. Committees

1. Requirements for Each DCO, DCM, and SEF

a. Nominating Committee

As stated above, the structural governance requirements contained herein focus on mitigating conflicts of interest through introducing a perspective independent of competitive, commercial, or industry considerations to the deliberations of DCO, DCM, and SEF governing bodies. Public director composition requirements are not, in and of themselves, sufficient to ensure the representation of such independent perspective. The Commission also must protect the integrity of the process by which the DCO, DCM, or SEF selects public directors.[57]

[55] *See, e.g.,* Comments from Slavkin ("I think having real experts on the boards of directors is a very important issue. We all saw situations in the last several years where there were boards that were two-thirds independent and made really stupid decisions about risk management. So, we need to make sure that there are people on those boards of directors that really understand the risks that exist within a clearinghouse and are prepared to perceive potential risks that may arise in the system down the road and address them. So they also need to have the personalities to stand up to a board of directors that may be entrenched and have their own interests that may differ from those that are in the best interests of the systemic stability"), Roundtable Tr. at 77; Comments from Johnathan Short, Senior Vice President, General Counsel and Corporate Secretary, the IntercontinentalExchange, Inc. ("I mean, she's right, but I just want to point out that there really is a tension there, because some of the people who are best qualified to assess risk in a given market are the people that some parts of the—you know, of the market are complaining about is controlling clearinghouses and controlling key infrastructure"), Roundtable Tr. at 78; Comments from William H. Navin, Executive Vice President and General Counsel, Options Clearing Corporation ("I would second those remarks. Our experience has been that we've benefited greatly from the expertise of industry directors, and I think it would be throwing the baby out with the bathwater if substantial restrictions on industry governance were to be enacted"), Roundtable Tr. at 78; Comments from Greenberger ("I do agree with what has been said, that you need experts on the board. What I disagree with is that all expertise comes from five swaps dealers or it all comes from people who work for banks. There are academics, former regulators, and, you know, other participants in the market who have talked today about their need for open and fair access. I think that kind of diversity on the board is important"), Roundtable Tr. at 164.

[56] *See* Article 25 of the European Commission Proposal.

[57] *See, e.g.,* Comments from Rick McVey, Chief Executive Officer, MarketAxess ("McVey") ("I personally think that one of the most important areas to focus on is the governance and nominating committee. How do people get on these boards?

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To this end, the Commission proposes requiring each DCO, DCM, or SEF to have a Nominating Committee. The role of the Nominating Committee would be to: (i) Identify individuals qualified to serve on the Board of Directors, consistent with the criteria that the Board of Directors require and any composition requirement that the Commission promulgates; and (ii) administer a process for the nomination of individuals to the Board of Directors. The Commission proposes that (i) public directors comprise at least 51 percent of the Nominating Committee, and (ii) a public director chair the Nominating Committee.

b. Disciplinary Panels

As stated above, each DCM and SEF must fulfill self-regulatory obligations under the CEA and the Dodd-Frank Act. Also, each DCO has certain self-regulatory obligations.[58] The Commission proposes requiring each DCO, DCM, or SEF to have one or more disciplinary panels.[59] The role of such disciplinary panels would be to conduct hearings, render decisions, and impose sanctions with respect to disciplinary matters.

The Commission believes that it is imperative for each DCO, DCM, or SEF to exercise its disciplinary authority in an impartial manner. In the DCM Conflicts of Interest Release, the Commission acknowledged the value of fair representation in maintaining such impartiality.[60] To ensure that fair representation results in impartiality, the Commission proposes (i) maintaining the requirement that each DCM adopt rules that would preclude any group or class of participants from dominating or exercising disproportionate influence on the disciplinary panel, and (ii) extending such requirement to each DCO or SEF. The Commission also proposes mandating that each DCO, DCM, or SEF adopt rules that would prohibit any member of a disciplinary panel from participating in deliberations or voting on any matter in which the member knowingly has a financial interest.

In the DCM Conflicts of Interest Release, the Commission also acknowledged the importance of an independent perspective.[61] The Commission proposes retaining and strengthening the role that such perspective plays in DCO, DCM, or SEF disciplinary processes. First, the Commission proposes (i) maintaining the requirement that each DCM disciplinary panel include at least one "public participant,"[62] and (ii) extending such requirement to each DCO or SEF disciplinary panel. Second, the Commission proposes requiring that the chair of each disciplinary panel be a public participant.

2. Requirements for Each DCO Only

a. Risk Management Committee (and Subcommittee)

The central purpose of a DCO is to guarantee the performance of each derivatives contract that it clears. In order to fulfill such guarantee, each DCO must appropriately manage the risks associated with such contract. In general, a DCO convokes a committee to oversee risk management. The Commission proposes to require each DCO to have a Risk Management Committee.

Swap contracts, as well as commodity futures and options, are complex instruments. Managing the risks of such instruments requires expertise. In general, clearing members constitute the main source of such expertise, as they (i) routinely execute trades in such instruments and (ii) have experience in managing risks posed by customer trades. Because of the lack of a centralized market for swap contracts, swap clearing members also perform the function of (i) pricing a swap contract and (ii) participating in an auction to liquidate the swap contract in the event of member default.

However, as discussed above, swap clearing members at DCOs that currently clear large volumes of swap contracts are exclusively enumerated entities. Some have argued that the enumerated entities have an incentive to influence DCO risk assessments regarding (i) whether a swap contract is capable of being cleared, (ii) the appropriate membership criteria for a swap clearing member, and (iii) whether a particular entity meets such criteria. Therefore, the Commission must carefully consider the composition of the Risk Management Committee, in order to achieve (i) the increased clearing of swap contracts that the Dodd-Frank Act contemplates without compromising (ii) DCO safety and soundness.

The Commission proposes a three-pronged approach to mitigating the potential conflict of interest identified above, while still ensuring that the Risk Management Committee retains sufficient expertise. First, the Commission proposes requiring that 35 percent of the Risk Management Committee be composed of public directors, with sufficient expertise in, among other things, clearing services.[63] Second, the Commission proposes requiring that 10 percent of the Risk Management Committee be composed of customers of clearing members, who also routinely execute swap contracts (as well as commodity futures and options) and who have experience in using pricing models for such contracts (if only to ensure that they receive a fair price from the enumerated entities).[64] Because customers benefit from a wider pool of swap clearing members and greater competition between such members, customers have an incentive to ensure that the membership criteria of a DCO are risk-based, and do not reflect the private, competitive interests of the enumerated entities. Third, the Commission proposes to permit a DCO Risk Management Committee to delegate to a subcommittee (the "Risk

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And if there is a requirement that that process be independent I think you would get both qualified people that are going to look after the best interest of the company, and you would get better independence on these boards"), Roundtable Tr. at 150.

[58] For example, to the extent that a DCO determines that it must impose requirements on members in order to comport with a core principle or other regulatory requirement (*e.g.*, limits on ownership and voting power), a DCO must monitor member compliance with such requirement, and must have the authority and ability to enforce such requirement. *See* Section 5b(c)(2)(H) of the CEA, as added by Section 725(c) of the Dodd-Frank Act.

[59] The Commission understands that DCOs currently may not have disciplinary panels, but that the Risk Management Committee of a DCO may perform the functions of such panel. Therefore, consistent with current practice, the Commission proposes to permit the DCO Board of Directors to delegate to the Risk Management Committee the performance of such functions. If the Board of Directors so delegates, (i) the DCO would no longer need to maintain a disciplinary panel, but (ii) the composition requirements applicable to a disciplinary panel would be extended to any committee (or similar body) to which a decision of the Risk Management Committee may be appealed.

[60] *See* 72 FR at 6952 (stating that "fair disciplinary procedures, with minimal conflicts of interest, require disciplinary bodies that represent a diversity of perspectives and experiences").

[61] *Id.* (stating that "[t]he presence of at least one public person on disciplinary bodies * * * provides an outside voice and helps to ensure that the public's interests are represented and protected. This approach is consistent with the Commission's overall objective of ensuring an appropriate level of public representation at every level of DCM decision making, while simultaneously calibrating the required number of public persons to the nature and responsibility of the decision-making body in question").

[62] *Id.* at 6957. In the proposed rules, a "Public Participant" is defined as an entity that meets the bright-line materiality tests in the definition of "Public Director."

[63] *See* Comments from Greenberger, *supra* note 55, regarding the availability of such public directors.

[64] *See, generally, supra* note 55.

Because customers do not contribute to the DCO default fund, customers may have less capital at stake than clearing members if a DCO improperly measures risk. Therefore, the Commission believes that 10 percent representation would ensure that customers have adequate voice on the DCO Risk Management Committee, without adversely impacting the risk assessments of such committee.

Management Subcommittee") the responsibility to: (i) Determine the standards and requirements for initial and continuing clearing membership eligibility; (ii) approve or deny (or review approvals or denials of) clearing membership applications; and (iii) determine products eligible for clearing. If the Risk Management Committee effects such a delegation, then it would free itself of the composition requirements. The decisions of the Risk Management Subcommittee would be subject to review by the Risk Management Committee. Therefore, if the Risk Management Committee determines that a particular decision by the Risk Management Subcommittee is overly risky, then the Risk Management Committee may overrule that decision.[65]

In order to prevent evasion of the above-mentioned composition requirements through internal reorganization, the Commission proposes to prohibit:

- A decision of the Risk Management Subcommittee from being subject to the approval of, or otherwise restricted or limited by, a body other than the DCO Board of Directors or the DCO Risk Management Committee, including, without limitation, any advisory committee; and
- Certain decisions of the Risk Management Committee[66] from being subject to the approval of, or otherwise restricted or limited by, a body other than the DCO Board of Directors, including, without limitation, any advisory committee.

The Commission requests comment on its three-pronged approach, including any alternatives to such approach. The Commission also requests comment on (i) the specific percentages set forth above, and (ii) the prohibitions on certain bodies approving of, or otherwise restricting or limiting, the decisions of the Risk Management Committee (or Risk Management Subcommittee, as applicable).

3. Requirements for Each DCM or SEF Only

a. Membership or Participation Committee

As mentioned above, increased competition may exacerbate conflicts of interest, causing a DCM or SEF to (i) prioritize commercial interests over self-regulatory responsibilities; and (ii) restrict access or impose burdens on access in a discriminatory manner. Roundtable participants identified a specific example of (ii), where swap clearing members may seek to limit access to SEF execution and pricing to customers executing through such members.[67] The rationale of such example would apply to a DCM as well. To protect decisions regarding access from DCM or SEF commercial interests, or the interests of the enumerated entities, the Commission proposes requiring a DCM or SEF to have a Membership or Participation Committee, composed of thirty-five percent public directors.[68] Such committee would have the responsibility to: (i) Determine the standards and requirements for initial and continuing membership or participation eligibility; (ii) review appeals of staff denials of membership or participation applications; and (iii) approve rules that would result in different categories or classes of members or participants receiving disparate access. The Commission proposes prohibiting the Membership or Participation Committee from upholding any staff denial if the relevant application meets the standards and requirements that such committee sets forth. Further, the Commission proposes prohibiting the Membership or Participation Committee from restricting access or imposing burdens on access in a discriminatory manner, within each category or class of members or participants or between similarly situated categories or classes of members or participants. Nothing in this preamble is meant to prohibit the Commission from issuing substantive proposals regarding access to a DCM or SEF in any subsequent proposed rulemaking.

b. Regulatory Oversight Committee

In the DCM Conflicts of Interest Release, the Commission emphasized the importance of a DCM Regulatory Oversight Committee ("ROC"):

> Properly functioning ROCs should be robust oversight bodies capable of firmly representing the interests of vigorous, impartial, and effective self-regulation. ROCs should also represent the interests and needs of regulatory officers and staff; the resource needs of regulatory functions; and the independence of regulatory decisions. In this manner, ROCs will insulate DCM self-regulatory functions, decisions, and personnel from improper influence, both internal and external.[69]

The Commission also underscored the importance of the DCM ROC being composed of 100 percent public directors:

> The Commission strongly believes that new structural conflicts of interest within self-regulation require an appropriate response within DCMs. The Commission further believes that ROCs, consisting exclusively of public directors, are a vital element of any such response * * *. ROCs make no direct commercial decisions, and therefore, have no need for industry directors as members. The public directors serving on ROCs are a buffer between self-regulation and those who could bring improper influence to bear upon it.[70]

The Commission proposes (i) maintaining the requirement that DCMs have a ROC composed of only public directors, and (ii) extending such requirement to SEFs, which also have self-regulatory obligations. However, the Commission recognizes that SEFs—but not DCMs—must have a chief compliance officer (i) to monitor SEF adherence to statutory, regulatory, and

[65] The Commission is contemplating requiring the DCO to report to the Commission whenever the Risk Management Committee overrules the Risk Management Subcommittee, or whenever the Board of Directors overrules the Risk Management Committee. If the Commission decides to propose such requirement, it would be included in the second rulemaking that the Commission contemplates finishing on governance and mitigation of conflicts of interest. *See supra* note 17.

[66] *I.e.,* any decision pertaining to (i) whether a swap contract is capable of being cleared, (ii) the appropriate membership criteria for a swap clearing member, and (iii) whether a particular entity meets such criteria.

[67] *See, e.g.,* Comments from Kastner ("I'll take the ball for a second with the SEFs. The same principles that apply to DCOs in terms of open access—also if you carefully apply to SEFs, anybody who is able to get a clearing account at a qualified swap clearing member or FCM to use the, you know, futures analog, anybody that wants to trade on a SEF, the SEF should not have any barriers to entry."), Roundtable Tr. at 52, ("The point is if you have a firm who is doing customer business and wants to engage in an interest rate swap with an end user who is not a clearing member, that they should be able to execute that trade with the end user and then give up to a clearing member."), Roundtable Tr. at 84; Comments from William DeLeon, Executive Vice President, Global Head of Portfolio Risk Management, PIMCO ("You know, that concept of using a SEF, I think it should be free and open access * * *. The issue is that there needs to be a guarantee that when you access a SEF, that when you do a trade, that there is someone who is guarantee that that is a good trade. So whether that means that there's a market maker * * * or if that means that there's a DCM or an FCM or someone who's going to guarantee that they're going to stand behind * * * unknown clients * * *"), Roundtable Tr. at 56.

[68] The Commission acknowledges that a DCM may have already assigned the functions of a Membership or Participation Committee to other governing bodies. Therefore, the proposed rules permit the DCM Board of Directors to delegate the performance of the functions of the Membership or Participation Committee to one or more other committees, provided that each such committee meets the applicable composition requirements. If the Board of Directors chooses to so delegate, the registered swap execution facility would no longer need to maintain a Membership or Participation Committee.

[69] *See* 72 FR 6950, 6951.

[70] *Id.* at 6951.

self-regulatory requirements and (ii) to resolve conflicts of interest that may impede such adherence. The chief compliance officer must report to the SEF Board of Directors (or similar governing body) or the senior SEF officer.[71] Since the Dodd-Frank Act charges the SEF Board of Directors (or similar governing body) or the senior SEF officer with the responsibility for overseeing the chief compliance officer (including with respect to the resolution of conflicts of interest), the Commission requests comment on whether requiring a SEF to also have a ROC is necessary.

iv. Definition of Public Director

The proposed rules include a definition of "public director" that makes several modifications to the definition of "public director" that the Commission adopted in 2009.[72] Such modifications bring several aspects of the definition in line with the definition of "independent director" that the SEC proposed in 2004.[73] Since the Commission is currently, or will in the future, be regulating some of the same entities as the SEC,[74] the modifications to the definition of "public director" are intended to allow for greater harmonization with the SEC and currently accepted practices.[75]

First, the proposed rules include a new bright-line test that prohibits any director that is an officer of another entity, which entity has a compensation committee, on which any officer of the registered entity serves, from being a public director. This test is a part of the independence tests of most listing standards and prevents a public director from having a financial relationship that would likely impair his independence. In light of the obvious conflicts that could arise as a result of such a financial relationship, the Commission proposes that this additional bright-line test be included in the definition of "public director."

Second, the proposed rules would preclude directors that are employees of members of DCOs, DCMs, and SEFs from being public directors. The proposed rules would also preclude a director, or an entity with which the director is an employee, from being a public director if certain payments are made to such director. In 2009, the Commission moved the evaluation of employment relationships from the bright-line test to an analysis under the overarching materiality standard. The Commission is re-evaluating such move in light of current concerns regarding further protecting regulatory functions from directors that are conflicted due to industry ties. The Commission notes that CBOE Futures Exchange, LLC ("CFE") submitted a comment letter to this effect in 2009. In particular, CFE expressed concern that, as a result of the removal of employment relationships from the bright-line tests, all required public directors could be member employees.[76] At the time, the Commission felt that such a situation would be incompatible with the overarching materiality test, even if such prohibition against employment was not included in the bright-line test. The Commission seeks comments regarding the re-insertion of employment relationships in the bright-line tests.

Third, the proposed "public director" definition includes an expanded definition of "immediate family" that includes certain family members, whether by blood, marriage or adoption, and also includes any person residing in the home of the director or his immediate family. Such change attempts to harmonize the "public director" definition with the SEC 2004 Release and currently accepted practices.

Finally, the Commission notes that the proposed rules retain the one-year look-back period. The Commission seeks comment as to whether such period should be increased, given (i) current concerns regarding further protecting regulatory functions from directors that are conflicted due to industry ties, and (ii) the goal of achieving harmony with the SEC and currently accepted practices.

v. Questions on Committees and the Definition of Public Director

In addition to any questions that the Commission may have posed above, the Commission seeks comment on the following questions regarding DCO, DCM, or SEF committees, and the attendant composition requirements, as well as the definition of public director:

- Is each of the committees or panels specified above necessary or appropriate for the mitigation of the conflicts of interest described in Section II, or of any conflict of interest not identified herein? If so, are the composition requirements applicable to such committees necessary or appropriate to effect such mitigation?
- What other ways should the Commission consider defining "public director"? Are there other circumstances that the Commission should include in the bright-line materiality tests? Are there circumstances that the Commission should remove from such tests?

b. Ownership and Voting Limits

As mentioned above, the structural governance requirements mitigate DCO, DCM, or SEF conflicts of interest by introducing a perspective independent of competitive, commercial, or industry considerations to the deliberations of governing bodies. The Commission believes that limits on ownership of voting equity and the exercise of voting rights would enhance the structural governance requirements.[77] In general, individuals are compensated for service on the Board of Directors (and the committees thereof). Voting shareholders elect, directly or indirectly, members of the Board of Directors. Such members serve as fiduciaries to all shareholders under state law. Therefore, to ensure that DCO, DCM, or SEF public directors maintain their independent perspective (rather than solely representing the competitive, commercial, or industry considerations of shareholders), the Commission believes that limits on ownership of voting equity and the exercise of voting rights are necessary.[78]

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[71] *See* Section 5h(f)(15) of the CEA, as added by Section 733 of the Dodd-Frank Act.

[72] *See, generally,* 74 FR 18982 (April 27, 2009).

[73] *See* 69 FR 71127 (December 8, 2004) (the "SEC 2004 Release").

[74] *E.g.,* the Options Clearing Corporation, or a SEF that lists both CDS indices and single-name CDS contracts.

[75] *See, e.g.,* the listing standards of NYSE Euronext or NASDAQ OMX.

[76] CFE Comment Letter at 2.

[77] The Commission proposes not to limit non-voting equity. In general, a shareholder would have direct influence over a DCO, DCM, or SEF Board of Directors only if the shareholder has the ability to exercise voting rights with respect to, *e.g.,* election, compensation, or removal of directors. However, the Commission notes that certain Roundtable participants disagree. *See, e.g.,* Comments from Slavkin ("I actually disagree with what the gentleman from JP Morgan said when he said that he doesn't think that having an economic stake without having a voting interest is a concern. I think most of us can imagine a situation where someone owns 5 percent of our company and asks us to do something. I don't think it matters if that person gets to vote for the board of directors, that person has real influence regardless of whether it's formal influence, there is going to be influence over the decision making, there's going to be influence over the strategy and innovation and the trajectory of the institution in general, so I do think we need to look at ownership restrictions related to voting interests as well as related to economic interests even when they're not tied to actual voting shares"), Roundtable Tr. at 153. The Commission requests comment on whether limits on non-voting equity would be appropriate to the mitigation of conflicts of interest.

[78] Certain Roundtable Participants agree. *See, e.g.,* Comments from Slavkin ("What I'm hearing from the people who support governance as opposed to real caps on ownership is an argument in favor of the status quo, and I think that when Congressman Brown—I'm sorry, when Congressman Lynch proposed this amendment that was passed in the House legislation, and when Senator Brown proposed, you know, the Lynch Light version that was passed by the entire Congress, their intention

i. DCOs

According to the DCM Conflicts of Interest Release, "[t]oday's DCMs * * * are vibrant commercial enterprises competing globally in an industry whose ownership structures, business models, trading practices, and products are evolving rapidly." [79] The same evolution, and the diversity in ownership structures that it engenders, may be observed in DCOs. Therefore, in acknowledgement of the different DCO ownership structures that currently or may in the future exist, the Commission proposes that a DCO choose between one of two alternative limitations on ownership of voting equity and the exercise of voting rights. However, the Commission recognizes that circumstances may exist where neither alternative may be appropriate. Consequently, the Commission also proposes a waiver procedure.

1. First Alternative

For the first alternative, the Commission proposes a combination of a single-member limitation and an aggregate limitation (the "First Alternative").

a. Single-Member Limitation

First, the Commission proposes requiring a 20 percent limitation on the voting equity that any single member (and related persons) [80] may own.[81] Economic research suggests that holding 20 percent voting equity of an entity may be sufficient for exerting control over an entity,[82] especially if that entity has otherwise diffuse ownership.[83]

As described above, based on Commission experience, control of a DCO by members collectively has generally permitted the DCO to serve the purposes of the CEA. However, such description does not necessarily hold true if, for example, the DCO has demutualized but one member retains sufficient voting ownership to dominate the DCO.[84] Such domination may result in the DCO relaxing risk management standards with respect to that member, but imposing more stringent standards on others.

Given the increased importance of the DCO in managing systemic risk, the Commission believes that limiting the amount of voting equity that any one member may own is appropriate to ensure impartiality in risk assessment, especially in a DCO with otherwise diffuse ownership. To prevent evasion of the 20 percent limitation, the Commission proposes requiring an identical limit on voting rights; and if the DCO is a subsidiary, extending the limitation to the shareholders of its direct or indirect parent. If any parent is publicly-listed, then that parent would have to comply with shareholder voting requirements promulgated by the SEC or the exchange on which the parent is listed.

b. Aggregate Limitation

Further, the Commission proposes a 40 percent limitation on the voting equity that the enumerated entities (and their related persons) may own in the aggregate, regardless of whether such entities are DCO members.[85] As mentioned above, some market participants, investor advocates, and academics have argued that the enumerated entities may have commercial incentives to influence DCO risk assessments regarding (i) whether a swap contract is capable of being cleared, (ii) the appropriate membership criteria for a swap clearing member, and (iii) whether a particular entity meets such criteria. The enumerated entities may directly influence such assessments through participation on the Risk Management Committee as clearing members, or indirectly influence such assessments as voting shareholders. In general, the Commission believes that the enumerated entities would attempt to influence such assessments as voting shareholders only if the DCO has a mutualized structure with concentrated ownership.[86] In such a structure, the percentage necessary for control would be higher than the abovementioned 20 percent, which is sufficient for a diffuse ownership structure.

In counterweight to the commercial incentives that the enumerated entities may have to influence DCO risk assessments regarding (i), (ii), and (iii)

was to create real change in recognition of the fact that the current system is broken. It doesn't work. That's why we're all sitting around this table today. Governance is a valuable tool, it's not the only tool, and I think it's our responsibility to try to examine other options and I think that the ownership cap is a real valuable tool that can be used to mitigate the problems that exist in the current system"), Roundtable Tr. at 124 to 125.

The European Commission Proposal explicitly rejects ownership limitations. *See* Section 4.3.4 of the European Commission Proposal (stating that structural governance requirements "are considered more effective in addressing any potential conflicts of interest that may limit the capacity of CCPs to clear, than any other form of regulation which may have undesirable consequence on market structures (*e.g.,* limitation of ownership, which would need to extend also to so-called vertical structures in which exchanges own a CCP)").

However, the European Commission Proposal explicitly preserves the power of the regulator to refuse authorization of a CCP "where, it is not satisfied as to the suitability of the shareholders or members that have qualifying holdings in the CCP, taking into account the need to ensure the sound and prudent management of a CCP." *See* Article 28(2) of the European Commission Proposal. Further, the European Commission Proposal permits the regulator to terminate authorization of a CCP where "shareholders or members, whether direct or indirect, * * * exercise an influence which is likely to be prejudicial to the sound and prudent management of the CCP." *See* Article 28(1) and (4) of the European Commission Proposal.

The Commission requests comment as to whether a reservation of power similar to that contained in the European Commission Proposal would complement the limits on ownership of voting equity and the exercise of voting power described above.

[79] 72 FR at 6938.

[80] The Commission requests comment on whether the definitions of "related person" in the proposed rules are under or over-inclusive.

[81] Ruben Lee, *The Governance of Financial Infrastructure,* Oxford Finance Group, at 256 (January 2010) (stating that "[m]andatory ownership constraints may prevent a single firm from exercising undue influence over a market institution that is also an SRO").

[82] *See, generally,* e.*g.,* Bae, K–H., J–K and J–M Kang (2002). "Tunneling or value added? Evidence from mergers by Korean business groups", *Journal of Finance* 57, pp. 2695–2740; Barclay, M. and C. Holderness (1989) "Private benefits from control of public corporations", *Journal of Financial Economics* 25, pp. 371–395; Barclay, M. and C. Holderness (1991) "Negotiated block trades and corporate control", *Journal of Finance* 46, pp. 861–878; Barclay, M. and C. Holderness and D. Sheehan (2001) "The block pricing puzzle", Working Paper; Cheung,Y–L, P.R. Rao and A. Stouraitis (2006) "Tunneling, propping, and expropriation: evidence from connected party transactions in Hong Kong", *Journal of Financial Economics* 82, pp. 343–386; Claessens, S., S. Djankov, L.H.P. Lang (2000) "The separation of ownership and control in East Asian corporations", *Journal of Financial Economics* 58, pp. 81–112; Dyck, A and L. Zingales (2004) "Private benefits of control: An international comparison", *Journal of Finance* 59, pp. 537–600; Faccio, M., L.H.P Lang, and L. Young (2001) "Dividends and expropriation", *American Economic Review* 91, 54–78; and Morck, R., D. Wolfenzon, and B. Yeung (2005) "Corporate governance, economic entrenchment, and growth", *Journal of Economic Literature,* 43, pp. 655–72.

The 20 percent limitation also accords with the proposals in the SEC 2004 Release. *See* 69 FR at 71143–44.

[83] As mentioned above, CME, for example, is wholly-owned by CME Group. However, CME Group is a publicly-listed company with diffuse ownership.

[84] Comments from Greenberger ("if we want governance with teeth, governance with teeth will have ownership limitations. You can talk about fair representation, board governance, the fact of the matter is, and I think this will bear its way out in the comments to you, that does not protect fair and open access * * *"), Roundtable Tr. 135.

[85] *Cf.* The Lynch Amendment, which prohibited certain "restricted owners" from collectively acquiring more than 20 percent of the voting equity in a DCO.

[86] *See, generally,* Barclay, M. and C. Holderness (1989) "Private benefits from control of public corporations", *Journal of Financial Economics* 25, pp. 371–395. The premise of this paper is that (i) buyers of equity blocks in a publicly-traded corporation appear, on average, to pay a premium above market price, and (ii) such premium reflects the value to the buyer of being able to influence the decisions of the corporation in a way that is privately profitable, but not profitable to other shareholders. In general, the Commission believes that, if a DCO has diffuse ownership, the outlay that an enumerated entity would need to make to influence DCO risk assessments as a voting shareholder would likely exceed the outlay necessary to obtain the same amount of influence through other means.

above, the Commission acknowledges that the enumerated entities have the capital and expertise necessary to manage the risks of clearing swap contracts.[87] Therefore, the Commission believes that a 40 percent aggregate limitation is appropriate, assuming that the DCO has a mutualized structure with concentrated ownership, because it permits the enumerated entities to influence, directly or indirectly, but not control, DCO risk assessments.

In conjunction with the 40 percent aggregate limitation, the Commission proposes requiring a majority vote for the passage of any shareholder resolution; and if the DCO is a subsidiary, extending the aggregate limitation and the requirement for a majority vote to the shareholders of its direct or indirect parent. If any parent is publicly-listed, then that parent would have to comply with shareholder voting requirements promulgated by the SEC or the exchange on which the parent is listed.

2. Second Alternative

For the second alternative, the Commission proposes a 5 percent limitation on the voting equity that any DCO member or enumerated entity (whether or not such entity is a DCO member), and the related persons thereof in each case, may own (the "Second Alternative"). Such a limitation effectively ensures that neither a DCO member nor an enumerated entity would have sufficient power, in a concentrated or diffuse ownership structure, to exert undue influence, as a voting shareholder, over DCO operations (including with respect to risk assessments regarding (i), (ii), and (iii) above). Certain Roundtable participants favor a similar approach.[88]

To prevent evasion of the 5 percent limitation, the Commission proposes requiring an identical limit on voting rights; and if the DCO is a subsidiary, extending the limitation to the shareholders of its direct or indirect parent. If any parent is publicly-listed, then that parent would have to comply with shareholder voting requirements promulgated by the SEC or the exchange on which the parent is listed.

3. Waiver

As mentioned above, the Commission believes that there may be circumstances where the imposition of rigid limitations on ownership or voting rights may not be appropriate for certain DCO ownership structures. To provide flexibility, a DCO may request that the Commission waive individual and/or aggregate ownership or voting rights limitations by any entity for a reasonable period of time.

The Commission may grant the requested waiver if it determines that ownership or voting rights limitations are not necessary or appropriate to:

- Improve the governance of the DCO;
- Mitigate systemic risk;
- Promote competition;
- Mitigate conflicts of interest in connection with a swap dealer's or major swap participant's conduct of business with the DCO with respect to fair and open access and participation and product eligibility; and
- Otherwise accomplish the purposes of the Act.

The Commission may, at any time, revoke the waiver. Upon such revocation, or at the expiration of the waiver period, any such DCO shall require divestiture of any relevant entity's ownership or voting rights percentages to an individual and/or aggregate level that is consistent with the First or Second Alternative, or such other level that the Commission deems appropriate based on the foregoing factors as set forth in Section 726(b) of the Dodd-Frank Act.

4. Questions on the First and Second Alternatives and the Waiver

The Commission seeks comment on the questions set forth below on the First and Second Alternatives, as well as the Waiver:

a. First and Second Alternatives

- Are the First and Second Alternatives effective for mitigating, on a prophylactic basis, conflicts of interest arising from the control that (i) one member may exert as a dominant voting shareholder of a DCO and (ii) the enumerated entities may collectively exert as voting shareholders of a DCO (specifically with respect to the DCO risk assessments referenced above)? What methods, other than the First and Second Alternatives, should the Commission consider to mitigate such conflicts of interest? What are the advantages and disadvantages of such methods?
- Under what circumstances would the First and Second Alternatives not be appropriate for a DCO? For example, should the First and Second Alternatives apply equally to established DCOs and start-up DCOs?[89]
- Are the percentages that the Commission specifies in the First and Second Alternatives effective for mitigating conflicts of interest arising from the control that (i) one member may exert as a dominant voting shareholder of a DCO and (ii) the enumerated entities may collectively exert as voting shareholders of a DCO? If not, what alternative percentages should the Commission consider to achieve such mitigation?
- Would the First and Second Alternatives be effective to mitigate any potential conflicts of interest not discussed herein? If not, then what other equity ownership and voting limits should the Commission consider?
- Should the limits in the First and Second Alternatives only apply to clearing members, and not enumerated entities that are not clearing members? Should the limits in the First and Second Alternatives apply only to

[87] *See, e.g.,* Comments from Jeremy Barnum, Managing Director, J.P. Morgan ("Barnum") ("So, on the question of—on the question of ownership of clearinghouses and expertise and the Lynch amendment, the—it is very appealing in principle to imagine that these systemically important financial players into which we are putting much more risk, could somehow be entirely free of the nefarious influence of the evil dealers who contributed to the crisis to quote Mr. Greenberger. But, unfortunately, they are, in fact, the market participants who need to use the clearinghouses"), Roundtable Tr. at 115; Comments from Olesky ("I think it's really important to recognize—for all of us to recognize—that market participants really engender many market facilities. And in my experience in the investment of capital and the knowledge about a particular space has led directly to innovations and advances both with Tradeweb and another company I was with, BrokerTech; exchanges; clearing corps. If you go back in history, those are the folks that have the capital to support this innovation and the knowledge and experience to move it forward. And while it's easy to sort of be critical of that group, I think it's also important not to cut off that flow of capital into innovative organizations that are really groups of market participants that are investing in these types of mechanisms * * * Tradeweb was started in 1997 with the internet with a group of banks. We had four banks initially. Then we sold 100 percent of the company in 2004 and we weren't owned by any banks for 4 years. Then we had another investment back in, and we had a minority stake by some banks. I think we really have to separate out the ownership argument from the governance argument, because it's critical to be able to access that capital for entrepreneurs and for innovators when they're trying to build these mechanisms"), Roundtable Tr. at 60 to 61.

[88] *See, e.g.,* Comments of Roger Liddell, Chief Executive Officer, LCH.Clearnet Group ("Liddell") ("To go back to the question, I think with established organizations, then I think the concept of some combination of ownership limits and voting caps actually does make sense. For example, in the [LCH] clearinghouse, we've got a 5 percent voting cap and have done for many years. And the reason for that was to take away any incentive for anyone to build up a stake greater than that so that we would be highly unlikely to ever have less than 20 shareholders. That works well for us"), Roundtable Tr. at 118 to 119.

[89] *See, e.g.,* Comments from Olesky, *supra* note 87; Comments from Liddell ("However, to pick upon the point that Lee Olesky made before, I think you have to be a little bit careful in how you treat entrepreneurials or starter ventures because most of the successful starter ventures have started with a relatively small number of banks sharing an interest in creating something which then becomes a lot bigger"), Roundtable Tr. at 119.

DCOs, and not to their parent companies?

b. Waiver

- The Commission seeks comment on (i) the circumstances which may require an alternative ownership structure for a DCO, (ii) the types of alternative ownership structures of DCOs that may require flexibility in setting ownership or voting rights levels consistent with achieving the goal of Section 726 of the Dodd-Frank Act to mitigate conflicts of interest, and (iii) the appropriate means to provide such flexibility to the Commission during the DCO application process if such an organization were to adopt an alternative structure.

ii. DCMs or SEFs

The Commission proposes a 20 percent limitation on the voting equity that any single member (and related persons) may own in a DCM or SEF. As mentioned above, economic research suggests that holding 20 percent voting equity of an entity would be sufficient for control, especially if such entity has otherwise diffuse ownership. Such a limitation would prevent any one member of a DCM or SEF from dominating the decision-making process. The Commission also proposes an identical limitation on voting rights; and if the DCM or SEF is a subsidiary, extending the limitation to the shareholders of its direct or indirect parent. If any parent is publicly-listed, then that parent would have to comply with shareholder voting requirements promulgated by the SEC or the exchange on which the parent is listed.

The Commission, however, does not propose imposing a limitation on the voting equity that the enumerated entities may own in the aggregate. As mentioned above, the Dodd-Frank Act specifically attempts to encourage sustained competition between multiple DCMs and SEFs over listing the same swap contract. Based on comments from Roundtable participants, the enumerated entities would be the most likely source of funding for a new DCM or SEF.[90] In this instance, the Commission believes that the benefits of sustained competition between new DCMs and SEFs outweigh the incremental benefit of better governance through limitations on the aggregate influence of the enumerated entities.[91]

1. Questions on DCM or SEF Limits on Ownership and Voting Power

The Commission seeks comment on the questions set forth below on the DCM or SEF limits on ownership and voting power:

- Are the single-member limits on ownership and voting power effective for mitigating, on a prophylactic basis, the conflicts of interest that Section II identifies? What methods, other than such limits, should the Commission consider to mitigate such conflicts of interest? What are the advantages and disadvantages of such methods?
- Should the Commission also consider instituting a waiver procedure for DCMs and SEFs with respect to the single-member limitation?
- Should the single-member limitation be extended to the parent company of a DCM or SEF?

IV. Effectiveness and Transition Period

As noted above, the Commission is contemplating rulemakings on further defining certain entities implicated by the proposed rules (*e.g.,* swap dealers, major swap participants, and swap execution facilities). The Commission anticipates that such rulemakings would be completed by the statutory deadline of July 15, 2011. Therefore, the Commission is proposing a staggered effective date for the final rules on mitigation of conflicts of interest. Any portion of the final rules implicating entities subject to further definition would not become effective until sixty (60) days after July 15, 2011. Portions of the final rules not involving such entities would become effective sixty (60) days after the **Federal Register** publication of the final rules.

Although the Commission proposes that the final rules become effective within the time periods specified above, consistent with the DCM Conflicts of Interest Release, the Commission will permit each existing DCO, DCM, and SEF to phase-in implementation of the final rules over two (2) years or two regularly-scheduled Board of Directors elections. The Commission expects, however, all new DCO, DCM, and SEF applicants to fully comply with the final rules.

The Commission requests comment on the (i) timing of effectiveness for the final rules, and (ii) the length of the phase-in implementation period. The Commission further requests comment on whether new DCO, DCM, and SEF applicants should have to demonstrate compliance with the final rules to receive registration.

V. Numbering

As the proposed rules constitute amendments or additions to Regulation Parts 1, 37, 38, 39, and 40, the Commission anticipates that the numbering of such proposed rules will change upon completion of other rulemakings concerning such parts.

VI. Related Matters

a. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires that agencies, in proposing rules, consider the impact of those rules on "small entities." [92] The term "small entity" has the same meaning as the term "small business" under the RFA [93] and the term "small business" generally has the same meaning as the term "small business concern" under section 3 of the Small Business Act.[94]

The proposed rules detailed in this release would only affect DCOs, DCMs, and SEFs. The Commission has previously determined that DCOs [95] and DCMs [96] are not "small entities" for purposes of the RFA. In contrast, SEFs constitute a new category of registrant that the Dodd-Frank Act created. Accordingly, the Commission has not addressed the question of whether SEFs are, in fact, "small entities" for purposes of the RFA.

The Dodd-Frank Act defines a SEF to mean a trading system or platform in which multiple participants have the

[90] *See, e.g.,* Comments of McVey ("I think when it comes to ownership we have to realize that we are embarking on a major transformation of OTC markets and all of these entities are going to need capital to provide the market efficiencies that we're all seeking to achieve. And rightly or wrongly, historically a tremendous amount of the capital for clearing, e-trading, data and affirmation hubs, has come from the dealer community, and I think it would be very dangerous to cut off an important source of capital that can lead to some of the market improvements that we're all seeking to achieve"), Roundtable Tr. at 121 to 122.

[91] *See, generally,* Comments of Barnum ("The traditional vertically integrated exchange model for futures works beautifully in a whole range of respects for those products from the perspective of liquidity and systemic risk, but it has a couple problems. It is—it does seem to create some natural monopoly properties. You can debate whether they're severe enough to warrant action or not and that's one of the kinds of tensions that needs to be balanced. In addition, they work very well for the types of products that naturally attract liquidity on exchanges. The whole premise of this is that we're pushing a whole new set of products with different liquidity characteristics into central counterparties. That means that you cannot apply exactly the same framework. There are new challenges that are being introduced. They create tensions. And those tensions need to be looked at rationally in a continuum framework that balances different social goods against each other"), Roundtable Tr. at 116 to 117.

[92] 5 U.S.C. 601 *et seq.*

[93] 5 U.S.C. 601(6).

[94] A "small business concern" is generally defined as one which is independently owned and operated and which is not dominant in its field of operation. 15 U.S.C. 632.

[95] 66 FR 45604, 45609 (August 29, 2001).

[96] 47 FR 18618, 18619 (April 30, 1982).

ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between persons and is not a designated contract market.[97] The Commission is hereby proposing that SEFs not be considered to be "small entities" for essentially the same reasons that DCMs and DCOs have previously been determined not to be small entities. These reasons include the fact that the Commission designates a contract market or registers a derivatives clearing organization only when it meets specific criteria including expenditure of sufficient resources to establish and maintain adequate self-regulatory programs. Likewise, the Commission will register an entity as a SEF only after it has met specific criteria including the expenditure of sufficient resources to establish and maintain an adequate self-regulatory program.[98] Accordingly, the Commission does not expect the rules, as proposed herein, to have a significant impact on a substantial number of small entities. Therefore, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed amendments will not have a significant economic impact on a substantial number of small entities. The Commission invites the public to comment on whether SEFs covered by these rules should be considered small entities for purposes of the RFA.

b. Paperwork Reduction Act

The Paperwork Reduction Act ("PRA") [99] imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. The proposed rules do not require a new collection of information on the part of any entities that would be subject to the proposed rules. Accordingly, for purposes of the PRA, the Commission certifies that the proposed rules, if promulgated in final form, would not impose any new reporting or recordkeeping requirements.

[97] *See* Section 721 of the Dodd-Frank Act. The Commission anticipates proposing regulations that would further specify those entities that must register as a SEF. The Commission does not believe that such proposals would alter its determination that a SEF is not a "small entity" for purposes of the RFA.

[98] See Core Principle 2 applicable to SEFs under Section 733 of the Dodd-Frank Act.

[99] 44 U.S.C. 3501 *et seq.*

c. Cost-Benefit Analysis

Section 15(a) of the CEA [100] requires that the Commission, before promulgating a regulation or issuing an order, to consider the costs and benefits of its action. By its terms, Section 15(a) of the CEA does not require the Commission to quantify the costs and benefits of a new regulation or to determine whether the benefits of the regulation outweigh its costs. Rather, Section 15(a) of the CEA simply requires the Commission to "consider the costs and benefits" of its action.

Section 15(a) of the CEA further specifies that costs and benefits shall be evaluated in light of the following considerations: (1) Protection of market participants and the public; (2) efficiency and competition; (3) financial integrity of the futures markets and price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the Commission could, in its discretion, give greater weight to any one of the five considerations and could determine that, notwithstanding its costs, a particular regulation was 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 Commission has evaluated the costs and benefits of the proposed rules, in light of the specific provisions of Section 15(a) of the CEA, as follows:

1. *Protection of market participants and the public.* The proposed rules concern governance and conflicts of interest and seek to improve governance arrangements to prevent conflicts of interest that if not addressed, would serve the interests of one group of constituents over other groups, including other market participants and the public. The proposed rules require governance arrangements that allow the registered entities to better serve the public interest.

2. *Efficiency and competition.* The proposed rules provide for the identification and mitigation of conflicts of interest, which improves efficiency in decision-making and increases fair access to clearing and markets which improves competition.

3. *Financial integrity of futures markets and price discovery.* The proposed rules facilitate transparency in governance which, in turn, facilitates transparency in matters governed including increased fair access to clearing and trading which, in turn, facilitates price discovery. This decreases risk which, in turn, increases financial integrity.

[100] 7 U.S.C. 19(a).

4. *Sound risk management practices.* The proposed rules provide for participation in decision-making by those who share in the risk presented by the operation of the registered entity. The governance arrangements provided by the proposed rules provide for a balance among different interests (including the public interest) so that risks presented by one group's interests will not dominate decision-making in the organization. This balance should prevent excess risk associated with any one group's interests from affecting operations.

5. *Other public interest considerations.* The proposed rules provide for governance arrangements for DCOs, DCMs, and SEFs, as well as methods of mitigating the presence of conflicts of interest, that should, for the reasons, cited above, operate in the best interests of the public.

Accordingly, after considering the five factors enumerated above, the Commission has determined to propose the regulations set forth below. The Commission invites public comment on its evaluation of the costs and benefits of the proposed rules. Specifically, commenters are invited to submit data quantifying the costs and benefits of the proposed rules with their comment letters.

VII. Text of Proposed Rules

List of Subjects

17 CFR Part 1

Definitions, Directors, Committees.

17 CFR Part 37

Swap execution facility, Conflict of Interest, Membership, Access, Voting, Ownership.

17 CFR Part 38

Designated contract markets, Conflict of interest, Membership, Access, Voting, Ownership.

17 CFR Part 39

Registered clearing organization, Conflict of interest, Membership, Access, Voting, Ownership.

17 CFR Part 40

Governance, Directors, Committees, Conflict of interest.

For the reasons stated in this release, the Commission hereby amends 17 CFR parts 1, 37, 38, 39, and 40 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. Revise the authority citation for part 1 to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 60, 6p, 7, 7a, 7b, 8, 9, 12, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24 and Sec. 726, Pub. L. 111–203, 124 Stat. 1376.

2. Section 1.3 is amended by adding paragraphs (zz) through (aaa) to read as follows:

§ 1.3 Definitions

(zz) *Board of Directors.* This term means the Board of Directors or Board of Governors of a company or organization, or equivalent governing body.

(aaa) *Disciplinary Panel.* This term shall be as defined in § 40.9(c)(3)(i).

(bbb) *Executive Committee.* This term shall mean a committee of the Board of Directors that may exercise the authority delegated to it by the Board of Directors with respect to the management of the company or organization.

(ccc) *Public Director.* This term means a member of the Board of Directors (each, a "director") of a registered derivatives clearing organization (as defined in Section 1a(15) of the Act), a board of trade designated as a contract market pursuant to Section 5 of the Act, or a registered swap execution facility (as defined in Section 1a(50) of the Act), as applicable, who has been found, by the Board of Directors of the registered entity, on the record, to have no material relationship with such registered entity. The Board of Directors must make such finding upon the nomination or appointment of the director and as often as necessary in light of all circumstances relevant to such director, but in no case less than annually.

(1) For purposes of this definition, a "material relationship" is one that reasonably could affect the independent judgment or decision-making of the director. In making the finding specified in paragraph (ccc) of this section, the Board of Directors need not consider previous service as a director of the registered entity to constitute a "material relationship." Circumstances in which a director shall be considered to have a "material relationship" with the registered entity include, but are not limited to, the following:

(i) Such director is an officer or an employee of the registered entity, or an officer or an employee of its affiliate. In this context, "affiliate" includes parents or subsidiaries of the registered entity or entities that share a common parent with the registered entity;

(ii) Such director is a member of the registered entity, or a director, an officer, or an employee of a member. In this context, "member" is defined according to Section 1a(34) of the Act and any regulation promulgated thereunder, including, without limitation, §§ 1.3(c) and (q) of this chapter and any successor provisions;

(iii) Such director is an officer of another entity, which entity has a compensation committee (or similar body) on which any officer of the registered entity serves;

(iv) Such director, or an entity with which the director is a partner, an officer, an employee, or a director, receives more than $100,000 in combined annual payments for legal, accounting, or consulting services from the registered entity, any affiliate thereof (as defined in paragraph (ccc)(1)(i) of this section), any member of the registered entity (as defined in paragraph (ccc)(1)(ii) of this section), or any affiliate of such member. Compensation for services as a director of the registered entity or as a director of an affiliate thereof does not count toward the $100,000 payment limit, nor does deferred compensation for services rendered prior to becoming a director of the registered entity, so long as such compensation is in no way contingent, conditioned, or revocable; or

(v) Notwithstanding paragraph (ccc)(1)(iv) of this section, in the case of a public director that is a member of the Regulatory Oversight Committee, the Risk Management Committee (or any subcommittee thereof), or the Membership or Participation Committee (or any committee serving a similar function), such director (other than in the capacity of a member of such committee, any other committee, or the Board of Directors, in each case, of the registered entity), accepts, directly or indirectly, any consulting, advisory, or other compensatory fee from the registered entity, any affiliate thereof (as defined in paragraph (ccc)(1)(i) of this section), any member of the registered entity (as defined in paragraph (ccc)(1)(ii) of this section), or any affiliate of such member, other than deferred compensation for service rendered prior to becoming a member of the Regulatory Oversight Committee, the Risk Management Committee (or any subcommittee thereof), or the Membership or Participation Committee (or any committee serving a similar function), *provided that* such compensation is in no way contingent, conditioned, or revocable.

(vi) Any of the relationships set forth in paragraphs *(ccc)(1)(i)* through (ccc)(1)(v) of this section apply to the "immediate family" of such director, *i.e.,* spouse, parents, children, and siblings, in each case, whether by blood, marriage, or adoption, or any person residing in the home of the director or that of his or her "immediate family."

(2) All of the disqualifying circumstances described in paragraph (ccc)(1)(i) through (ccc)(1)(v) of this section shall be subject to a one-year look back.

(3) A public director of any registered entity specified in paragraph (ccc) of this section may also serve as a public director of an affiliate of the registered entity (as defined in paragraph (ccc)(1)(i) of this section) if he or she otherwise meets the requirements in paragraph (ccc)(1)(i) through (ccc)(1)(v) of this section.

(ddd) *Membership or Participation Committee.* This term shall be as defined in § 37.19(c)(1)(i), with respect to a registered swap execution facility, and § 38.851(c)(1)(i), with respect to a designated contract market.

(eee) *Nominating Committee.* This term shall be as defined in § 40.9(c)(1)(i).

(fff) *Regulatory Oversight Committee.* This term shall be as defined in § 37.19(b)(1), with respect to a registered swap execution facility, and § 38.851(b)(1), with respect to a designated contract market.

(ggg) *Risk Management Committee.* This term shall be as defined in § 39.13(g)(1).

PART 37—SWAP EXECUTION FACILITIES

3. Revise the authority citation for part 37 to read as follows:

Authority: Sec. 726, Pub. L. 111–203, 124 Stat. 1376.

4. Revise the heading to Part 37 to read as set forth above.

5. Add § 37.19 to read as follows:

§ 37.19 Conflicts of Interest.

(a) *General.* The swap execution facility shall:

(1) Establish and enforce rules to minimize conflicts of interest in its decision-making process; and

(2) Establish a process for resolving the conflicts of interest. Nothing in this section shall supersede any requirement applicable to the registered swap execution facility under § 40.9 of this chapter.

(b) *Regulatory Oversight Committee.*

(1) *General.* A registered swap execution facility shall have a regulatory oversight committee (the "Regulatory Oversight Committee"), which shall:

(i) Monitor the regulatory program of the registered entity for sufficiency, effectiveness, and independence;

(ii) Oversee all facets of the regulatory program, including:

(A) Trade practice and market surveillance; audits, examinations, and other regulatory responsibilities with respect to members (including ensuring compliance with, if applicable, financial integrity, financial reporting, sales practice, recordkeeping, and other requirements); and the conduct of investigations;

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

(C) Reviewing the performance of the Chief Compliance Officer (as referenced in Section 5h(f)(15) of the Act) and making recommendations with respect to such performance to the Board of Directors;

(D) Recommending changes that would ensure fair, vigorous, and effective regulation; and

(E) Reviewing all regulatory proposals prior to implementation and advising the Board of Directors as to whether and how such changes may impact regulation.

(2) *Reporting.* The Regulatory Oversight Committee shall report to the Board of Directors of the registered swap execution facility.

(3) *Composition.* The Regulatory Oversight Committee shall be composed entirely of Public Directors.

(4) *Delegation.* The Regulatory Oversight Committee shall oversee the regulatory program of the registered swap execution facility on behalf of the Board of Directors. The Board of Directors shall delegate sufficient authority, dedicate sufficient resources, and allow sufficient time for the Regulatory Oversight Committee to fulfill its mandate.

(c) *Membership or Participation.*

(1) *Committee.*

(i) *General.* A registered swap execution facility shall have a membership or participation committee (the "Membership or Participation Committee"), which shall, at a minimum, perform the following functions:

(A) Determine the standards and requirements for initial and continuing membership or participation eligibility;

(B) Review appeals of staff denials of membership or participation applications; and

(C) Approve rules that would result in different categories or classes of members or participants receiving disparate access to the registered swap execution facility.

(ii) *Reporting.* The Membership or Participation Committee shall report to the Board of Directors of the registered swap execution facility.

(iii) *Composition.* The Membership or Participation Committee shall be composed of thirty-five percent Public Directors.

(iv) *Delegation.* The Board of Directors may choose to delegate the performance of the functions of the Membership or Participation Committee to one or more other committees, *provided that* each such committee meets the composition requirements set forth in paragraph (c)(1)(iii) of this section. If the Board of Directors chooses to so delegate, the registered swap execution facility would no longer need to maintain a Membership or Participation Committee.

(2) *Access.*

(i) In reviewing appeals of staff denials of membership or participation applications, the Membership or Participation Committee (or entity performing the functions of such committee) shall not uphold any staff denial if the relevant application meets the standards and requirements that such committee sets forth.

(ii) The Membership or Participation Committee (or entity performing the functions of such committee) shall not, and shall not permit the registered swap execution facility to, restrict access or impose burdens on access in a discriminatory manner, within each category or class of members or participants or between similarly-situated categories or classes of members or participants.

(d) *Limits on Voting Equity Ownership and the Exercise of Voting Power.*

(1) *Definitions.* For purposes of this § 37.19(d):

(i) *Related Persons* means, with respect to any member of a registered swap execution facility:

(A) Any person that, directly or indirectly, is a parent or subsidiary of, or shares a common parent with, such member;

(B) Any partner, director, officer, or other employee of such member;

(C) Any immediate family member of such member, or any immediate family member of such member's spouse, in each case, who has the same home as such member; or

(D) Any immediate family member of the persons enumerated in paragraph (d)(1)(i)(B) of this section, or any immediate family member of such person's spouse, in each case, who has the same home as such person.

(2) *Limits.* A registered swap execution facility shall not permit any member, together with any Related Persons of such member, to:

(i) Beneficially own, directly or indirectly, more than twenty percent of any class of equity interest of the registered swap execution facility entitled to vote; or

(ii) Directly or indirectly vote, cause the vote of, give any consent or proxy with respect to the voting of, or enter into any shareholder agreement regarding the voting of, any interest in the registered swap execution facility that exceeds twenty percent of the voting power of any class of equity interest of the registered swap execution facility.

(3) *Parent Companies.* If the registered swap execution facility is a subsidiary, paragraph (d)(2) of this section shall apply to its parent, whether direct or indirect, in the same manner as it applies to the registered swap execution facility. If any parent is publicly-listed on a domestic exchange, then such parent must follow the voting requirements promulgated by the Securities and Exchange Commission or the entity on which such parent is listed.

(4) *Remediation.* A registered swap execution facility must have rules addressing the manner in which it would remediate any breach of the limits set forth in paragraph (d)(2) of this section. Such rules must specify, at a minimum:

(i) The manner in which the registered swap execution facility would redeem any equity interest that a member or a Related Person purchased in excess of the limits set forth in paragraph (d)(2) of this section;

(ii) The manner in which the registered swap execution facility would disregard any votes cast in excess of such limits; and

(iii) The manner in which the registered swap execution facility would cause any breach of such limits to be reported to the Chief Compliance Officer (as referenced in Section 5h(f)(15) of the Act).

PART 38—DESIGNATED CONTRACT MARKETS

6. Revise the authority citation for part 38 to read as follows:

Authority: 7 U.S.C. 2, 5, 6, 6c, 7, 7a–2 and 12a and Sec. 726, Pub. L. 111–203, 124 Stat. 1376.

7. Section 38.1 is amended by adding a new sentence to the end of the section to read as follows:

§ 38.1 Scope.

* * * Nothing in this Part 38 shall apply to a board of trade designated as a contract market pursuant to Section 5f of the Act.

8. Add § 38.851 to read as follows:

§ 38.851 Conflicts of interest.

(a) *General.* A designated contract market shall establish and enforce rules to minimize conflicts of interest in its decision-making process and establish a process for resolving any conflicts of interest. Nothing in this section shall supersede any requirement applicable to the designated contract market under § 40.9 of this chapter.

(b) *Regulatory Oversight Committee.*

(1) *General.* A designated contract market shall have a regulatory oversight committee ("Regulatory Oversight Committee"), which shall:

(i) Monitor the regulatory program of the registered entity for sufficiency, effectiveness, and independence;

(ii) Oversee all facets of the regulatory program, including:

(A) Trade practice and market surveillance; audits, examinations, and other regulatory responsibilities with respect to members (including ensuring compliance with, if applicable, financial integrity, financial reporting, sales practice, recordkeeping, and other requirements); and the conduct of investigations;

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

(C) Supervising the chief regulatory officer of the designated contract market, who will report directly to the Regulatory Oversight Committee;

(D) Recommending changes that would ensure fair, vigorous, and effective regulation; and

(E) Reviewing all regulatory proposals prior to implementation and advising the Board of Directors as to whether and how such changes may impact regulation.

(2) *Reporting.* The Regulatory Oversight Committee shall report to the Board of Directors of the designated contract market.

(3) *Composition.* The Regulatory Oversight Committee shall be composed entirely of Public Directors.

(4) *Delegation.* The Regulatory Oversight Committee shall oversee the regulatory program of the designated contract market on behalf of the Board of Directors. The Board of Directors shall delegate sufficient authority, dedicate sufficient resources, and allow sufficient time for the Regulatory Oversight Committee to fulfill its mandate.

(c) *Membership or Participation.*

(1) *Committee.*

(i) *General.* A designated contract market shall have a membership or participation committee ("Membership or Participation Committee"), which shall, at a minimum, perform the following functions:

(A) Determine the standards and requirements for initial and continuing membership or participation eligibility;

(B) Review appeals of staff denials of membership or participation applications; and

(C) Approve rules that would result in different categories or classes of members or participants receiving disparate access to the designated contract market.

(ii) *Reporting.* The Membership or Participation Committee shall report to the Board of Directors of the designated contract market.

(iii) *Composition.* The Membership or Participation Committee shall be composed of thirty-five percent Public Directors.

(iv) *Delegation.* The Board of Directors may choose to delegate the performance of the functions of the Membership or Participation Committee to one or more other committees, *provided that* each such committee meets the composition requirements set forth in paragraph (c)(1)(iii) of this section. If the Board of Directors chooses to so delegate, the registered swap execution facility would no longer need to maintain a Membership or Participation Committee.

(2) *Access.*

(i) In reviewing appeals of staff denials of membership or participation applications, the Membership or Participation Committee (or entity performing the functions of such committee) shall not uphold any staff denial if the relevant application meets the standards and requirements that such committee sets forth.

(ii) The Membership or Participation Committee (or entity performing the functions of such committee) shall not, and shall not permit the registered swap execution facility to, restrict access or impose burdens on access in a discriminatory manner, within each category or class of members or participants or between similarly-situated categories or classes of members or participants.

(d) *Limits on Voting Equity Ownership and the Exercise of Voting Power.*

(1) *Definitions.* For purposes of this § 38.851(d):

(i) *Related Persons* means, with respect to any member of a designated contract market:

(A) Any person that, directly or indirectly, is a parent or subsidiary of, or shares a common parent with, such member;

(B) Any partner, director, officer, or other employee of such member;

(C) Any immediate family member of such member, or any immediate family member of such member's spouse, in each case, who has the same home as such member; or

(D) Any immediate family member of the persons enumerated in paragraph (d)(1)(i)(B) of this section, or any immediate family member of such person's spouse, in each case, who has the same home as such person.

(2) *Limits.* A designated contract market shall not permit any member, together with any Related Persons of such member, to:

(i) Beneficially own, directly or indirectly, more than twenty percent of any class of equity interest of the designated contract market entitled to vote; or

(ii) Directly or indirectly vote, cause the vote of, give any consent or proxy with respect to the voting of, or enter into any shareholder agreement regarding the voting of, any interest in the designated contract market that exceeds twenty percent of the voting power of any class of equity interest of the designated contract market.

(3) *Parent Companies.* If the designated contract market is a subsidiary, paragraph (d)(2) of this section shall apply to its parent, whether direct or indirect, in the same manner as it applies to the designated contract market. If any parent is publicly-listed on a domestic exchange, then such parent must follow the voting requirements promulgated by the Securities and Exchange Commission or the entity on which such parent is listed.

(4) *Remediation.* A designated contract market must have rules addressing the manner in which it would remediate any breach of the limits set forth in paragraph (d)(2) of this section. Such rules must specify, at a minimum:

(i) The manner in which the designated contract market would redeem any equity interest that a member or a Related Person purchased in excess of the limits set forth in paragraph (d)(2) of this section;

(ii) The manner in which the designated contract market would disregard any votes cast in excess of such limits; and

(iii) The manner in which the designated contract market would cause any breach of such limits to be reported to the chief regulatory officer.

PART 39—DERIVATIVES CLEARING ORGANIZATIONS

9. Revise the authority citation for part 39 read as follows:

Authority: 7 U.S.C. 7b and Sec. 726, Pub. L. 111–203, 124 Stat. 1376.

10. Add § 39.13 to read as follows:

§ 39.13 Risk Management.

(a) through (g) [Reserved]

(g) *Risk Management Committee.*

(1) *General.* A derivatives clearing organization shall have a risk management committee (the "Risk Management Committee"), which shall, at a minimum, perform the following functions:

(i) Advise the Board of Directors on significant changes to the derivatives clearing organization's risk model and default procedures;

(ii) Determine the standards and requirements for initial and continuing clearing membership eligibility;

(iii) Approve or deny (or review approvals or denials of) clearing membership applications;

(iv) Determine products eligible for clearing; and

(v) Review the performance of the Chief Compliance Officer (as referenced in Section 5b(i) of the Act) and make recommendations with respect to such performance to the Board of Directors.

(2) *Reporting.* The Risk Management Committee shall report to the Board of Directors of the derivatives clearing organization.

(3) *Composition.*

(i) The Risk Management Committee shall be composed of at least thirty-five percent Public Directors of a derivatives clearing organization and at least ten percent representatives of customers. In this context, a "customer" means any customer of a clearing member, including, without limitation:

(A) Any "customer" or "commodity customer" within the meaning of § 1.3(k) of this chapter;

(B) Any "foreign futures or foreign options customer" within the meaning of § 30.1(c) of this chapter; and

(C) Any customer entering into a cleared swap (as defined in Section 1a(7) of the Act).

(ii) The remaining members of such Risk Management Committee (or subcommittee thereof as described in paragraph (g)(5) of this section) may be, in the discretion of the derivatives clearing organization, representatives of clearing members. No such member shall be an employee of the derivatives clearing organization.

(iii) The Chairman of the Risk Management Committee (or subcommittee thereof as described in paragraph (g)(5) of this section) shall be a Public Director.

(4) *Meetings.* The Risk Management Committee shall hold regular meetings. The Committee may invite employees of the derivatives clearing organization to attend its meetings in a non-voting capacity.

(5) *Delegation.* The Risk Management Committee may delegate, in writing, the performance of the functions enumerated in paragraph (g)(1)(ii) to (iv) of this section to a subcommittee, *provided that* such subcommittee meets the composition requirements set forth in paragraph (g)(3) of this section. If the Risk Management Committee chooses to so delegate, then it would no longer be subject to such composition requirements.

(6) *Discretion.*

(i) No decision of a subcommittee with delegated authority under paragraph (g)(5) of this section, pertaining to the functions enumerated in paragraph (g)(1)(ii) to (iv) of this section, may be subject to the approval of, or otherwise restricted or limited by, a body other than the Board of Directors or the Risk Management Committee of the derivatives clearing organization, including, without limitation, any advisory committee.

(ii) No decision of the Risk Management Committee pertaining to the functions enumerated in paragraph (g)(1)(ii) to (iv) of this section, may be subject to the approval of, or otherwise restricted or limited by, a body other than the Board of Directors of the derivatives clearing organization, including, without limitation, any advisory committee.

11. Add § 39.25 to read as follows:

§ 39.25 Conflicts of interest.

(a) *General.* (1) A derivatives clearing organization shall establish and enforce rules to minimize conflicts of interest in its decision-making process and establish a process for resolving any conflicts of interest.

(2) Governance arrangements for derivatives clearing organizations should be clear and transparent and be designed to promote the safety and efficiency of the derivatives clearing organization, to support the stability of the broader financial system and other relevant public interest considerations, and to support the objectives of relevant stakeholders.

(3) Nothing in this section shall supersede any requirement applicable to the derivatives clearing organization under § 40.9 of this chapter.

(b) *Limits on Voting Equity Ownership and the Exercise of Voting Power.*

(1) *Definitions.* For purposes of this § 39.25(b):

(i) *Affiliate* means any person that, directly or indirectly, controls, is controlled by, or is under common control with, another person.

(ii) *Enumerated Entities* means:

(A) A bank holding company (as defined in Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)) with total consolidated assets of $50,000,000,000 or more,

(B) A nonbank financial company (as defined in Section 102 of the Dodd-Frank Wall Street Reform and Consumer Protection Act) supervised by the Board of Governors of the Federal Reserve System,

(C) An Affiliate of such bank holding company or nonbank financial company,

(D) A swap dealer (as defined in Section 1a(49) of the Act and any regulations promulgated thereunder),

(E) A major swap participant (as defined in Section 1a(33) of the Act and any regulations promulgated thereunder), and

(F) An associated person of a swap dealer or major swap participant (as defined in Section 1a(3) of the Act and any regulations promulgated thereunder).

(iii) *Related Persons* means, with respect to any person:

(A) An Affiliate of such person;

(B) Any partner, director, officer, or other employee of such person;

(C) Any immediate family member of such person, or any immediate family member of such person's spouse, in each case, who has the same home as such person; or

(D) Any immediate family member of the persons enumerated in paragraph (b)(1)(iii)(B) of this section, or any immediate family member of such person's spouse, in each case, who has the same home as such person.

(2) *Limits.* A derivatives clearing organization shall choose to comport with either paragraph (b)(2)(i) or (b)(2)(ii) of this section:

(i)(A) The derivatives clearing organization shall not permit any member, together with any Related Persons of such member, to:

(1) Beneficially own, directly or indirectly, more than twenty percent of any class of equity interest of the derivatives clearing organization entitled to vote; or

(2) Directly or indirectly vote, cause the vote of, give any consent or proxy with respect to the voting of, or enter into any shareholder agreement regarding the voting of, any interest in the derivatives clearing organization that exceeds twenty percent of the voting power of any class of equity interest of the derivatives clearing organization.

(B) Additionally, a derivatives clearing organization shall not permit the Enumerated Entities (whether or not they are clearing members), together with any Related Persons of such Enumerated Entities, to collectively:

(1) Own, on a beneficial basis, directly or indirectly, more than forty percent of

any class of equity interest of the derivatives clearing organization entitled to vote; or

(2) Directly or indirectly vote, cause the vote of, give any consent or proxy with respect to the voting of, or enter into any shareholder agreement regarding the voting of, any interest in the derivatives clearing organization that exceeds forty percent of the voting power of any class of equity interest of the derivatives clearing organization.

(C) The derivatives clearing organization shall ensure that no resolution or similar measure on which the Enumerated Entities are entitled to vote shall be passed by less than a majority of all outstanding equity interests similarly entitled to vote.

(ii) The derivatives clearing organization shall not permit any member or any Enumerated Entity (whether or not such entity is a member), together with any Related Persons in each case thereof, to:

(A) Beneficially own, directly or indirectly, more than five percent of any class of equity interest of the derivatives clearing organization entitled to vote; or

(B) Directly or indirectly vote, cause the vote of, give any consent or proxy with respect to the voting of, or enter into any shareholder agreement regarding the voting of, any interest in the derivatives clearing organization that exceeds five percent of the voting power of any class of equity interest of the derivatives clearing organization.

(3) *Waiver.*

(i) A derivatives clearing organization may request that the Commission waive the requirements set forth in paragraph (b)(2) of this section.

(ii)(A) The Commission may grant a waiver for a period of time that it deems reasonable if, upon a showing by a derivatives clearing organization, the Commission determines that, with respect to the derivatives clearing organization, the requirements set forth in paragraph (b)(2) of this section are not necessary or appropriate to:

(1) Improve the governance of the derivatives clearing organization;

(2) Mitigate systemic risk;

(3) Promote competition;

(4) Mitigate conflicts of interest in connection with a swap dealer or major swap participant's conduct of business with the derivatives clearing organization, including with respect to Section 2(h)(1)(B) and Section 5b(c)(2)(c) of the Act; and

(5) Otherwise accomplish the purposes of the Act.

(B) The Commission may, at any time, revoke the waiver upon its own motion. Upon such revocation, or at the expiration of the waiver period, the derivatives clearing organization shall require all equity holders to comport, through divestiture or other means, with the requirements set forth in paragraph (b)(2) of this section.

(4) *Parent Companies.* If the derivatives clearing organization is a subsidiary, paragraph (b)(2) of this section shall apply to its parent, whether direct or indirect, in the same manner as it applies to the derivatives clearing organization. If any parent is publicly listed on a domestic exchange, then such parent must follow the voting requirements promulgated by the Securities and Exchange Commission or the entity on which such parent is listed.

(5) *Remediation.* A derivatives clearing organization must have rules addressing the manner in which it would remediate any breach of the limits set forth in paragraph (b)(2) of this section. Such rules must specify, at a minimum:

(i) The manner in which the derivatives clearing organization would redeem any equity interest that a member, the Enumerated Entities, or a Related Person in each case thereof, purchased in excess of the limits set forth in paragraph (b)(2) of this section;

(ii) The manner in which the derivatives clearing organization would disregard any votes cast in excess of such limits; and

(iii) The manner in which the derivatives clearing organization would cause any breach of such limits to be reported to the Chief Compliance Officer (as referenced in Section 5b(i) of the Act).

PART 40—PROVISIONS COMMON TO REGISTERED ENTITIES

1. Revise the authority citation for part 40 to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 7, 7a, 8, and 12a, and Sec. 726, Pub. L. 111–203, 124 Stat. 1376.

2. Add § 40.9 to read as follows:

§ 40.9 Governance.

(a) *General.* (1) Nothing in this section shall apply to a board of trade designated as a contract market pursuant to Section 5f of the Act.

(2) Capitalized terms not defined herein shall have the meanings assigned to them in § 1.3 of this chapter.

(3) Nothing in this section shall supersede any requirement applicable to the registered entity under Parts 37, 38, or 39 of this chapter.

(b) *The Board of Directors.*

(1) *General.*

(i) The Board of Directors of a registered derivatives clearing organization, a designated contract market, or a registered swap execution facility shall be composed of at least thirty-five percent, but no less than two, Public Directors.

(ii) The roles and responsibilities of such Board of Directors must be clearly articulated, especially in respect of the manner in which the Board of Directors ensures that a registered entity referenced in paragraph (b)(1)(i) of this section complies with all statutory, regulatory, and self-regulatory responsibilities under the Act and the regulations promulgated thereunder.

(2) *Parent Companies.*

(i) For purposes of paragraph (b)(2) of this section, "operate" shall mean the direct exercise of control (including through the exercise of veto power) over the day-to-day business operations of a registered entity specified in paragraph (b)(1)(i) of this section by the sole or majority shareholder of such registered entity, whether through the ownership of voting equity, by contract, or otherwise. The term "operate" shall not prohibit an entity, acting as the sole or majority shareholder of such registered entity, from exercising its rights as a shareholder under any contract, agreement, or other legal obligation.

(ii) A registered entity specified in paragraph (b)(1)(i) of this section shall not permit itself to be operated by any entity unless such entity agrees that:

(A) Paragraph (b)(1) of this section shall apply to such entity in the same manner as it applies to the registered entity;

(B) The officers, directors, employees, and agents of such entity shall be deemed to be the officers, directors, employees, and agents of the registered entity, and shall thereby be subject to the authority of the Commission pursuant to the Act and the regulations promulgated thereunder; and

(C) Any books and records of such entity relating to such operation shall be deemed to be the books and records of the registered entity for purposes of the Act and the regulations promulgated thereunder. Such books and records shall be subject at all times to inspection and copying by the Commission, regardless of whether such books and records contain confidential information, as long as such entity operates the registered entity.

(3) *Expertise.* The members of the Board of Directors, including Public Directors, of each registered entity specified in paragraph (b)(1)(i) of this section, shall be of sufficiently good repute and, where applicable, have sufficient expertise in financial services, risk management, and clearing services.

(4) *Compensation.* The compensation of the Public Directors and other non-executive members of the Board of Directors of a registered entity specified in paragraph (b)(1)(i) of this section shall not be linked to the business performance of such registered entity.

(5) *Annual Self-Review.* The Board of Directors of a registered entity specified in paragraph (b)(1)(i) of this section shall review its performance and that of its individual members annually. It should consider periodically using external facilitators for such reviews.

(6) *Board Member Removal.* A registered entity specified in paragraph (b)(1)(i) of this section shall have procedures to remove a member from the Board of Directors, where the conduct of such member is likely to be prejudicial to the sound and prudent management of the registered entity.

(c) *Committees and Panels.*

(1) *Nominating Committee.*

(i) *General.* Each registered derivatives clearing organization, designated contract market, or registered swap execution facility must have a nominating committee ("Nominating Committee"), which shall, at a minimum:

(A) identify individuals qualified to serve on the Board of Directors, consistent with criteria approved by the Board of Directors, and with the composition requirements set forth in this section; and

(B) Administer a process for the nomination of individuals to the Board of Directors.

(ii) *Reporting.* The Nominating Committee shall report to the Board of Directors of the registered entity.

(iii) *Composition.* The Nominating Committee shall be composed of at least fifty-one percent Public Directors. The chair of the Nominating Committee shall be a Public Director.

(2) *Executive Committee.* Any Executive Committee of a registered derivatives clearing organization, designated contract market, or registered swap execution facility shall be composed of at least thirty-five percent, but no less than two, Public Directors.

(3) *Disciplinary Panels.*

(i) *General.* Each registered derivatives clearing organization, designated contract market, or registered swap execution facility must have one or more disciplinary panels (each, a "Disciplinary Panel"), each of which shall be responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters.

(ii) *Composition.* Each Disciplinary Panel shall include at least one person who would not be disqualified from serving as a Public Director by § 1.3(ccc)(1)(i)–(vi) and (2) of this chapter (a "Public Participant"). Such Public Participant shall chair each Disciplinary Panel. In addition, any registered entity specified in paragraph (c)(3)(i) of this section shall adopt rules that would, at a minimum:

(A) Further preclude any group or class of participants from dominating or exercising disproportionate influence on a Disciplinary Panel and

(B) Prohibit any member of a Disciplinary Panel from participating in deliberations or voting on any matter in which the member has a financial interest.

(iii) *Appeals.* If the rules of the registered entity provide that the decision of a Disciplinary Panel may be appealed to another committee of the Board of Directors (or similar body), then such committee must also include at least one Public Participant, and such Public Participant must chair the committee.

(iv) *Exception.* Notwithstanding the foregoing, paragraphs (c)(3)(ii) through (c)(3)(iii) of this section do not apply to a Disciplinary Panel convened for cases solely involving decorum or attire.

(v) *Delegation.* With respect to a registered derivatives clearing organization, the Board of Directors may delegate to the Risk Management Committee the performance of the functions of the Disciplinary Panel. If the Board of Directors so delegates:

(A) The registered derivatives clearing organization need no longer maintain a Disciplinary Panel, but

(B) Paragraph (c)(3)(iii) of this section would still apply to any committee (or similar body) to which a decision of the Risk Management Committee may be appealed.

Issued in Washington, DC, on October 1, 2010, by the Commission.

David A. Stawick,

Secretary of the Commission.

Concurring Statement of Commissioner Scott D. O'Malia

October 1, 2010 Public Meeting

I concur in the Commission's proposal of rules pursuant to Section 726 of the Dodd-Frank Act (the "Act"). However, I have a number of concerns associated with the prescriptiveness of the proposed conflict of interest rules. I believe, given the goals of the Act, it is appropriate to consider more flexible ownership structures and voting rights levels as well as the availability of waivers for derivatives clearing organizations ("DCOs").

Ownership and Voting Limits on DCOs

A main goal of the Act is to mitigate systemic risk in the U.S. financial system by imposing a mandatory clearing requirement on swaps. Additionally, the business of clearing is serious and financially complex. I am concerned that the proposed rules may not properly consider the effect on mitigation of systemic risk, competition, and capital formation in the DCO space, or afford the Commission with the necessary flexibility to achieve those outcomes. Given that the Commission has yet to consider any new DCO applications under the Act, it is extremely unwise to conduct an experiment with the ownership structure of DCOs.

Second, a stated goal of the Act was to provide all market participants with fair, open, and non-discriminatory access to DCOs. To achieve that end, Congress included Open Access and Participant and Product Eligibility provisions in the Act.[101] Each provision addresses and attempts to eliminate the potential for clearing entities to use ownership control to obstruct market participants from gaining access to a DCO. Rather than utilizing the limited and inflexible ownership caps in the proposed rules, I believe that the open access and eligibility provisions will be more effective in achieving the Act's goals of fair, open, and non-discriminatory access to DCOs.

Third, an overarching goal of the Act is the international harmonization of financial regulation. I believe that it's especially important for the Commission to harmonize its rules with those of foreign regulators in order to prevent regulatory arbitrage. With that said, the European Commission released (September 15, 2010) a proposal on financial reform which does not place individual or aggregate ownership limits on DCOs under European Union jurisdiction.

For the aforementioned reasons, I am in favor of a more flexible approach to limitations on DCO ownership and voting rights, including the availability of a full waiver for individual and aggregate ownership or voting limits on swap dealers or major swap participants that hold or desire to hold debt or equity positions in DCOs.

Public Directors

I fully support the Commission's decision to require a registered entity to have its board of directors and certain other committees composed of thirty-five percent (35%) public directors. This standard is consistent with the Commission's previous core principle 15 for designated contract markets ("DCMs"). The Commission thoroughly vetted this percentage with the public in a recent rulemaking and it concluded that having a board of directors for DCMs composed of thirty-five percent (35%) public directors was neither overly burdensome nor cost prohibitive. Today's proposed rulemaking also raises the question as to whether it is desirable to expand the existing rule from thirty-five percent (35%) up to fifty-one percent (51%) for DCMs, DCOs, and swap execution facilities. I am interested to know how this proposal would enhance the governance of the existing board structures of certain registered entities, and more specifically, how it would expand the clearing and risk management expertise of a DCO.

[101] Section 2(h)(1)(B) and Section 5b(c)(2)(c) of the Act.

I strongly encourage the public to closely analyze the language of each proposed rule and to provide the Commission with constructive and detailed comments on each of them. In particular, I am interested to know (i) what effect the Commission's proposed rules on voting and ownership limitations will have on competition, raising capital, and managing risk, and (ii) whether or not the open access and eligibility provisions in Sections 2(h)(1)(B) and 5b(c)(2)(c) of the Act would be a more effective method for the Commission to expand access to clearing, rather than placing limits on the voting and ownership of DCOs.

Proposed Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest

Commissioner Jill E. Sommers, Dissenting

The Commission is voting today on a proposal to implement two sections of the Dodd-Frank Act regarding the governance of CFTC regulated trading venues and clearinghouses that trade or clear swaps and how to mitigate conflicts of interest that may arise in connection with ownership interests that certain entities may have in these registrants. Specifically, Section 725(d) of the Act directs the Commission to:

Adopt rules mitigating conflicts of interest in connection with the conduct of business by a swap dealer or a major swap participant with at [DCO], [DCM], or a [SEF] that clears or trades swaps in which the swap dealer or major swap participant has a material debt or material equity investment.

Section 726 of the Act provides that the Commission shall adopt rules which "may" include numerical limits on the degree of control or voting rights that certain enumerated entities may possess with respect to DCOs, DCMs and SEFs if the Commission determines, after a review:

That such rules are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with a swap dealer or major swap participant's conduct of business with, a [DCO], [DCM], or [SEF] that clears or posts swaps or makes swaps available for trading and in which such swap dealer or major swap participant has a material debt or equity investment.

I recognize that these provisions direct the Commission to adopt strong governance rules to mitigate conflicts of interest in connection with the interaction between swap dealers and major swap participants and DCOs, DCMs and SEFs in which they have a material debt or equity investment. In my opinion, however, the voting equity restrictions being proposed are not necessary or appropriate to mitigate the perceived conflicts and in fact, may do more harm than good to the emerging marketplace for trading and clearing swaps.

In 2009, after more than two years of study, the Commission finalized acceptable practices to provide a safe harbor for complying with Core Principle 15 for DCMs dealing with conflicts of interest. I support making those acceptable practices mandatory for DCMs, DCOs and SEFs, as augmented by some of the additional provisions being proposed today, such as the Risk Management Committee for DCOs. I believe that strong governance rules, coupled with the Commission's ultimate authority to determine which swaps must be cleared, under Section 723 of Dodd-Frank, is sufficient to ensure that swaps that should be listed for trading and cleared will be listed for trading and cleared.

I have grave concerns that the proposed limitations on voting equity, especially those proposed for enumerated entities in the aggregate with respect to DCOs, may stifle competition by preventing new DCMs, DCOs and SEFs that trade or clear swaps from being formed. The Commission recognizes in the preamble to the proposal that the enumerated entities will be the most likely source of funding for new DCMs and SEFs and thus chose not to propose the aggregate limits for trading venues. I believe the same logic applies with even greater force for DCOs. I am equally concerned that a number of recent entrants into the swaps trading and clearing space will potentially be required to disband their operations if they are unable to attract the required amount of non-voting equity within the two-year/two board election cycles proposed. I also note that the European Commission explicitly rejected ownership limitations in its proposal for regulating OTC derivatives announced September 15th because such limitations may have negative consequences for market structures. I agree. And I hope that we will be mindful of global consistency as we move forward. The marketplace for trading and clearing swaps is in its infancy. I strongly believe that the limitations the Commission is proposing will have the effect of inhibiting emerging competition rather than promoting it. I therefore cannot support today's proposal.

[FR Doc. 2010–26220 Filed 10–15–10; 8:45 am]

BILLING CODE P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA–3098; File No. S7–25–10]

RIN 3235–AK66

Family Offices

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (the "Commission") is proposing a rule to define "family offices" that would be excluded from the definition of an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act") and thus would not be subject to regulation under the Advisers Act.

DATES: Comments must be received on or before November 18, 2010.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form, *http://www.sec.gov/rules/proposed.shtml*; or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–25–10 on the subject line; or
- Use the Federal eRulemaking Portal, *http://www.regulations.gov.* Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–25–10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Web site, *http://www.sec.gov/rules/proposed.shtml.* Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Sarah ten Siethoff, Senior Special Counsel, or Vivien Liu, Senior Counsel, at (202) 551–6787 or *IArules@sec.gov,* Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–8549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is requesting public comment on proposed rule 202(a)(11)(G)–1 [17 CFR 275.202(a)(11)(G)–1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (the "Advisers Act" or "Act").[1]

Table of Contents

[1] 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified.