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Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and NationalSecurities Exchanges With Respect to Security-Based Swaps Under Regulation MC; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34–63107; File No. S7–27–10]

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Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges With Respect to Security-Based Swaps Under Regulation MC

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: In accordance with Section 765 ("Section 765") of Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), the Securities and Exchange Commission ("SEC" or "Commission") is proposing Regulation MC under the Securities Exchange Act of 1934 ("Exchange Act") for clearing agencies that clear security-based swaps ("security-based swap clearing agencies") and for security-based swap execution facilities ("SB SEFs") and national securities exchanges that post or make available for trading security-based swaps ("SBS exchanges"). Regulation MC is designed to mitigate potential conflicts of interest that could exist at these entities. Specifically, the Commission seeks to mitigate the potential conflicts of interest through conditions and structures relating to ownership, voting, and governance of security-based swap clearing agencies, SB SEFs, and SBS exchanges.

DATES: Comments should be submitted on or before November 26, 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 S7–27–10 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 St., NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–27–10. 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 Internet 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 St., 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; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: *Proposals relating to security-based swap clearing agencies:* Catherine Moore, Senior Special Counsel, at (202) 551–5710; and Joseph P. Kamnik, Special Counsel, at (202) 551–5710; Office of Clearance and Settlement, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–7010; *proposals relating to security-based swap execution facilities and national securities exchanges that post or make available for trading security-based swaps:* Nancy Burke-Sanow, Assistant Director, at (202) 551–5621; Molly Kim, Special Counsel, at (202) 551–5644; Steven Varholik, Special Counsel, at (202) 551–5615; Sarah Schandler, Attorney, at (202) 551–7145; and Iliana Lundblad, Attorney, at (202) 551–5871; Office of Market Supervision, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–7010.

SUPPLEMENTARY INFORMATION: The Commission is proposing new Regulation MC under the Exchange Act relating to conflicts of interest with respect to security-based swap clearing agencies, SB SEFs, and SBS exchanges.

I. Introduction

On July 21, 2010, the President signed the Dodd-Frank Act into law.[1] The Dodd-Frank Act was enacted to, among other purposes, promote the financial stability of the United States by improving accountability and transparency in the financial system.[2] Title VII of the Dodd-Frank Act provides the Commission and the Commodity Futures Trading Commission ("CFTC") with the authority to regulate over-the-counter ("OTC") derivatives in light of the recent financial crisis, which demonstrated the need for enhanced regulation in the OTC derivatives market. The Dodd-Frank Act is intended to close loopholes in the existing regulatory structure and to provide the Commission and the CFTC with effective regulatory tools to oversee the OTC swaps market, which has grown exponentially in recent years and is capable of affecting significant sectors of the U.S. economy.

The Dodd-Frank Act provides that the CFTC will regulate "swaps," the Commission will regulate "security-based swaps," and the CFTC and the Commission will jointly regulate "mixed swaps."[3] The Dodd-Frank Act amends the Exchange Act to require, among other things, the following:
(1) Transactions in security-based swaps must be cleared through a clearing agency if they are of a type that the Commission determines must be cleared, unless an exemption from mandatory clearing applies; (2) transactions in security-based swaps must be reported to a registered security-based swap data repository or

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111–203, H.R. 4173).

[2] *See* Public Law 111–203, Preamble.

[3] Section 712(d) of the Dodd-Frank Act provides that the Commission and the CFTC, in consultation with the Board of Governors of the Federal Reserve System ("Federal Reserve"), shall jointly further define the terms "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," "eligible contract participant," and "security-based swap agreement." These terms are defined in Sections 721 and 761 of the Dodd-Frank Act and, with respect to the term "eligible contract participant," in Section 1a(18) of the Commodity Exchange Act ("CEA"), 7 U.S.C. 1a(18), as re-designated and amended by Section 721 of the Dodd-Frank Act. Further, Section 721(c) of the Dodd-Frank Act requires the CFTC to adopt a rule to further define the terms "swap," "swap dealer," "major swap participant," and "eligible contract participant," and Section 761(b) of the Dodd-Frank Act permits the Commission to adopt a rule to further define the terms "security-based swap," "security-based swap dealer," "major security-based swap participant," and "eligible contract participant," with regard to security-based swaps, for the purpose of including transactions and entities that have been structured to evade Title VII of the Dodd-Frank Act. Finally, Section 712(a) of the Dodd-Frank Act provides that the Commission and CFTC, after consultation with the Federal Reserve, shall jointly prescribe regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII. To assist the Commission and CFTC in further defining the terms specified above, and to prescribe regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII, the Commission and the CFTC have requested comment from interested parties. *See* Securities Exchange Act Release No. 62717 (August 13, 2010), 75 FR 51429 (August 20, 2010) (File No. S7–16–10) (advance joint notice of proposed rulemaking regarding definitions contained in Title VII of the Dodd-Frank Act) ("Definitions Release").

the Commission; and (3) if a security-based swap is subject to a clearing requirement, it must be traded on a registered trading platform, *i.e.,* a SB SEF or SBS exchange, unless no facility makes such security-based swap available for trading.[4]

II. Mandated Rulemaking on Mitigating Conflicts of Interest

Section 765 of the Dodd-Frank Act requires the Commission to adopt rules to mitigate specified conflicts of interest.[5] Section 765(a) requires the Commission to adopt rules, which rules may include numerical limits on the control of, or the voting rights with respect to, any security-based swap clearing agency, or on the control of any SB SEF or SBS exchange, by specified entities, such as a bank holding company with total consolidated assets of $50 billion or more,[6] a nonbank financial company,[7] an affiliate of such bank holding company or nonbank financial company, a security-based swap dealer,[8] or a major security-based swap participant (collectively, "Specified Entities").[9]

Section 765(b)—captioned "Purposes"—provides that the Commission shall adopt such rules if it determines they 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 security-based swap dealer's or major security-based swap participant's conduct of business with, a security-based swap clearing agency, SB SEF, or SBS exchange and in which such security-based swap dealer or major security-based swap participant has a material debt or equity investment.[10] Section 765(b) sets forth a number of underlying policy objectives for the Commission's rulemaking—improving governance, mitigating systemic risk, promoting competition, and mitigating conflicts of interest with respect to security-based swap clearing agencies, SB SEFs, and SBS exchanges. In considering proposed rules to mitigate conflicts of interest, the Commission is mindful that, in some instances, certain of these diverse policy objectives may be in tension with others. For example, as described in Section III.A.2.a below, with respect to security-based swap clearing agencies, the statutory objective of promoting competition, which may be furthered through enhanced access to cleared products and clearing venues, may to some extent be in tension with the objective of minimizing systemic risk through effective risk management of the clearing agency.

Section 765(c) of the Dodd-Frank Act also provides that in adopting rules under Section 765, the Commission shall consider any conflicts of interest arising from the amount of equity ownership and voting by a single investor; the ability of owners to vote, cause the vote of, or withhold votes entitled to be cast on any matters by the holders of the ownership interest; and the governance arrangements of any derivatives clearing organization that clears swaps, or swap execution facility or board of trade designated as a contract market that posts swaps or makes swaps available for trading.[11]

The Commission is cognizant that the proposed rules discussed herein, as well as other proposals that the Commission may consider in the coming months to implement the Dodd-Frank Act, if adopted, could significantly affect—and be significantly affected by—the nature and scope of the security-based swaps market in a number of ways. For example, the Commission recognizes that if the measures proposed in this release are adopted and are too onerous for new entrants, they could hinder the further development of a market for security-based swaps by unduly discouraging competition and the formation of new security-based swap clearing agencies and of new SB SEFs or SBS exchanges. On the other hand, if the Commission adopts rules that are too permissive, conflicts of interest may be inadequately mitigated and such conflicts may incentivize restricting access to centralized clearing and lack of transparency in the trading of security-based swaps as described in detail in Section III below. The Commission is also mindful that the further development of the security-based swaps market may alter the calculus for future regulation of conflicts of interest. As commenters review the instant proposals, they are urged to consider generally the role that regulation may play in fostering or limiting the development of the market for security-based swaps (or, vice versa, the role that market developments may play in changing the nature and implications of regulation) and specifically to focus on this issue with respect to the proposals to mitigate conflicts of interest for security-based swap clearing agencies, SB SEFs, and SBS exchanges.

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[4] *See* Section 761 of the Dodd-Frank Act, added as Section 3(a)(77) of the Exchange Act, 15 U.S.C. 78(c)(a), which defines the term "security-based swap execution facility" to mean "a trading system or platform in which multiple participants have the ability to execute or trade security-based 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 (A) facilitates the execution of security-based swaps between persons; and (B) is not a national securities exchange." *See* Public Law 111–203, Section 761. The Dodd-Frank Act amends the CEA to provide for a similar regulatory framework with respect to transactions in swaps regulated by the CFTC.

[5] *See* Public Law 111–203, Section 765.

[6] The term "bank holding company" has the meaning set forth in Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) ("Bank Holding Company Act"), and generally means any company that has control over any bank or over any company that is or becomes a bank holding company by virtue of the Bank Holding Company Act.

[7] Under Section 765(a) of the Dodd-Frank Act, the term "nonbank financial company" has the meaning set forth in Section 102 of the Dodd-Frank Act, and generally means a company, other than a bank holding company, national securities exchange, clearing agency, SB SEF, registered security-based swap data repository, board of trade designated as a contract market ("DCM"), derivatives clearing organization, swap execution facility ("SEF") or registered swap data repository, that is predominantly engaged in financial activities (including through a branch in the U.S., if such company is incorporated or organized in a country other than the U.S.). *See* Public Law 111–203, Section 102 for the complete definition.

[8] Pursuant to Section 761 of the Dodd-Frank Act, the term "security-based swap dealer" is added as Section 3(a)(71) of the Exchange Act, 15 U.S.C 78c(a), and generally means any person who (A) holds themselves out as a dealer in security-based swaps; (B) makes a market in security-based swaps; (C) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (D) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps. *See* Public Law 111–203, Section 761 for the complete definition. *See also* Definitions Release, 75 FR 51429, *supra* note 3.

[9] Pursuant to Section 761 of the Dodd-Frank Act, the term "major security-based swap participant" is added as Section 3(a)(67) of the Exchange Act, 15 U.S.C 78c(a), and generally means any person (A) who is not a security-based swap dealer; and (B)(I) who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the Commission, excluding positions held for hedging or mitigating commercial risk; (II) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (III) that is a financial entity that (a) is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking regulator; and (b) maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the Commission. *See* Public Law 111–203, Section 761 for the complete definition. *See also* Definitions Release, 75 FR 51429, *supra* note 3.

[10] *See* Public Law 111–203, Section 765(b).

[11] *See* Public Law 111–203, Section 765(c). Although this provision refers to swaps and to entities regulated by the CFTC, the Commission believes that the Congress intended it to refer to security-based swaps and to security-based swap clearing agencies, SB SEFs, and SBS exchanges, because Section 765 pertains to transactions in security-based swaps and persons and entities related thereto.

The Commission must adopt the rules required by Section 765 of the Dodd-Frank Act by January 17, 2011, which is 180 days after enactment of the Dodd-Frank Act.[12] The Commission therefore is proposing Regulation MC under the Exchange Act to mitigate conflicts of interest with respect to security-based swap clearing agencies, SB SEFs, and SBS exchanges.

This proposed rulemaking is among the first that the Commission has considered in connection with its mandates under the Dodd-Frank Act, and the Commission is mindful of the considerations raised by this timing. In particular, under the prescribed timeframes of the Dodd-Frank Act, the Commission must propose rules required by Section 765 before it has the opportunity to consider proposed rules that also are likely to affect the development of security-based swap clearing agencies, SB SEFs, and SBS exchanges, as well as the security-based swaps market overall. The Commission also notes that the market for security-based swaps is in a nascent stage of development compared to the markets for equity securities and listed options and that the market for security-based swaps could develop further as the Dodd-Frank Act is fully implemented and these transactions continue to move to central clearing and trading on organized markets.

III. Discussion of Potential Conflicts of Interest

A. Security-Based Swap Clearing Agencies

1. Current Regulatory Structure

Credit market events from the last few years have demonstrated that a security-based swaps market operating without meaningful regulation [13] and central counterparties [14] can pose systemic risks. In November 2008, under the auspices of the President's Working Group on Financial Markets, the Secretary of the Department of the Treasury, the Chairs of the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the CFTC, and the Commission established as a policy objective for the OTC derivatives market that regulators and prudential supervisors require participants in a central counterparty ("CCP") arrangement to clear all eligible contracts through that CCP.[15] In furtherance of this policy objective, the Commission, the Federal Reserve, and the CFTC signed a Memorandum of Understanding that established a framework for consultation and information sharing on issues related to central counterparties for the OTC derivatives market.[16]

The Commission has taken steps to help foster the prompt development of CCPs. In particular, the Commission acted to authorize the clearing of OTC security-based swaps by permitting certain clearing agencies to clear credit default swaps ("CDS") on a temporary conditional basis.[17] Today, a significant volume of CDS transactions is cleared centrally and the Commission monitors the activities of these clearing agencies.[18]

The Exchange Act does not impose specific requirements regarding the ownership structure of a clearing agency. As a result, clearing agencies may operate under a variety of appropriate organizational structures provided that they have the capacity to meet the standards in Section 17A of the Exchange Act.[19] Certain clearing agencies registered with the Commission are owned either by participants or by securities exchanges.[20] Other clearing agencies, such as the security-based swap clearing agencies that, once registered, would be required to comply with proposed Regulation MC, are subsidiaries of or partly-owned by publicly traded companies.[21] These entities are not wholly-owned by participants or exchanges and may have different governance related issues than the securities clearing agencies currently registered with the Commission.

Upon the effective date of Title VII of the Dodd-Frank Act, clearing agencies that clear and settle security-based swap transactions will be subject to a number of regulatory obligations that are intended to promote the policy objectives of the Dodd-Frank Act, including increased clearing of security-based swaps and effective risk management. Accordingly, security-based swap clearing agencies will be required to be registered with, and regulated by, the Commission under Section 17A.[22] In addition, all registered

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[12] Section 726 of the Dodd-Frank Act similarly requires the CFTC to adopt rules designed to mitigate conflicts of interest with respect to entities under its jurisdiction that clear or trade swaps. *See* Public Law 111–203, Section 726. The Commission preliminarily believes that an entity that registers with the Commission as either a security-based swap clearing agency or a SB SEF is likely to register also with the CFTC as a derivatives clearing organization or swap execution facility, respectively. As a result, the Commission staff and the CFTC staff have consulted and coordinated with one another regarding their respective agencies' proposed rules to mitigate conflicts of interest.

[13] *See, generally,* Policy Objectives for the OTC Derivatives Market, The President's Working Group on Financial Markets (November 14, 2008) (available at *http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf*).

[14] *See* The Role of Credit Derivatives in the U.S. Economy before the H. Agric. Comm., 110th Cong. (2008) (Statement of Erik Sirri, Director of the Division of Trading and Markets, Commission) (available at *http://agriculture.house.gov/testimony/110/110-49.pdf*).

[15] *See supra* note 13. *See also* Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets (March 13, 2008) (available at *http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf*) and Progress Update on March Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets (October 2008) (available at *http://www.treas.gov/press/releases/reports/q4progress%20update.pdf*).

[16] *See* Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, the U.S. Commodity Futures Trading Commission, and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps (November 14, 2008) (available at *http://www.treas.gov/press/releases/reports/finalmou.pdf).*

[17] The Commission authorized five entities to clear credit default swaps. *See* Securities Exchange Act Release Nos. 60372 (July 23, 2009), 74 FR 37748 (July 29, 2009) and 61973 (April 23, 2010), 75 FR 22656 (April 29, 2010) (CDS clearing by ICE Clear Europe Limited); 60373 (July 23, 2009), 74 FR 37740 (July 29, 2009) and 61975 (April 23, 2010), 75 FR 22641 (April 29, 2010) (CDS clearing by Eurex Clearing AG); 59578 (March 13, 2009), 74 FR 11781 (March 19, 2009), 61164 (December 14, 2009), 74 FR 67258 (December 18, 2009) and 61803 (March 30, 2010), 75 FR 17181 (April 5, 2010) (CDS clearing by Chicago Mercantile Exchange Inc.); 59527 (March 6, 2009), 74 FR 10791 (March 12, 2009), 61119 (December 4, 2009), 74 FR 65554 (December 10, 2009) and 61662 (March 5, 2010), 75 FR 11589 (March 11, 2010) (CDS clearing by ICE Trust US LLC); 59164 (December 24, 2008), 74 FR 139 (January 2, 2009) (temporary CDS clearing by LIFFE A&M and LCH.Clearnet Ltd.) (collectively, "CDS Clearing Exemption Orders"). LIFFE A&M and LCH.Clearnet Ltd. allowed their order to lapse without seeking renewal.

[18] To date most cleared CDS transactions have cleared at ICE Trust US LLC ("ICE Trust") or ICE Clear Europe Limited ("ICE Clear Europe"). As of October 8, 2010, ICE Trust had cleared approximately $7.1 trillion notional amount of CDS contracts based on indices of securities and approximately $490 billion notional amount of CDS contracts based on individual reference entities or securities. As of October 8, 2010, ICE Clear Europe had cleared approximately €3.09 trillion notional amount of CDS contracts based on indices of securities and approximately €560 billion notional amount of CDS contracts based on individual reference entities or securities. *See https://www.theice.com/marketdata/reports/ReportCenter.shtml.*

[19] *See* 78q–1(b)(3)(A).

[20] The Depository Trust and Clearing Corporation ("DTCC") is participant-owned and has three separate subsidiaries that are registered clearing agencies which function as quasi-utilities. The Options Clearing Corporation is owned by five unaffiliated options exchanges.

[21] These clearing agencies include ICE Trust US LLC, ICE Clear Europe Limited, Eurex Clearing AG, and Chicago Mercantile Exchange Inc.

[22] Section 763(b) of the Dodd-Frank Act adds new Section 17A(k) to the Exchange Act, which authorizes the Commission to exempt, conditionally or unconditionally, a security-based swap clearing agency from registration if the Commission determines it is subject to comparable, comprehensive supervision and regulation by the CFTC or appropriate government authorities in the

clearing agencies must comply with the standards in Section 17A, which include, but are not limited to, maintaining rules for promoting the prompt and accurate clearance and settlement of securities transactions, assuring the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, fostering cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, removing impediments to and perfecting the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, protecting investors and the public interest.[23] A registered clearing agency is also required to provide fair access to clearing and to have the capacity to facilitate the prompt and accurate clearance and settlement of securities transactions and derivative agreements, contracts, and transactions for which it is responsible, as well as to safeguard securities and funds in its custody or control or for which it is responsible.[24]

Pursuant to Section 765 of the Dodd-Frank Act, the Commission must identify the nature and sources of any conflicts of interest relating to the voting interests in and governance of a security-based swap clearing agency that may interfere with achieving the policy objectives described above or with the clearing agency complying with the regulatory mandates of Section 17A of the Exchange Act described above, including the obligation to adopt rules consistent with the protection of investors and the public interest.

2. Sources of Conflicts of Interest

The Commission's experience in monitoring the activities of the clearing agencies engaged in clearing CDS has provided it with insight into the potential sources of conflicts of interest that may exist at security-based swap clearing agencies. Since shortly after the enactment of the Dodd-Frank Act, the Commission staff and staff from the CFTC have met with interested persons to learn more about potential conflicts. Moreover, on August 20, 2010, the staff of the Commission and CFTC held a joint public roundtable in part to gain further insight into the sources of conflicts of interest at security-based swap clearing agencies, SB SEFs, and SBS exchanges, as well as methods for mitigating conflicts of interest ("Conflicts Roundtable").[25] Panelists from this roundtable included industry and non-industry participants.[26]

Drawing on these experiences, the Commission has reviewed the potential for conflicts of interest at security-based swap clearing agencies in accordance with Section 765 of the Dodd-Frank Act and has identified those conflicts that could affect access to clearing agency services, products eligible for clearing, and risk management practices of the clearing agencies. Preliminarily, the Commission believes that the most significant conflicts of interest that may have an adverse effect on statutory goals in Section 765 of the Dodd-Frank Act are those that arise when a small number of participants,[27] including participants that are Specified Entities and including related persons of the participants,[28] exercise undue control or influence over a security-based swap clearing agency.

The Commission has identified three key areas where it believes a conflict of interest of participants who exercise undue control or influence over a security-based swap clearing agency could adversely affect the central clearing of security-based swaps. First, participants could limit access to the security-based swap clearing agency, either by restricting direct participation in the security-based swap clearing agency or restricting indirect access by controlling the ability of non-participants to enter into correspondent clearing arrangements.[29] Second, participants could limit the scope of products eligible for clearing at the security-based swap clearing agency, particularly if there is a strong economic incentive to keep a product traded in the OTC market for security-based swaps. Third, participants could use their influence to lower the risk management controls of a security-based swap clearing agency in order to reduce the amount of collateral they would be required to contribute and liquidity resources they would have to expend as margin or guaranty fund to the security-based swap clearing agency.

Each of these potential conflicts of interest could limit the benefits of a security-based swap clearing agency in the security-based swaps market, and even potentially cause substantial harm to that market and the broader financial markets, as described below. Conflicts of interest in these areas could also potentially undermine the mandatory clearing requirement in Section 763 of the Dodd-Frank Act, thereby affecting transparency, investor protection, risk management, efficiency, and competition in the security-based swaps market.[30]

a. Limitations on Open Access to Security-Based Swap Clearing Agencies

The Commission believes that the increased use of central clearing for security-based swaps should help to promote robust risk management, foster greater efficiencies, improve investor protection, and promote transparency in the market for security-based swaps. For these reasons, the Commission has encouraged the use of central clearing for security-based swaps.[31] A consequence of increased use of central clearing services, however, is that participants that control or influence a security-based swap clearing agency may gain a competitive advantage in the security-based swaps market by restricting access to the clearing agency. If that occurred, financial institutions and marketplaces that do not have access to central clearing would have limited ability to trade in or list security-based swaps. This problem would continue to exist after the mandatory clearing requirement under Section 763 of the Dodd-Frank Act becomes effective, because financial institutions may be required either to submit security-based swaps for central

home country of the security-based swap clearing agency. *See* Public Law 111–203, Section 763(b).

[23] *See* 15 U.S.C. 78q–1(b)(3)(F). Section 17A of the Exchange Act also includes standards that help to mitigate conflicts of interest. *See infra* Section IV.C. for a discussion of these standards.

[24] 15 U.S.C. 78q–1(b)(3)(A), (B), and (F).

[25] *See* Securities Exchange Act Release No. 62725, 75 FR 51305 (August 19, 2010). The Commission solicited comments on the Conflicts Roundtable (comments received by the Commission are available at *http://sec.gov/cgi-bin/ruling-comments?ruling=4-609&rule_path=/comments/4-609&file_num=4-609&action=Show_Form&title=SEC%2DCFTC Roundtable on Swaps and Security%2DBased Swaps%3A Notice of roundtable discussion and request for comment*).

[26] The transcript of the Conflicts Roundtable is available on the CFTC's Web site at *http://cftc.gov/ucm/groups/public/@newsroom/documents/file/derivative9sub082010.pdf*.

[27] The term "participant" when used with respect to a clearing agency has the meaning set forth in Section 3(a)(24) of the Exchange Act, 15 U.S.C 78c(a), and shall include Specified Entities. *See* proposed Rule 700(o) under Regulation MC.

[28] *See infra* Section IV.A.3. for a discussion of "related person" in the context of a security-based swap clearing agency.

[29] *See, generally,* Matthew Leising and Shannon D. Harrington, "Wall Street Dominance of Swaps Must End, Brokers Say (Update 1)," *Bloomberg* (March 16, 2010).

[30] *See* Public Law 111–203, Section 763(a). Section 763(a) of the Dodd-Frank Act adds new Section 3C to the Exchange Act, which requires clearing for certain security-based swaps. Specifically, Section 3C(a)(1) provides that "It shall be unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a clearing agency that is registered under the Exchange Act or a clearing agency that is exempt from registration under the Exchange Act if the security-based swap is required to be cleared."

[31] *See* CDS Clearing Exemption Orders, *supra* note 17.

clearing or face heightened capital or margin requirements associated with bilateral agreements.

Market participants generally obtain access to a clearing agency in one of two ways: (1) Directly, by becoming a participant in a clearing agency or (2) indirectly, by entering into a correspondent clearing arrangement with a participant in a clearing agency.[32] There are several ways that both direct and indirect access to a security-based swap clearing agency could be restricted if persons who make decisions for or act on behalf of the clearing agency have a conflict of interest because of their incentives to further their own business interests outside of the security-based swap clearing agency. Participants may seek to limit the number of other direct participants in a security-based swap clearing agency in order to limit competition and increase their ability to maintain higher profit margins. A security-based swap clearing agency that is controlled by a limited number of participants might also adopt policies and procedures that are designed to unduly restrict access, or have the effect of unduly restricting access, to the clearing agency by other participants in ways that are unrelated to sound risk management practices.[33] At the same time, affording greater access to the clearing agency at some point may come at the expense of sound risk management practices.

The Commission recognizes that security-based swap clearing agencies must establish reasonable participation standards in order to ensure the participants in the clearing agency do not expose it to unacceptable risk or otherwise adversely affect the performance of the clearing agency, particularly during periods of market stress. However, participant standards may have the effect of restricting access to the clearing agency. On the one hand, panelists at the Conflicts Roundtable and others have raised the concern that participation requirements could be unnecessarily restrictive and primarily designed to limit the number of entities that are permitted to become direct participants in the clearing agency.[34] While appropriate participation standards are necessary for the sound operation of the security-based swap clearing agency, unduly high standards may needlessly exclude persons who are otherwise qualified to clear security-based swaps. On the other hand, some panelists at the Conflicts Roundtable also suggested that increasing access can come at the expense of sound risk management practices.[35]

Access could also be restricted by the way that clearing members determine executable end-of-day settlement prices. Since there is currently no exchange or other venue that publishes security-based swap prices, the Commission has required security-based swap clearing agencies to publish end-of-day settlement prices and any other prices with respect to cleared security-based swaps that the security-based swap clearing agency may use to calculate mark-to-market requirements.[36] To ensure that end-of-day settlement prices are reliable and consistent, a security-based swap clearing agency may require that the price submission be executable.[37] The security-based swap clearing agency, however, might not permit an entity to rely on a third party to provide an executable end-of-day settlement price. This could potentially prevent all but the largest dealer firms from having direct access to the clearing agency as they may be the only firms that have the processes to determine executable end-of-day settlement prices.[38]

In situations where direct access is limited by reasonable participation standards, non-participant firms may be able to access the security-based swap clearing agency through correspondent clearing arrangements with direct participants. Correspondent clearing is common in securities markets as well as in futures markets. However, the non-participant firms ultimately would be required to enter into a correspondent clearing arrangement with a participant in order to have the transactions submitted to the security-based swap clearing agency. Thus, the success of correspondent clearing arrangements depends on the willingness of security-based swap participants to enter into such arrangements with non-participant firms that may act as direct competitors to the participants. Given that current participants may have an incentive to restrict access to potential competitors, correspondent clearing arrangements may not be readily established while only the large dealer firms are direct participants in the security-based swap clearing agency.

In addition, procedural barriers may prohibit a firm from having indirect access to a security-based swap clearing agency. For example, although there are no overt restrictions on indirect access at the currently exempted security-based swap clearing agencies, many of the processing platforms by which participants submit transactions to the security-based swap clearing agency do not have the functionality to allow a non-participant firm to submit a trade with a customer to the security-based swap clearing agency through a correspondent arrangement with a direct member.

Prohibitively burdensome or restrictive direct participation standards and lack of availability of correspondent clearing arrangements effectively deny non-participant firms access to the security-based swap clearing agency's services and, accordingly, create a substantial competitive advantage for those firms that are direct participants in the security-based swap clearing agency. As previously noted, this competitive advantage would become even more significant after the mandatory clearing requirement for security-based swaps in the Dodd-Frank Act becomes effective.

b. Limitations on the Scope of Products Eligible for Clearing

As discussed above, Congress found and the Commission believes that increased use of central clearing would provide significant benefits to the security-based swaps market and mitigate systemic risk, particularly

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[32] Correspondent clearing is an arrangement between a current participant of a clearing agency and a non-participant that desires to use the clearing agency for clearance and settlement services.

[33] An example of such restrictive policies and procedures would be a clearing agency establishing prohibitively high participation standards so that only the largest financial institutions qualify as participants.

[34] *See, generally,* Swaps and Derivatives Market Association, "Lessening Systemic Risk: Removing Final Hurdles to Clearing OTC Derivatives" (available at *http://media.ft.com/cms/fe51a538-78d7-11df-a312-00144feabdc0.pdf*) ("SDMA Letter"). *See also* Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swaps, comments of Darrell Duffie ("[W]e want to be very careful that the members of a central clearing counterparty that determine what gets cleared * * * are the members that have * * * the right social incentives to create competition.") (available at *http://cftc.gov/ucm/groups/public/@newsroom/documents/file/derivative9sub082010.pdf* at 62).

[35] *See supra* note 25.

[36] *See, e.g.,* CDS Clearing Exemption Orders, *supra* note 17.

[37] As part of their internal processes, security-based swap clearing agencies generally calculate end-of-day settlement prices for each product in which they hold a cleared interest each business day. *See, e.g.,* Letter from Kevin McClear, ICE Trust, to Elizabeth Murphy, Secretary, Commission, December 4, 2009, and letter from Ann K. Shuman, Managing Director and Deputy General Counsel, CME, to Elizabeth Murphy, Secretary, Commission, December 14, 2009. One method for calculating an end-of-day settlement price for open positions is based on prices submitted by participants. As part of this mark-to-market process, the security-based swap clearing agency may periodically require participants to execute certain security-based swap trades at the applicable end-of-day settlement price. This is designed to ensure that participants' submitted prices reflect their best assessment of the value of their open positions on a daily basis. *Id.*

[38] *See* SDMA Letter, *supra* note 34.

during times of financial crisis. Central clearing of security-based swaps likely would result in lower spreads and lower transaction costs for end-users. A participant in a security-based swap clearing agency might, however, derive greater revenues from its activities in the OTC market for security-based swaps than it would from sharing in the profits of a security-based swap clearing agency in which it holds a financial interest. As a result, the increased use of central clearing may be contrary to the economic interests of some participants to a security-based swap clearing agency. Such participants or their related persons could therefore seek to have the security-based swap clearing agency limit the types of security-based swaps that are eligible for clearing at a security-based swap clearing agency over which they exercise influence or control.[39]

A further incentive for a clearing agency controlled by participants to restrict the products that are eligible for clearing at the security-based swap clearing agency may be to control a security-based swap's price transparency. Trading in the OTC derivatives market is currently dominated by a small number of firms.[40] Prior to the use of clearing agencies to clear security-based swaps, end-users had to transact directly with a small number of firms to trade in security-based swaps without the benefit of publicly available pricing data. Security-based swap clearing agencies provide greater price transparency by making certain price data available to the public and thereby helping to reduce the information asymmetry that benefits firms in the OTC market.[41] Publicly available pricing data may result in reducing the spreads and reduce the profit per trade for firms that have dominated the OTC market.

While certain security-based swaps may be suitable for central clearing, the Commission recognizes the possibility that some security-based swaps may not be suitable for clearing if their risks cannot be adequately managed by the security-based swap clearing agency. Clearing products whose risks cannot be adequately managed may increase the potential of a default of a participant or even the failure of the security-based swap clearing agency.[42] This in turn could adversely affect systemic risk, as participants and their customers would likely have significant funds and securities tied to the clearing agency and would be dependent on the continued operations of a security-based swap clearing agency in order to enter into new transactions in security-based swaps. This again highlights the potential tensions between sound risk management and the increased use of central clearing services. Expanding the number and scope of products cleared would in some cases be in the best interests of the security-based swap clearing agency and the security-based swaps market generally, because it provides processing efficiencies and replaces bilateral counterparty risk. However, allowing a greater number and scope of products to be centrally cleared would in some cases be harmful to the security-based swap clearing agency and the security-based swaps market, if sound risk management standards are compromised in order to clear those products.

The Commission is mindful of the need to balance goals associated with promoting the central clearing of security-based swaps and assuring that proposed rules are designed to increase the number of products eligible for central clearing with the goals associated with effective risk management. The Commission is also aware that any rules that it may ultimately adopt relating to conflicts of interest may affect this balance. The Commission believes, however, that decisions regarding the products that are eligible for clearing by a security-based swap clearing agency should not be subject to undue influence by parties that have a financial interest in keeping such products from being centrally cleared, while also noting that non-participants may have an interest in increasing access, which potentially could serve to compromise effective risk management.

c. Reduced Risk Management Controls

Security-based swap clearing agencies will perform a critical function in mitigating financial risk for market participants. The Commission believes that through uniform margining and other risk controls, including controls over market-wide concentrations that cannot be implemented effectively when counterparty risk management is decentralized, security-based swap clearing agencies would help to prevent a single market participant's failure from destabilizing other market participants and, ultimately, the broader financial system.

Although participants may seek to raise risk management controls in order to restrict access to the clearing agency or protect their financial stake in the clearing agency, they might also seek to lower certain risk management controls such as margin requirements in order to release collateral that they may wish to use for other purposes. Furthermore, as security-based swap clearing agencies become more established and the mandatory clearing requirement under Section 763 is implemented, more security-based swaps will likely be centrally cleared and clearing participants will be required to provide a substantially larger amount of liquid collateral to security-based swap clearing agencies in the form of margin. As a result, participants may be willing to accept greater risk than is prudent for the security-based swap clearing agency in order to reduce the amount of their margin contributions. A reduction in risk management controls ultimately could function to increase systemic risk by increasing the potential for a financial loss that must be borne by the participants of the security-based swap clearing agency.[43]

The Commission recognizes that participants generally have a financial incentive to ensure that the security-based swap clearing agency collects sufficient margin from each participant.

[39] Representative Barney Frank, who chaired the conference committee that reconciled the House Bill and the Senate Bill, referred to this specific concern when discussing the amendment adding Section 765 to the Dodd-Frank Act. Chairman Frank stated, "The purpose of this in part is to get many more derivatives cleared. But the clearing houses have the right to refuse them if they say the transactions aren't suitable for clearing. We believe that some banks have an interest in not having them cleared. So we don't want entities that have an interest and [sic] there being no clearing, owning the clearing houses. That's why this is an important amendment to us, and it was passed after considerable debate on the House floor." House-Senate Conf. Comm. Holds Markup on HR 4173, Financial Regulatory Overhaul Bill, June 24, 2010, *reprinted in* CQ Congressional Transcripts, 111th Cong. 182 (2010) (statement of Barney Frank, Chairman, House Comm. on Fin. Serv.).

[40] *See* Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2010. ("Derivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions. Five large commercial banks represent 97% of the total banking industry notional amounts * * *.")

[41] *See* Darrell Duffie, Ada Li, and 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 ("Even after an OTC derivatives product has achieved relatively active trading * * * dealers have an incentive to maintain the wide bid-ask spreads that they can obtain in the OTC market * * *. Thus, from the viewpoint of profits, dealers may prefer to reduce the migration of derivatives trading from the OTC market to central exchanges.").

[42] Section 763(a) adds new Section 3C(d)(3)(A) to the Exchange Act, which prohibits the Commission from requiring any clearing agency to accept a security-based swap for central clearing. *See* Public Law 111–203, Section 763(a).

[43] Such a scenario would arise, for example, where a defaulting participant has contributed insufficient margin to meet its obligations to the security-based swap clearing agency.

A clearing agency's rules and procedures typically provide that in the event of a participant default, losses exceeding a participant's individual margin contribution may be satisfied from a guaranty fund composed of contributions from all participants. As a result, participants have a unique financial incentive to ensure that the security-based swap clearing agency has sufficient collateral from each participant to withstand a participant default in almost all market conditions. However, participant defaults occur infrequently and the incentive for participants to protect their guaranty fund contributions may have less weight than the incentive to reduce margin requirements in order to release margin collateral for immediate use.

A non-participant does not contribute to a guaranty fund and may not have the same incentives as a participant with respect to establishing and maintaining sufficiently robust participant margin requirements. Non-participants' incentives may be to focus less on risk management and focus more on allowing more participants to be admitted to the clearing agency and more products to be made eligible for central clearing.

d. Implications for Ownership and Governance

As described above, conflicts of interest may arise if participants exercise undue control or influence over a security-based swap clearing agency. This influence, typically acquired through an ownership stake in the clearing agency, generally may be exercised by participants through either (i) voting interests in the security-based swap clearing agency or (ii) participation in the governance of the security-based swap clearing agency, such as by selecting (or influencing the selection of) the directors of the security-based swap clearing agency.[44] In either case, undue control or influence may be particularly acute if (i) the participants are part of the process for nominating the directors, even if such participants are not themselves directors, or (ii) the election of directors is subject to concentrated voting power in a small number of participants, especially if such participants also dominate much of the trading in security-based swaps and could use their controlling position to maintain or extend their dominant market position.

In addition, it is important to consider the likely incentives of individual directors, once they are on the Board, when they are governing the security-based swap clearing agency.[45] Directors of a security-based swap clearing agency owe a fiduciary duty to the security-based swap clearing agency and all of its shareholders. In addition, among other obligations, the Board as a whole is ultimately responsible for overseeing the clearing agency's compliance with the regulatory obligations of security-based swap clearing agencies under the Dodd-Frank Act and the Exchange Act, including the open and fair access requirements. At the same time, however, directors may be subject to different perspectives when fulfilling these duties and roles. Although the Commission recognizes that incentives and motivations may vary among directors and over time for a range of reasons—and therefore it is not possible to predict precisely how any individual director will address a particular matter—directors who are appointed by or related to participants ("participant-related directors") may on balance be more likely to reflect the views of participants than would directors who are not appointed by or related to participants ("non-participant-related directors").[46]

In light of these dynamics, as between the two categories of directors, participant-related directors, like participants themselves, may on balance be more likely to favor reducing or minimizing the risk exposure of the clearing agency, potentially at the expense of more open access. In addition, participant-related directors may also be more likely to favor restricting access to the clearing agency, which as discussed above would serve to preserve profits that participants earn through trading security-based swaps in the OTC markets.

In contrast, non-participant-related directors may, on balance, be more likely to seek to maximize the value of the enterprise, which, in addition to sound risk management, may involve increasing the revenues of the security-based swap clearing agency, such as by expanding the number and scope of products being cleared. Moreover, at a minimum it would seem less likely that non-participant-related directors would favor unduly restricting access to the clearing agency and its services. Thus, non-participant-related directors may be inclined to favor expanded access to products and services, which may increase the amount of risk that the clearing agency must successfully manage. The interest in expanded access to products and services may be especially relevant in the early stages of a clearing agency's development, when establishing a new entity as a viable clearing agency is especially important.

The Commission recognizes that other factors may also affect director incentives and behavior. For example, it may be argued that participant-related directors may in general have greater risk management expertise and experience than non-participant-related directors, and that non-participant-related directors may tend to defer to the views or judgment of participants or participant-related directors on risk matters, with the effect that open access may be unduly compromised in favor of risk management. On the other hand, it may be argued that qualified non-participant-related directors with sufficient risk management expertise can be readily found, and in any event these directors' independence of participants would justify their heightened involvement on the Board.

In addition, directors may face other conflicts of interest. For example, there may be conflicts between the competing interests of different shareholders—whether or not participants—which could have implications for director behavior, as discussed more fully below. There also may be a tension between the directors' incentives to maximize profits and their duties to oversee the security-based swap clearing agency's compliance with applicable legal restrictions which, although not necessarily unique to clearing agencies, may nevertheless affect how they decide any particular matter.

As described more fully below, the proposed rules are intended to strike a balance among these various

[44] Section 765 of the Dodd-Frank Act authorizes the Commission to adopt rules regarding conflicts of interest of Specified Entities at security-based swap clearing agencies in general. However, the Commission preliminarily believes that those entities that are participants in a security-based swap clearing agency will have a conflict of interest that could be acted upon to adversely affect the development of the market for security-based swaps consistent with the policy objectives of Section 765 of the Dodd-Frank Act.

[45] The Commission's discussion in this Release of the motivations or incentives of directors of a clearing agency, SB SEF, or SBS exchange comes in the context of requiring modes of governance that permit consideration of a variety of perspectives. As noted throughout this Release, a company's directors have a duty to all the company's shareholders, and the Commission does not regard any directors as simply surrogates for a particular group of shareholders. The Commission's discussion is intended to forestall *possible* conflicts and does not reflect findings that particular conflicts are present.

[46] This distinction between participant-related and non-participant-related directors may be most significant where the clearing agency is (i) a publicly owned corporation, or part of a publicly owned corporation, or (ii) otherwise owned by persons other than participants. The Commission recognizes that ownership structures for clearing agencies may take other forms, including ownership solely by participants, in which case the incentives and perspectives of the directors may be somewhat different.

considerations by allowing participants to maintain a significant voice within a security-based swap clearing agency while also imposing ownership limitations and independent director requirements to mitigate the potential influences of participant owners and participant-related directors.

e. Request for Comments Regarding Identified Conflicts of Interest

The Commission requests comment on the conflicts of interest it has identified with respect to security-based swap clearing agencies, including the conflicts related to participant standards, product eligibility, and risk management. Do commenters agree with the potential conflict concerns that the Commission has identified? Some parties have questioned the benefits of central clearing generally in terms of reducing systemic risk,[47] potentially suggesting a different analysis with respect to the identified conflicts of interest. What are commenters views on the potential benefits and costs of central clearing and the resulting effect on the conflicts of interest analysis?

What effect would the identified conflicts of interest likely have? Should the Commission focus on any of these conflicts more than others? Are there other existing conflicts concerns that commenters believe warrant scrutiny? If so, what are they and how are they likely to affect security-based swap clearing agencies?

The conflicts of interest discussed in part stem from the current concentrated market structure for security-based swaps. How is the current market structure likely to evolve over time? What effect will that evolution have on the consideration of conflicts of interest? Are there any other conflicts of interest that may result due to expected changes in the security-based swaps market or the clearing of security-based swaps that the Commission should consider? If so, what are they and how are they likely to affect security-based swap clearing agencies?

The central clearing of security-based swaps is still developing and may change significantly as the market for security-based swaps develops. In particular, the new provisions in the Dodd-Frank Act relating to the central clearing of security-based swaps are not yet effective. Once they become effective, security-based swap clearing agencies will be subject to substantially more regulation, which may have an effect on conflicts of interest. How are conflicts of interest likely to change as the central clearing of security-based swaps, and security-based swap clearing agencies, become more established? What potential new conflicts of interest could arise that the Commission should consider? How will potential changes in the trading of security-based swaps affect conflicts of interest at security-based swap clearing agencies? In addition, competitive forces within the security-based swaps market may help to mitigate conflicts of interest, for example, by increasing the number of institutions that trade in security-based swaps and creating a broader market in security-based swaps. How might competition issues affect or change current conflicts of interest? Will competition potentially create different or additional conflicts of interest that the Commission should consider? Will competition potentially mitigate conflicts of interest?

What other parties may have conflicts of interest that would affect whether they should control or participate in the governance of a security-based swap clearing agency? In what circumstances do these conflicts of interest arise? Under certain circumstances, there is the potential that incentives of shareholders to maximize profits could compromise prudent risk management by a security-based swap clearing agency. For example, shareholders could seek to increase revenue from clearing fees by increasing the number of products cleared by the clearing agency beyond those that can be appropriately risk managed or by having the clearing agency expand its services or engage in new lines of business that would expose the security-based swap clearing agency to increased risk. Shareholders that are not users of a security-based swap clearing agency may also not have the same incentives to keep the costs of clearing low. The Commission requests comment on the conflicts of interest that non-participant shareholders may have and the effect such conflicts could have on a security-based swap clearing agency. What are the differences in conflicts of interest between participants and non-participants? What are the different effects these conflicts could have on a security-based swap clearing agency? Which conflicts of interest could potentially cause the greatest harm to the security-based swap clearing agency?

Do persons who are selected to be directors of a security-based swap clearing agency by participants have a conflict of interest based on their status as directors that would affect their ability to act in the best interest of the clearing agency, to act in conformity with the Exchange Act, or to act to meet the policy objectives in Section 765 of the Dodd-Frank Act? Would directors be less likely to act to meet the policy objectives in Section 765 of the Dodd-Frank Act if they are selected by shareholders seeking to maximize the profits of the security-based swap clearing agency? What effect would they likely have on security-based swap clearing agencies? How do participants' conflicts of interest that affect risk management and open access issues compare with non-participants' interests regarding these issues? How do participants' incentives with respect to risk management compare with the incentives of non-participant shareholders or directors? How do the incentives of independent directors differ from the non-independent directors in terms of considering the potential for conflicts of interest?

The Commission also requests comment on the interplay of the identified conflicts of interest, and any additional conflicts of interest identified by commenters, and how that may affect a security-based swap clearing agency. For example, there may at times be a trade-off between risk management standards and open access to the clearing agency. What is the best way to balance these and other potential conflicts of interest in order to assure that the clearing agency has both robust risk management and fair and open access to clearing services? Are there any other conflicts of interest that pose similar trade-offs? What conflicts are these and how should the Commission balance the related concerns?

The Commission recognizes that other conflicts of interest may arise in the governance of security-based swap clearing agencies—for example, there may be a conflict between the interests of certain shareholders. The rules the Commission is proposing today focus on the conflicts of interest presented by the potential influence of participants in the security-based swaps market because, as described above, the Commission believes those conflicts may be most relevant to the development of security-based swap clearing agencies. The Commission recognizes that conflicts of interest may also arise with respect to independent directors and has attempted to achieve a balance between the different incentives of participant-related and non-participant-related directors and the potential benefits each might bring to the Board of a security-based swap clearing agency.

[47] *See, e.g.,* Craig Pirrong, "The Inefficiency of Clearing Mandates," Cato Institute Policy Analysis No. 665, July 21, 2010.

B. Security-Based Swap Execution Facilities and National Securities Exchanges

The Commission has also reviewed the potential for conflicts of interest at SB SEFs and SBS exchanges in accordance with Section 765 of the Dodd-Frank Act and has identified those conflicts that it believes may be mitigated by rules designed to improve the governance of a SB SEF or SBS exchange, promote competition, or mitigate conflicts of interest in connection with the operation of a SB SEF or SBS exchange by a security-based swap execution facility participant ("SB SEF participant") [48] or a member of an SBS exchange ("SBS exchange member") [49] that has an ownership interest in the SB SEF or SBS exchange. As with security-based swap clearing agencies, the Commission preliminarily believes that conflicts of interest that may have an adverse affect on the statutory goals of Section 765 are those that arise when a small number of market participants, including participants that are Specified Entities and including related persons of participants,[50] exercise control or undue influence over a SB SEF or SBS exchange. This influence may be exercised either through ownership of voting interests [51] or participation in the governance of the SB SEF or SBS exchange.

The Commission believes that through ownership of voting interests or ability to influence governance, market participants could exercise influence with respect to the services provided by SB SEFs or SBS exchanges, the rules and policies applicable to participants or members of such entities, and, more generally, the security-based swaps market. When a small group of those same market participants also dominate much of the trading in security-based swaps, control of a SB SEF or SBS exchange by these participants raises a heightened concern. If a SB SEF or a SBS exchange is controlled by a small group of dealers who also dominate trading in the market for security-based swaps, the dealers may have competitive incentives to exert undue influence to control the level of access to the SB SEF or SBS exchange and thus impede competition by other market participants. In other words, participants or members in a SB SEF or SBS exchange, as applicable, might seek to limit the number of direct participants in the trading venue in order to limit competition and increase their ability to maintain higher profit margins. Given such incentives, a SB SEF or SBS exchange that is controlled by a limited number of participants or members might adopt policies and procedures that are designed to restrict access.

Participants or members also might be motivated to restrict the scope of security-based swaps that are eligible for trading at SB SEFs or SBS exchanges if there is a strong economic incentive to keep such swaps in the OTC market. On the other hand, this concern may be mitigated by competitive forces if a greater number and variety of facilities where security-based swaps can be traded are available. A small number of firms currently dominate trading in the OTC derivatives market.[52] Centralized trading of security-based swaps likely would result in lower spreads and lower transaction costs for end-users, particularly as a result of increased pre-trade and post-trade transparency of prices, assuming sufficient trading volume and liquidity.[53] As noted above, increased price transparency might help to eliminate much of the basis for asymmetrical information, reduce spreads, and reduce the profit per trade for firms that dominated the OTC security-based swaps market. As a result, this might create an incentive for participants or members in a SB SEF or SBS exchange, as applicable, to seek to limit the number of security-based swaps that are made available for trading by such venues. The Commission recognizes, however, that there could in certain circumstances be legitimate concerns regarding liquidity or other trading characteristics of a security-based swap that reasonably might justify the decision of participants in a SB SEF or members of a SBS exchange not to make a particular product available for trading on a SB SEF or a SBS exchange. However, decisions regarding the eligibility of security-based swaps for trading on a SB SEF or SBS exchange should not be subject to undue influence by parties that have a financial interest in keeping such products from being centrally traded on a facility or exchange.

Finally, the Commission also believes that a SB SEF or SBS exchange could have potential conflicts of interest between the commercial interests of the SB SEF or SBS exchange or the SB SEF's or SBS exchange's owners and the SB SEF's or SBS exchange's market oversight responsibilities.[54] With respect to these kinds of conflicts of interest, the Commission's proposal is informed, in part, by its experience overseeing national securities exchanges. The Commission notes, however, that a SB SEF's regulatory obligations under Section 763(c) of the Dodd-Frank Act are not identical to those of a national securities exchange's obligations under Section 6 of the Exchange Act.

National securities exchanges are self-regulatory organizations ("SROs") and are statutorily required to comply, and enforce compliance by their members and their associated persons, with the Federal securities laws, the rules and regulations thereunder, and their own rules.[55] Exchanges also generally operate for-profit markets and, as a result, are concerned with preserving and enhancing their competitive positions vis-à-vis other exchanges.[56] Consequently, exchanges have potential conflicts of interest between carrying out their regulatory obligations to vigorously oversee their members and marketplace and promoting their and their shareholders' economic interests. For example, an exchange could put its interest and that of its members or

[48] The term "security-based swap execution facility participant" means a person permitted to directly effect transactions on the security-based swap execution facility. *See* proposed Rule 700(z) under Regulation MC.

[49] A "member" when used with respect to a national securities exchange means (i) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker, (ii) any registered broker or dealer with which such a natural person is associated, (iii) any registered broker or dealer permitted to designate as a representative such a natural person, and (iv) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules. *See* Section 3(a)(3)(A) of the Exchange Act, 15 U.S.C. 78c(a)(3)(A).

[50] *See infra* Section V.A. for a discussion of "related person" in the context of a SB SEF and SBS exchange or facility thereof.

[51] *See infra* Section V.A. for a discussion of the ownership and voting limits of proposed Rule 702 under Regulation MC.

[52] *See supra* note 40.

[53] The Commission will address the issue of transparency of security-based swap pricing and transaction data in a separate rulemaking.

[54] An entity that registers as a SB SEF will have oversight responsibility over its market pursuant to the Exchange Act (as amended by the Dodd-Frank Act) and rules adopted thereunder. *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c). Similarly, all national securities exchanges, including those that may post or make available for trading security-based swaps, have oversight responsibilities over their markets and their members pursuant to the Exchange Act. *See* Section 6 of the Exchange Act, 15 U.S.C. 78(f).

[55] *See* Sections 6(b)(1) of the Exchange Act, 15 U.S.C. 78f(b)(1).

[56] Historically, national securities exchanges were structured as not-for-profit or similar organizations owned by their members. Exchanges, however, have more recently evolved to become shareholder-owned. *See supra* note 49 for the definition of "member" as applicable to national securities exchanges.

shareholders ahead of its regulatory responsibilities by failing to take regulatory or enforcement actions or to adequately fund self-regulation. Further, the commercial interests of the shareholders of an exchange may conflict with the regulatory obligations of an exchange. A shareholder may be incentivized to maximize profits through the economic stake it has in the exchange or, if the shareholder is also a member of the exchange, to more directly further its own commercial interests.[57] For example, a shareholder could promote the distribution of the exchange's revenues in a manner that could result in inadequate funding of the exchange's regulatory operations or, if also an exchange member, could use the exchange's disciplinary process potentially to harass or penalize a competitor.

The Commission has considered the conflicts between an exchange's regulatory responsibilities and its commercial interests in operating a marketplace for the trading of securities. To address these types of concerns, the Commission has developed, consistent with the requirements of Section 6 of the Exchange Act,[58] an approach to mitigate conflicts of interest for national securities exchanges.[59] Specifically, through its review of proposals filed by exchanges with respect to changes to their ownership and governance structures (generally from member-owned to shareholder-owned organizations) pursuant to Section 19 of the Exchange Act[60] or of applications filed by entities to register as national securities exchanges pursuant to Section 6 of the Exchange Act,[61] the Commission examines the way in which an exchange applies ownership and voting limits and addresses certain governance principles.[62] Namely, the Commission looks to ensure that there are limits on the ability of persons to own and control exchanges by, for example, requiring at a minimum that no person, alone or together with its related persons,[63] be permitted to own more than 40%, and no member, alone or together with its related persons, be permitted to own more than 20%, of the ownership interests of the exchange or be entitled to vote shares in excess of 20%.[64] Further, the Commission also looks to ensure that an exchange provide fair representation of members in the selection of directors and the administration of its affairs, consistent with the requirement in Section 6(b)(3) of the Exchange Act,[65] that an exchange is organized in a manner that allows it to carry out the purposes of the Exchange Act pursuant to Section 6(b)(1) of the Exchange Act,[66] and that it provides fair procedures for disciplining members, consistent with the requirements in Sections 6(b)(6) and 6(b)(7) of the Exchange Act.[67]

The Commission's recognition of potential conflicts of interest at exchanges and its approach to date in reviewing and approving measures designed to mitigate those conflicts of interest are a useful point of reference as the Commission identifies, and develops proposals to mitigate, the conflicts of interest potentially faced by SB SEFs and SBS exchanges as the trading of security-based swaps moves to regulated markets. However, as noted above, the Commission recognizes that a SB SEF's regulatory obligations are not the same as a national securities exchange's regulatory obligations.

The Commission in 2004 proposed rules to promote the fair administration and governance of, and to impose ownership and voting limitations on, national securities exchanges and registered national securities associations.[68] Among other things, the proposal would have required an exchange to: Have a Board composed of a majority of independent directors; maintain fully independent nominating, compensation, and audit committees; separate its regulatory obligations and business functions by establishing a fully independent regulatory oversight committee ("ROC") or equivalent structure; and limit ownership and voting control by members.[69] This proposal was intended to improve the governance of certain SROs by establishing independence standards for the board of directors ("Board") and key committees and by minimizing conflicts of interest by instituting ownership and voting limitations and the separation of the exchange's regulatory obligations and commercial interests. Although the

[57] *See* SRO Governance Proposing Release, 69 FR 71126, *infra* note 59.

[58] *See* Section 6(b) of the Exchange Act, 15 U.S.C. 78f(b).

[59] *See, e.g.,* Securities Exchange Act Release Nos. 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (In the Matter of the Applications of EDGX Exchange, Inc., and EGDA Exchange, Inc. for Registration as National Securities Exchanges; Findings, Opinion, and Order of the Commission) ("Exchange Act Release No. 61698"); 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (In the Matter of the Application of BATS Exchange, Inc. for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission) ("Exchange Act Release No. 58375"). In 2004, the Commission proposed rules relating to: the fair administration and governance of SROs; disclosure and regulatory reporting by SROs; recordkeeping requirements by SROs; ownership and voting limitations for SROs; and listing and trading of affiliated securities by SROs. The Commission has not taken action on these proposed rule changes. *See* Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) ("SRO Governance Proposing Release").

[60] 15 U.S.C. 78s.

[61] 15 U.S.C. 78f.

[62] *See, e.g.,* Securities Exchange Act Release Nos. 62158 (May 24, 2010), 75 FR 30082 (May 28, 2010) (order approving the demutualization of the Chicago Board Options Exchange, Incorporated ("CBOE")) and 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (order approving the merger of New York Stock Exchange, Inc. ("NYSE") and Archipelago and NYSE's demutualization).

[63] Generally, a "related person" means, with respect to any person, any other person, directly or indirectly, controlling, controlled by, or under common control with such person or any person acting in concert with such person.

[64] *See, e.g.,* Exchange Act Release No. 61698, 75 FR at 13156, *supra* note 59. The exchange's Board may waive the voting and ownership limits if it makes certain findings, including a finding that such a waiver would be consistent with the exchange's self-regulatory obligations. The board, however, may not waive these limits for any exchange members. Moreover, the exchange must file such waiver with the Commission as a proposed rule change for approval before it could be implemented.

The ownership limits currently in place for exchanges generally apply to any ownership interest. *See, e.g.,* Exchange Act Release No. 61698, 75 FR 13151, *supra* note 59; Amended and Restated Certificate of Incorporation of BATS Global Markets, Inc., Article FIFTH. In contrast, proposed Rule 702 would apply ownership limits only with respect to those shares or other interests entitled to vote. *See infra* Section V.A. for a discussion of the differences between the ownership and voting limits in proposed Rule 702 and those limits currently in place for exchanges.

[65] 15 U.S.C. 78f(b)(3). Pursuant to Section 6(b)(3), the Commission generally requires, at a minimum, that at least 20% of the directors on the board be selected by exchange members. The Commission also requires that exchange members be permitted to participate in the nomination process of such representative directors and that they have the right to petition for alternative candidates. *See, e.g.,* Securities Exchange Act Release No. 58375, 73 FR at 49500, *supra* note 59.

[66] 15 U.S.C. 78f(b)(1). Pursuant to Section 6(b)(1), the Commission generally requires, at a minimum, that the number of non-industry directors on the exchange's board equal or exceed the number of industry directors. Generally, a "non-industry director" is someone who is not subject to regulation by the exchange, is not a broker or dealer or an officer, director, or employee of a broker or dealer, is not associated with an entity that is affiliated with a broker or dealer, and has neither a material ownership interest nor investment in a broker or dealer. *See, e.g.,* CBOE By-Laws, Article III, Section 3.1. Some exchanges also have "independent directors." Typically, an independent director has no material relationship with the exchange or an exchange member. *See, e.g.,* Amended and Restated By-Laws of BATS Exchange, Inc., Article I(m). For example, an officer or director of a listed issuer generally is considered a non-industry director rather than an independent director. The definitions of "non-industry" and "independent" do, however, differ across exchanges.

[67] 15 U.S.C. 78f(b)(6) and (7). To find an exchange's disciplinary rules to be consistent with the Exchange Act, the Commission generally requires that disciplinary processes be balanced and include industry member participation. *See, e.g.,* Exchange Act Release No. 61698, 75 FR at 13160, n. 124, *supra* note 59.

[68] *See* SRO Governance Proposing Release, 69 FR 71126, *supra* note 59.

[69] *Id.*

Commission has not acted further on this proposal, a number of exchanges have adopted some of the governance concepts on their own initiative [70] and all of the exchanges registered under Section 6 of the Exchange Act have adopted ownership and/or voting limitations, with the Commission's approval.[71]

Each potential conflict of interest identified in this Section III.B. could limit the benefits of centralized trading in the security-based swaps market and potentially undermine the mandatory trading requirement in new Section 3C(h) of the Exchange Act, thereby negatively affecting efficiency and competition in the security-based swaps market.[72] Further, while the Commission believes that its past application of statutory requirements has been appropriate to improve the governance of, and mitigate the conflicts of interest for, exchanges, given the difference in the structure of the OTC derivatives market and the markets for exchange-listed securities, it also believes that potential conflicts of interest in SBS exchanges can and should be further examined.[73] Namely, unlike exchange-listed securities, trading in the OTC derivatives market is currently dominated by a small group of dealers.[74] Although mechanisms in place to address conflicts of interest among members, shareholders, and exchanges would help mitigate some concerns about conflicts of interest that could result from dealer control of the current security-based swaps market, the Commission believes that additional measures may be necessary to effectively mitigate conflict of interest concerns. For example, applying standards approved for exchanges to SB SEFs and SBS exchanges, as described above, may not alone adequately address the potential concern that a small group of dealers could gain control over such entities and limit security-based swaps from trading on, and participant or member access to, a centralized market. Accordingly, the Commission is proposing rules for SB SEFs and SBS exchanges that are designed to mitigate the potential conflicts of interest that it has identified in the context of the security-based swaps market, including ownership limitations and governance requirements, as more fully described below.[75]

The Commission has considered the mechanisms in place to mitigate conflicts of interest at national securities exchanges in developing its proposals to mitigate conflicts of interest for SB SEFs and SBS exchanges. The Commission notes that there are similarities and differences between the exchange-listed markets and the market for security-based swaps that merit consideration in crafting appropriate proposals to mitigate conflicts of interest for SB SEFs and SBS exchanges. National securities exchanges list and trade cash equity securities and options pursuant to a well-developed body of their own rules, as well as Commission rules, and compete actively with each other and with other non-exchange trading venues for market share and revenues associated with trading volume. The markets for cash equity securities and listed options are generally liquid, trading is widely dispersed, and there are numerous trading venues and market participants. Unlike the well-established cash equity and options markets, the security-based swaps market is at an earlier stage of development and, as noted above, is currently dominated by a small number of dealers. Further, the regulatory structure governing the security-based swaps market will not be completely realized until all provisions of the Dodd-Frank Act and any rules promulgated thereunder are fully implemented. However, like exchanges, SB SEFs may have shareholder-owners who also may be SB SEF participants and may compete with any other SB SEF to the extent that they trade the same security-based swaps. In addition, although SB SEFs would not be SROs and therefore would not be subject to the same obligations under the Exchange Act as SROs, they nonetheless will be subject to regulatory responsibilities under Section 763(c) of the Dodd-Frank Act and, as a result, will have to establish rules and enforce compliance with those rules by their participants.[76] Thus, the conflicts of interest that the Commission has experienced with exchanges may be similar, although not necessarily identical, to the conflicts of interest that SB SEFs and SBS exchanges may face. The Commission nevertheless is mindful of the need to mitigate conflicts of interest for SB SEFs and SBS exchanges without unduly restricting the ability of trading facilities to be formed or the emergence of a competitive market for the trading of security-based swaps.

The Commission requests comment on the types of conflicts of interest it has identified with respect to SB SEFs and SBS exchanges, including the listing and trading of security-based swaps on SB SEFs and SBS exchanges. Has the Commission identified all of the significant potential conflicts concerns? Do commenters disagree with any potential conflicts concerns that the Commission has identified? What other conflicts concerns may exist, if any?

As discussed above, the Commission seeks to minimize the conflicts of interest for national securities exchanges through ownership limitations and governance requirements. Are the conflicts of interest relating to exchanges, which could elect to trade swaps and thus become SBS exchanges, different than the conflicts of interest relating to SB

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[70] *See, e.g.,* CBOE By-Laws, Article III, Board of Directors ("Board of Directors" must have a majority of "Non-Industry Directors") and Article IV, Committees ("Regulatory Oversight Committee" must consist of at least three directors, all of whom shall be "Non-Industry Directors"); By-Laws of the NASDAQ Stock Market LLC ("Nasdaq"), Article III, Board of Directors, Section 2, Qualifications ("Board of Directors" must have a majority of "Non-Industry Directors") and Section 5, Committees Composed Solely of Directors (Regulatory Oversight Committee must consist of at least three members, each of whom shall be a "Public Director" and an "independent director" as defined in Nasdaq Rule 4200).

[71] *See, e.g.,* Amended and Restated Certificate of Incorporation of BATS Global Markets, Inc., Article FIFTH.

[72] *See* Public Law 111–203, Section 763(a). Section 3C(h) of the Exchange Act imposes a mandatory trading requirement, which provides that counterparties shall execute a transaction in a security-based swap subject to the clearing requirement of Section 3C(a)(1) on an exchange or a registered SB SEF or a SB SEF that is exempt from registration pursuant to Section 3D(e) of the Exchange Act.

[73] Within the past several years, the Commission has reviewed and assessed comprehensively the governance structure of each national securities exchange, either in connection with a significant transaction by the exchange or as part of its application for registration as a national securities exchange. *See, e.g.,* Securities Exchange Act Release Nos. 58324 (August 7, 2008), 73 FR 46936 (August 12, 2008) (order approving The NASDAQ OMX Group, Inc.'s ("Nasdaq OMX") acquisition of the Boston Stock Exchange, Inc. ("BSE")); 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (order approving Nasdaq OMX's acquisition of the Philadelphia Stock Exchange, Inc. ("Phlx")); 55293 (February 14, 2007), 72 FR 8033 (February 22, 2007) (order approving the business combination between NYSE and Euronext N.V.); 56955 (December 13, 2007), 72 FR 71979 (December 19, 2007) (order approving acquisition of International Securities Exchange, Inc. ("ISE") by Eurex Frankfurt AG); Exchange Act Release No. 58375, 73 FR at 49500, *supra* note 59; 61152 (December 10, 2009), 74 FR 66699 (December 16, 2009) (order approving application of C2 Options Exchange, Incorporated to register as a national securities exchange); Exchange Act Release No. 61698, 75 FR at 13156, *supra* note 59; 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (order approving Nasdaq's application to register as a national securities exchange).

[74] *See supra* note 40.

[75] As of the date of this release, the Commission has not proposed rules regarding the scope, registration requirements, and operation of a SB SEF, including the types of entities that would qualify for registration as a SB SEF.

[76] *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c).

SEFs, and, if so, how? To what extent, if any, should the Commission draw on its experience with conflicts of interest that may arise in the exchange context and with efforts to mitigate those conflicts and apply that experience in assessing conflicts of interest that may arise in the context of SB SEFs and SBS exchanges? What are the differences and similarities between the conflicts of interest that the Commission has encountered with respect to national securities exchanges and the conflicts of interest that it has identified with respect to SB SEFs and SBS exchanges?

Further, are the conflicts of interest relating to SBS exchanges different than the conflicts of interest relating to exchanges that do not post or make available for trading security-based swaps? If there are no differences, should the Commission propose to adopt rules to mitigate conflicts of interest with respect to national securities exchanges that are not SBS exchanges or are the existing approaches to mitigating conflicts of interest for such exchanges sufficient?

The Commission also requests comment on potential changes in these conflicts of interest. The Commission recognizes that the conflicts of interest that may exist today with respect to the trading of security-based swaps by SB SEFs and SBS exchanges may evolve over time and that, as this market evolves, the conflicts of interest that the Commission has identified for SB SEFs and SBS exchanges may change. The centralized trading of security-based swaps is still developing and may change significantly as the market for security-based swaps develops. In particular, the provisions in the Dodd-Frank Act relating to the centralized trading of security-based swaps are not yet effective. Once they become effective, market participants that trade security-based swaps will be subject to substantially more regulation, which may have an effect on the conflicts of interest at SB SEFs and SBS exchanges. What are commenters' views on whether and how conflicts of interest for SB SEFs and SBS exchanges may evolve over time and how the Commission should respond to such changes? How are conflicts of interest likely to change as the centralized trading of security-based swaps and SB SEFs and SBS exchanges become more established? Are the conflicts of interest identified by the Commission likely to change as the trading of security-based swaps moves to regulated markets that must provide for impartial access and, if so, how? What potential new conflicts of interest could arise that the Commission should consider? How will potential changes in the clearing of security-based swaps affect conflicts of interest at SB SEFs and SBS exchanges? In addition, competitive forces within the security-based swaps market may help to mitigate conflicts of interest, for example, by increasing the number of institutions that trade security-based swaps and creating a broader market for security-based swaps. How will competition issues affect or change current or identified conflicts of interest? Will competition potentially create different or additional conflicts of interest that the Commission should consider? Would the Commission's proposal to apply to SB SEFs and SBS exchanges standards to mitigate conflicts of interest that are similar to those approved for national securities exchanges influence whether those conflicts of interest will increase, diminish, or remain unchanged over time?

Are there any other conflicts of interest that warrant examination? What other parties may have conflicts of interest that would affect whether they should control or participate in the governance of a SB SEF or SBS exchange? In what circumstances would these conflicts of interest arise? For example, might non-participant or non-member shareholders have a conflict of interest? What would be the differences in conflicts of interest between participants and non-participants or members and non-members that would affect the SB SEF or SBS exchange?

Would persons who are selected to be directors of a SB SEF or SBS exchange by participants or members have conflicts of interest based on their status as directors that would affect their ability to act in the best interest of the entity or in conformity with the Exchange Act, or to act to meet the policy objectives in Section 765 of the Dodd-Frank Act? Would directors be less likely to act to meet the policy objectives in Section 765 of the Dodd-Frank Act if they are selected by shareholders seeking to maximize the profits of the SB SEF or SBS exchange? How would participants' or members' potential conflicts of interest concerning open access and products traded compare to non-participants' or non-members' conflicts on such issues? How do the incentives of independent directors differ from those of non-independent directors with respect to increasing access or promoting competition?

IV. Discussion of Proposed Regulation MC: Mitigation of Conflicts of Interest of Security-Based Swap Clearing Agencies

Section 765 directs the Commission to adopt rules to mitigate conflicts of interest, which rules may include numerical limits on control of, or voting rights with respect to, any security-based swap clearing agency. The Commission preliminarily believes that requirements applicable to both governance and voting interests can play an essential role in mitigating conflicts of interests. However, the Commission recognizes that the nature of the governance, ownership and voting requirements to mitigate conflicts may differ depending on the conflicts of interest of the persons making decisions on behalf of the security-based swap clearing agency. In particular, the nature of the ownership and voting power of stockholders of the security-based swap clearing agency plays a role in determining the nature of the conflicts of interest that directors of the security-based swap clearing agency will face.

As previously noted, the Commission preliminarily believes that conflicts of interest may arise when a small number of participants exercise control or undue influence over a security-based swap clearing agency. Conflicts of interest may also arise, however, simply because directors and other decision-makers at a security-based swap clearing agency have multiple interests and goals, including maximizing profit for the benefit of shareholders and imposing risk restraints that may limit short-term profits, among others.

In seeking to address conflicts of interests, the imposition of governance restrictions may lessen the need to impose certain voting limitations, while the imposition of certain voting limitations may alleviate the need to impose certain governance restrictions. Accordingly, the Commission is proposing two alternative approaches with respect to voting limitations and governance that would place differing levels of emphasis on each of these factors.[77]

The proposed rule would allow the security-based swap clearing agency to elect between the two alternatives. The first alternative places an emphasis on voting limitations while also imposing certain governance restrictions ("Voting Interest Focus Alternative").[78] The second alternative places an emphasis on governance restrictions while also

[77] *See* proposed Rule 701(a) and (b) of Regulation MC.

[78] *See* proposed Rule 701(a) under Regulation MC.

imposing certain voting limitations ("Governance Focus Alternative").[79] Although the Commission is proposing two separate alternatives, the Commission may also consider adopting only one alternative as the final rule or may combine aspects of each proposed alternative and adopt it as a single rule.[80]

In addition, the existing standards in Section 17A of the Exchange Act also help to mitigate conflicts of interest at registered clearing agencies and will be applied in addition to any standards adopted by the Commission under the Dodd-Frank Act.[81]

A. Alternative I: Voting Interest Focus Alternative

As more fully described below, under the Voting Interest Focus Alternative, the Commission is proposing limitations on the voting interests held by individual participants of a security-based swap clearing agency and by participants acting collectively as a group. In addition, the Commission is proposing certain requirements related to governance that would give independent directors a strong role in overseeing the security based-swap clearing agency.

1. Voting Interest Focus Alternative: Individual Voting Limitation

The Voting Interest Focus Alternative would provide that a security-based swap clearing agency may not permit a participant, either alone or together with its related persons, to (1) beneficially own, directly or indirectly, any interest in the security-based swap clearing agency that exceeds 20% of any class of securities, or other ownership interest, entitled to vote of such security-based swap clearing agency or (2) directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the security-based swap clearing agency that exceeds 20% of the voting power of any class of securities or other ownership interest of such security-based swap clearing agency.[82] This proposed limitation on individual participant voting interest is designed to prevent any individual participant from owning, on a direct or indirect basis, a voting interest that would allow it to act on conflicts of interest in the security-based swap clearing agency to the detriment of such security-based swap clearing agency and the security-based swaps market.

The terms "beneficial ownership," "beneficially owns" or any derivatives thereof would be defined in reference to Rule 13d–3 under the Exchange Act, Determination of Beneficial Ownership.[83] The concept of beneficial ownership in Rule 13d–3 is designed to encompass any person or group of persons that may be able to act to influence or control an issuer. The Commission proposes to use the same definition of beneficial ownership in this rule because it also would describe those persons or groups of persons that may be able to act to influence or control a security-based swap clearing agency. However, to the extent any participant beneficially owns any security or other ownership interest solely because such participant is a member of a group within the meaning of Section 13(d)(3) of the Exchange Act, such participant would not be deemed to beneficially own such security or other ownership interest for purposes of this section, unless such person had the power to direct the vote of such security or other ownership interest. The Commission proposes to exclude beneficial ownership that results solely from being a member of a group to provide more certainty to those that would be required to comply with the limitations, in light of the effect of exceeding the ownership limit—*i.e.*, that the participant will be divested of the excess interest.

While the Commission has not previously adopted voting interest limitations for registered clearing agencies in the other securities markets, the security-based swaps market presents a different potential concern with respect to conflicts of interests. In the securities markets for which clearing agencies currently registered with the Commission provide clearance and settlement services,[84] there are significantly more dealers and participants. The incentives of participant-owners of these registered clearing agencies are generally aligned with those of the clearing agency: To accept for clearing as many participants that can meet reasonable participation standards and as many transactions that fit into the clearing agencies' risk management structure. Furthermore, the OTC derivatives market has a relatively high concentration of market activity among a limited number of dealers [85] that earn significant revenues from the currently opaque OTC market.[86] The existing cash equities and listed options markets, on the other hand, are transparent and widely disbursed over a range of market participants. As previously discussed, participants in a security-based swap clearing agency may have incentives to limit participation in the clearing agency and to limit the scope of products cleared. Moreover, the Commission's experience regulating security-based swap clearing agencies along with the views expressed by market participants suggest that security-based swap clearing agencies may be particularly susceptible to conflicts of interest.[87] The Commission preliminarily believes that prohibiting a participant and its affiliates and related persons from having more than a 20% voting interest in a security-based swap clearing agency, taking into account the other requirements under the Voting Interest Focus Alternative as described below, would establish a sufficiently high threshold to preclude any one participant from exerting undue influence over the security-based swap clearing agency. The 20% threshold proposed for participant voting interests in a security-based swap clearing agency is similar to the threshold that the Commission previously proposed for national securities exchanges and national securities associations, is the same as the threshold now being proposed for SBS exchanges and SB SEFs, and is consistent with the limits

[79] *See* proposed Rule 701(b) under Regulation MC.

[80] *See infra* Section VIII requesting comment on whether alternatives with or without modifications should be allowed and whether certain requirements in each alternative should be combined to form a single approach.

[81] *See* discussion *infra* Section IV.C. Security-based swap clearing agencies will be required to be registered with the Commission under Section 17A of the Exchange Act upon the effective date of Title VII and, as a result, must comply with the standards in Section 17A that are applicable to all registered clearing agencies.

[82] *See* proposed Rule 701(a)(1)(i) and (ii) under Regulation MC.

[83] *See* proposed Rule 700(b) under Regulation MC, which provides that the terms "beneficial ownership," "beneficially owns," or any derivative thereof would be defined as having the same meaning, with respect to any security or other ownership interest, as set forth in § 240.13d–3, as if (and whether or not) such security or other ownership interest were a voting equity security registered under Section 12 of the Exchange Act (15 U.S.C. 78l); provided that to the extent any person beneficially owns any security or other ownership interest solely because such person is a member of a group within the meaning of Section 13(d)(3) of the Exchange Act (15 U.S.C. 78m(d)(3)), such person shall not be deemed to beneficially own such security or other ownership interest, unless such person has the power to direct the vote of such security or other ownership interest.

[84] The four clearing agencies registered with the Commission that have active business operations include: The Depository Trust Company, The National Securities Clearing Corporation, The Fixed Income Clearing Corporation, and The Options Clearing Corporation.

[85] *See supra* note 40.

[86] *Id.* (stating that U.S. commercial banks reported trading revenues of $8.3 billion in the first quarter of 2010).

[87] *See supra* notes 26 and 34.

currently in place with respect to national securities exchanges.[88]

2. Voting Interest Focus Alternative: Aggregate Voting Limitation

The Voting Interest Focus Alternative would provide that a security-based swap clearing agency may not permit a participant, either alone or together with its related persons, to in the aggregate with any other security-based swap clearing agency participants and their related persons (1) beneficially own, directly or indirectly, any interest in the security-based swap clearing agency that exceeds 40% of any class of securities, or other ownership interest, entitled to vote of such security-based swap clearing agency or (2) directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the security-based swap clearing agency that exceeds 40% of the voting power of any class of securities or other ownership interest of such security-based swap clearing agency.[89] Under the individual participant voting limitation and without this aggregate limitation on voting interest, five entities that have voting interests of 20% could control the security-based swap clearing agency. Since a small number of dealers currently control the OTC derivatives market,[90] the Commission preliminarily believes that this aggregate limitation on voting interest is a necessary corollary to the individual participant voting limitation. The 40% aggregate limitation on voting interest, which is consistent with limits used in similar contexts,[91] would restrict participants' ability to collectively acquire a majority voting interest, while maintaining the integrity of the 20% individual participant limitation.

3. Voting Interest Focus Alternative: Indirect or Affiliate Ownership and Ownership Through Related Persons

The Voting Interest Focus Alternative would also address conflicts of interest created by indirect voting interests of the security-based swap clearing agency because a rule that limits only direct voting interests could be circumvented by holding the interest through an affiliated party or by holding an interest in a controlling entity. For purposes of determining a security-based swap clearing agency participant's voting interest, the proposed rule would, as indicated in the description of the rules above, combine such person's interest with those of its "related persons." [92]

The Commission proposes to define the term "related person" to include persons whose relationship with respect to a participant would likely cause them to have the same conflicts of interest with respect to the security-based swap clearing agency (*e.g.,* "affiliate," "immediate family member," and "person associated with a participant in a security-based swap clearing agency"). Specifically, proposed Rule 700(u) would define "related person" as that term relates to security-based swap clearing agencies as: (i) Any affiliate [93] of a participant in a security-based swap clearing agency; (ii) any person associated with a participant in a security-based swap clearing agency; [94] (iii) any immediate family member [95] of a participant in the security-based swap clearing agency that is a natural person, or any immediate family member of the spouse of such person, who, in each case, has the same home as the participant in the security-based swap clearing agency, or who is a director or officer of the security-based swap clearing agency or any of its parents or subsidiaries; and (iv) any immediate family member of a person associated with a participant in the security-based swap clearing agency that is a natural person, or any immediate family member of the spouse of such person, who, in each case, has the same home as the person associated with the participant in the security-based swap clearing agency, or who is a director or officer of the security-based swap clearing agency, or any of its parents or subsidiaries.

A voting interest limitation of 20% for an individual participant of a security-based swap clearing agency and an aggregate voting interest limitation of 40% for all participants of a security-based swap clearing agency is intended to restrict the ability of security-based swap clearing agency participants to exercise undue influence over the governance of a security-based swap clearing agency for their own self-interest. At the same time, these voting limitations would still permit participants to hold significant economic interests in a security-based swap clearing agency.

4. Voting Interest Focus Alternative: Divestiture and Voting Restriction Requirement

In order to assure that a security-based swap clearing agency maintains the proposed voting interest limitations, the Commission is proposing to require security-based swap clearing agencies to have rules in place for the divestiture of voting interests that exceed the prescribed limitations.[96] The Commission preliminarily believes that in order for the voting limitations to be effective, the rule must require security-based swap clearing agencies to take action to reduce participants' and participants' related persons' voting interests.

The Commission is proposing to provide security-based swap clearing agencies flexibility in determining how

[88] As previously noted, national securities exchanges generally prohibit exchange members, alone or together with their related persons, from owning more than 20% of the exchange or being entitled to vote shares in excess of 20%. *See, e.g.,* Securities Exchange Act Release No. 61698, 75 FR at 13156, *supra* note 59.

[89] *See* proposed Rule 701(a)(1)(iii) and (iv) under Regulation MC.

[90] *See supra* note 40.

[91] As previously noted, the Commission has generally prohibited any person, alone or together with its related persons, from owning more than 40% of a national securities exchange. *See, e.g.,* Securities Exchange Act Release No. 61698, 75 FR at 13156, *supra* note 59.

[92] *See* proposed Rule 700(u) of Regulation MC.

[93] The term "affiliate" would be defined as any person that, directly or indirectly, controls, is controlled by, or is under common control with, the person. *See* proposed Rule 700(a) under Regulation MC. "Control" would be defined as the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. Any person that (i) is a director, general partner, or officer exercising executive responsibility (or having similar status or function); (ii) directly or indirectly has the right to vote 25% or more of a class of voting securities or has the power to sell or direct the sale of 25% or more of a class of voting securities; or (iii) in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that person. *See* proposed Rule 700(e) under Regulation MC.

[94] There is currently not a definition for a "person associated with a participant in a clearing agency" in the Exchange Act or in Commission rules. However, the Commission believes that the definition for the term "person associated with a member" in Section 3(a)(21) of the Exchange Act should be used as the basis for the definition of the term "person associated with a participant in a security-based swap clearing agency," as the purposes of the two defined terms are similar. Accordingly, the Commission proposes to define the term "person associated with a participant in a security-based swap clearing agency" as (1) any partner, officer, director, or branch manager of such security-based swap dealer or major security-based swap participant (or any person occupying a similar status or performing similar functions); (2) any person directly or indirectly controlling, controlled by, or under common control with such security-based swap dealer or major security-based swap participant; or (3) any employee of such security-based swap dealer or major security-based swap participant. This term does not include any person associated with a participant in a security-based swap clearing agency whose functions are solely clerical or ministerial. *See* proposed Rule 700(r) of Regulation MC.

[95] The term "immediate family member" would be defined in the proposed rules as a person's spouse, parents, children, and siblings, whether by blood, marriage, or adoption, or anyone residing in such person's house. *See* proposed Rule 700(i) under Regulation MC.

[96] *See* proposed Rule 701(a)(2) under Regulation MC.

to implement this divesture requirement. Any rules adopted by a security-based swap clearing agency must assure that the security-based swap clearing agency has a viable, enforceable mechanism to divest a participant and its related persons of any voting interest owned in excess of the 20% limitation, and not to give effect to the portion of any voting interest in excess of the 20% individual limitation or the 40% aggregate limitation. The Commission is also proposing to require a security-based swap clearing agency's procedures to provide a mechanism for the security-based swap clearing agency to obtain information relating to the voting interests in the security-based swap clearing agency held by its participants and their related persons.[97] The Commission believes that this requirement is essential to a security-based swap clearing agency's ability to monitor the voting interest held by its participants and their related persons in relation to the proposed voting limitations.

5. Voting Interest Focus Alternative: Independent Directors on Board

The Commission's Voting Interest Focus Alternative would impose substantive requirements on the governance of security-based swap clearing agencies that are designed to address the concern that participants' conflicts of interest may lead them to take actions that would potentially limit fair and open access and product eligibility for central clearing, as well as potentially weaken the risk management of security-based swap clearing agencies. The proposed governance provisions, as discussed below, are intended to help mitigate potential conflicts of interest and assure the fair administration and governance of a security-based swap clearing agency by limiting the control that any one participant or group of participants may exercise over the security-based swap clearing agency.

The Commission proposes under the Voting Interest Focus Alternative to require the Board[98] of a security-based swap clearing agency to be composed of at least 35% independent directors.[99] The presence of a significant number of independent directors on the Board of a security-based swap clearing agency should provide the addition of strong and independent oversight within the security-based swap clearing agency to serve as a potential check against conflicts of interest that could pose a detriment to the security-based swap clearing agency, other firms, or the security-based swaps market generally. The Commission preliminarily believes that a level below 35% independent directors may not be sufficient to assure that independent directors have a significant voice.[100] A requirement lower than 35% would potentially place independent directors in a small enough minority that, relative to the remaining director slots that could potentially be filled by participant or management directors, the views of the independent directors would not be given enough consideration. While independent directors would have less than a majority representation on the Board under the Voting Interest Focus Alternative, they would have a meaningful opportunity to contribute to determinations made by the Board and the various Board committees. The Commission is proposing to require at least 35% independent directors combined with the proposal to limit participant voting interests in a security-based swap clearing agency, both on an individual and aggregate basis, as a means of effectively mitigating conflict of interest concerns while also permitting a greater proportion of participants to serve on the Board of a security-based swap clearing agency.[101] This aspect of the proposal may address potential concerns that requiring a majority independent Board would affect the Board's ability to effectively perform risk management functions.

The Commission also proposes that no director may qualify as an independent director unless the Board affirmatively determines that the director does not have a material relationship with the security-based swap clearing agency or any affiliate of the security-based swap clearing agency, or a participant in the security-based swap clearing agency, or any affiliate of a participant in the security-based swap clearing agency. The purpose of this proposal is to provide assurance that an independent director candidate does not have any relationships or affiliations that would prevent the candidate from being independent of the security-based swap clearing agency. Accordingly, the Commission proposes to define the term "independent director," as it is used with respect to a security-based swap clearing agency, as a director who has no material relationship with:

(1) The security-based swap clearing agency;

(2) Any affiliate of the security-based swap clearing agency;

(3) A participant in the security-based swap clearing agency; or

(4) Any affiliate of a participant in the security-based swap clearing agency.[102]

Some relationships or affiliations would clearly exclude a director from qualifying as independent of a security-based swap clearing agency. For example, a director would not be considered independent if any of the following circumstances exists:

- The director, or an immediate family member, is employed by or otherwise has a material relationship with the security-based swap clearing agency or any affiliate thereof; or within the past three years was employed by or otherwise had a material relationship with the security-based swap clearing agency or any affiliate thereof;
- The director is a participant in the security-based swap clearing agency or within the past three years was employed by or affiliated with a participant or any affiliate thereof, or the director has an immediate family member that is, or within the past three years was, an executive officer of a participant in the security-based swap clearing agency or any affiliate thereof;
- The director, or an immediate family member, has received during any twelve-month period within the past three years payments that reasonably could affect the independent judgment or decision-making of the director from the security-based swap clearing agency or any affiliate thereof or from a participant in the security-based swap clearing agency or any affiliate thereof, other than the following:
  - ○ Compensation for Board or Board committee services;
  - ○ Compensation to an immediate family member who is not an executive officer of the security-based swap clearing agency or any affiliate thereof or of a participant in the security-based

[97] *Id.*

[98] The term "Board" would be defined as the Board of Directors or Board of Governors of the SB SEF, SBS exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any equivalent body. *See* proposed Rule 700(c) under Regulation MC.

[99] The term "director" would be defined as any member of the Board. *See* Proposed Rule 700(f) under Regulation MC.

[100] Other regulators have previously chosen 35% as an appropriate level for independent representation on the Board of self-regulatory organizations. *See* 72 FR 6936 (February 14, 2007), which adopts final rules to address conflicts of interest at self-regulatory organizations regulated by the CFTC. Specifically, the final rules establish acceptable practices under Core Principle 15 applicable to DCMs and that provide that the Board is composed of at least 35% public directors.

[101] Proposed Rule 700(c) under Regulation MC does not prescribe the number of participant directors that are required to be on the Board. A security-based swap clearing agency may choose to have the majority of the Board be composed of independent directors.

[102] *See* proposed Rule 700(j) under Regulation MC.

swap clearing agency or any affiliate thereof; or

○ Pension and other forms of deferred compensation for prior services, not contingent on continued service.

• The director, or an immediate family member, is a partner in, or controlling shareholder or executive officer of, any organization to or from which the security-based swap clearing agency or any affiliate thereof made or received payments for property or services in the current or any of the past three full fiscal years that exceed 2% of the recipient's consolidated gross revenues for that year, other than the following:

○ Payments arising solely from investments in the securities of the security-based swap clearing agency or affiliate thereof; or

○ Payments under non-discretionary charitable contribution matching programs.

• The director, or an immediate family member, is, or within the past three years was, employed as an executive officer of another entity where any executive officers of the security-based swap clearing agency serve on that entity's compensation committee;

• The director, or an immediate family member, is a current partner of the outside auditor of the security-based swap clearing agency or any affiliate thereof, or was a partner or employee of the outside auditor of the security-based swap clearing agency or any affiliate thereof who worked on the audit of the security-based swap clearing agency or any affiliate thereof, at any time within the past three years; or

• In the case of a director that is a member of the audit committee, such director (other than in his or her capacity as a member of the audit committee, the Board, or any other Board committee), accepts, directly or indirectly, any consulting, advisory, or other compensatory fee from the security-based swap clearing agency or any affiliate thereof or a participant in the security-based swap clearing agency or any affiliate thereof, other than fixed amounts of pension and other forms of deferred compensation for prior service, provided such compensation is not contingent in any way on continued service.[103]

Under the proposed rule, the term "material relationship" would be defined as a relationship, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the director.[104] This definition is intended to encompass all significant instances in which a director's independence is compromised.[105] In determining whether a "material relationship" exists, security-based swap clearing agencies should consider the known relationships between a director and the security-based swap clearing agency to determine whether the relationship is likely to impair the independence of the director in making decisions that affect the security-based swap clearing agency. The proposed definitions of "independent director" and "material relationship" should help to reduce the potential that the independent directors on the Board of the security-based swap clearing agency are subject to conflicts of interest.

Under the Voting Interest Focus Alternative, the security-based swap clearing agency would be required to establish policies and procedures to require each director, on his or her own initiative or upon request of the security-based swap clearing agency, to inform the security-based swap clearing agency of the existence of any relationship or interest that may reasonably be considered to bear on whether such director is an independent director.[106] The security-based swap clearing agency would be expected to take reasonable measures to confirm the accuracy of the information provided. This requirement should help the security-based swap clearing agency to assure that it is informed of the existence of any relationship or interest that may reasonably be considered to bear on whether a director is independent as soon as possible and without requiring the security-based swap clearing agency to investigate for such information.

6. Voting Interest Focus Alternative: Board Committees

a. Nominating Committee

The Voting Interest Focus Alternative would require security-based swap clearing agencies to create and maintain a nominating committee for the selection of Board members, and would require that such nominating committee be composed of a majority of independent directors.[107] Directors serving on the nominating committee that are not independent may be more likely to select Board candidates whose views align with such directors' interests instead of the interests of the security-based swap clearing agency or the markets generally. Having a nominating committee that is composed of majority independent directors should help to address and facilitate the selection of independent directors.

The Voting Interest Focus Proposal would also require that the nominating committee identify candidates for Board membership through a consultative process with the participants of the security-based swap clearing agency consistent with criteria approved by the Board.[108] This should help assure that the selection of directors of the Board is conducted in a prudent manner while at the same time allowing for the participants of the security-based swap clearing agency to have fair representation in the selection of the directors of the Board.[109]

b. Other Board Committees

The Voting Interest Focus Alternative would require that other Board committees of a security-based swap clearing agency that are delegated authority to act on the Board's behalf, including but not limited to the risk committee, consist of at least 35% independent directors similar to the requirement that would be imposed on the Board itself.[110] This requirement should give independent directors a meaningful voice, similar to the one they would have in the Board itself, within Board committees that essentially perform the functions of a Board. The proposed requirement would also apply to an "advisory committee" to the extent that the committee is authorized to act on behalf of the Board, including instances where the Board is required to seek approval from the committee before making a determination. However, the Commission preliminarily believes that the independence requirement should not extend to a committee that functions in a purely advisory role, because members of those committees are not in a position to exercise powers of the

[103] *See* proposed Rule 700(j)(2) under Regulation MC.

[104] *See* proposed Rule 700(l) under Regulation MC.

[105] *See* Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003) (order approving SRO rules that would find a director independent only where that director does not have a relationship with the company that would impair her independence).

[106] *See* proposed Rule 701(a)(3)(iii) under Regulation MC.

[107] *See* proposed Rule 701(a)(4)(i) under Regulation MC.

[108] *See* proposed Rule 701(a)(4)(ii) under Regulation MC.

[109] Section 17A(a)(3)(C) of the Exchange Act requires fair representation among participants of a clearing agency by providing them with a meaningful opportunity to participate in the selection of directors. 15 U.S.C. 78q–1(a)(3)(C).

[110] *See* proposed Rule 701(a)(5) under Regulation MC.

Board or exert influence over the Board by dictating how the Board will act.

c. Disciplinary Panels

The Commission's Voting Interest Focus Alternative would impose special requirements on the composition of disciplinary panels (or their equivalents) of security-based swap clearing agencies that have not been delegated authority to act on the Board's behalf.[111] The Commission believes that participants of a security-based swap clearing agency should be appropriately disciplined for failure to comply with the rules of a security-based swap clearing agency, particularly as they relate to the ongoing risk management related requirements applicable to participants. Accordingly, the Commission is proposing that the disciplinary processes of a security-based swap clearing agency preclude any group or class of persons that are participants in the security-based swap clearing agency from exercising disproportionate influence on any disciplinary panels. In other words, to the extent that there is more than one type of group or class of persons that are participants in a security-based swap clearing agency, the composition of the disciplinary panel shall include representation of each group or class and shall not allow one group or class to have representation on the disciplinary panel that is out of proportion as compared to other groups or classes of persons that are participants in the security-based swap clearing agency. Furthermore, the disciplinary panel of the security-based swap clearing agency would include at least one person who would qualify as an independent director.

7. Voting Interest Focus Alternative: Request for Comment

The Commission requests comment on all aspects of the voting limitations under the Voting Interest Focus Alternative, including whether the 20% limitations on individual participant voting interest and the 40% aggregate limitation on participant voting interest are sufficient to limit the ability of a participant or a group of participants to exercise undue influence or control over the governance of a security-based swap clearing agency. Should the 20% and 40% limitations be lower given the existing concentration of the industry in a small number of large dealers? If so, what limitations would be appropriate and why? Are there other conflicts of interest not discussed in this release that the Commission should consider generally and specifically with respect to voting limitations? Would the proposed restrictions have an effect on the ability to form new security-based swap clearing agencies or to effectively operate existing security-based swap clearing agencies?

The Commission also requests comment on whether there may be other ways to structure the interests in a security-based swap clearing agency to mitigate potential conflicts of interest. Are there other thresholds for voting limitations or approaches that the Commission should consider? Are there other methods for mitigating conflicts of interest the Commission should consider, such as limitations on holding non-voting interests in a security-based swap clearing agency? How would non-voting interests affect the potential for conflicts of interests?

Section 765 enumerates Specified Entities for the Commission to consider in its rulemaking. The proposed rule would apply only to Specified Entities that are participants of the security-based swap clearing agency and not to other Specified Entities, because the Commission preliminarily believes that those entities that are participants of a clearing agency are most likely to have a conflict of interest that would affect the access, product eligibility, and risk management issues discussed in this release. However, the Commission requests comment on whether all Specified Entities, regardless of participant status, should be subject to the proposed restrictions on voting interests. What are the potential conflicts of interest associated with Specified Entities that are not participants? Might Specified Entities that are not participants in a security-based swap clearing agency have an interest in limiting the number or type of security-based swaps that are accepted for clearing to the extent that they may profit from trading security-based swaps that are not centrally cleared? Are there any other classes of persons, such as participants or members of SB SEFs or SBS exchanges, that should also be subject to the proposed restrictions even though they are not participants of a security-based swap clearing agency? What effect would such restrictions have on mitigating conflicts of interest at security-based swap clearing agencies? What effect would such restrictions have on the ability to form new security-based swap clearing agencies?

The Voting Interest Focus Alternative would require that voting limitations be determined by including interests held directly by a participant in the security-based swap clearing agency, by including indirect interests of a participant in the security-based swap clearing agency, and by including interests held by related persons of a participant in the security-based swap clearing agency. The Commission requests comment on whether its formulation for calculating the aggregate and individual limits is appropriate. Specifically, the Commission requests comment on whether the scope of the definitions of "affiliate," "immediate family member," and "related person" are over-inclusive or under-inclusive and, if either, why? Is there a different methodology to reach the interest of any person with whom a security-based swap clearing agency participant may be able to act in concert with to unduly influence or control a security-based swap clearing agency that the Commission should consider?

The Commission seeks comment on whether requiring the Board of a security-based swap clearing agency to be composed of at least 35% independent directors would improve governance of the security-based swap clearing agency and mitigate potential conflicts of interest. Is 35% sufficient to give independent directors a meaningful voice within the Board, or would a higher or lower level be appropriate? Should the Commission require that a majority of the Board be composed of independent directors? How are these independent directors likely to affect the activities of the security-based swap clearing agency? What are their incentives to assure open and fair access, increased product eligibility, and sound risk management at a security-based swap clearing agency? Do independent directors have any conflicts of interest that would affect their ability to facilitate these objectives?

The Commission also requests comment on whether other measures concerning governance should be used to mitigate conflicts of interest at security-based swap clearing agencies, either in addition to or instead of the proposals outlined in this release. In particular, what other approaches would improve governance and mitigate conflicts of interest for security-based swap clearing agencies? For example, would State laws governing the fiduciary duty owed by the Board to a corporation help to mitigate conflicts of interest? Should the Commission

[111] *See* proposed Rule 701(a)(6) under Regulation MC. If the security-based swap clearing agency does not have a disciplinary panel, these requirements should be interpreted as applying to the equivalent of a disciplinary panel in the security-based swap clearing agency's internal processes, unless the disciplinary panel (or its equivalent) has been delegated authority to act on the Board's behalf, in which case it would be subject to the 35% independent director requirement.

consider any additional requirements related to fiduciary duties? The policies and charter documents of individual corporations also often impose additional responsibilities and obligations on directors. Should security-based swap clearing agencies be required to put in place specific policies or charters to address conflicts of interest by the Board? What policies or charters would be necessary to provide assurance that participant directors will act in the best interests of the security-based swap clearing agency? What other requirements, if any, should be in place with respect to the duties owed by the Board in order to mitigate conflicts of interest at security-based swap clearing agencies?

In addition, the Commission requests comment on its proposed definitions, including the definitions of "independent director" and "material relationship." Are there other ways to define "independent director" or "material relationship?" If so, what are they? Should the Commission adopt other provisions that contain particular circumstances that would preclude a finding that a director is independent or that would deem a relationship material? Should the Commission take into account a director's salary or benefits he or she receives for being a director in order to consider whether an interest in keeping the directorship could make a director more likely to act favorably toward those that control the Board? Should the Commission adopt a specific look-back period within which to determine whether a "material relationship" exists? Should additional terms used in the proposed rule be defined?

The Commission requests comment on the proposed compositional requirements of committees of the Board under the Voting Interest Focus Alternative. Is the requirement that Board committees that are delegated authority to act on behalf of the Board be composed of at least 35% independent directors appropriate? The Commission also requests comment on whether there may be other ways to structure governance restrictions for security-based swap clearing agencies to mitigate potential conflicts of interest. In particular, the Commission requests comment on the proposed compositional requirements of the nominating committee. What is the potential effect of requiring a security-based swap clearing agency to have a majority independent nominating committee? Are there other processes for the selection of independent directors and the fair representation of the participants and shareholders of a security-based swap clearing agency that the Commission should consider with respect to the nominating committee? Should end-users or any other group be given guaranteed rights of participation in the governance of the security-based swap clearing agency? Should the Commission participate in the Board selection process, such as by requiring consultation on appointments? Should the Commission consider an alternative to a compositional requirement for a nominating committee, such as allowing a security-based swap clearing agency to have a board of trustees responsible for nominating candidates for the Board? If this were a viable alternative, should there be compositional requirements or other limits imposed on the board of trustees? How should such a board of trustees be appointed? Would the alternative of a board of trustees to nominate directors provide greater assurance that independent directors are truly independent not only at the time of their nomination but during their service on the Board as well?

With respect to governance as it relates to the risk committee, should there be special requirements relating to the risk committee, or its equivalent, of the Board? For instance, one possible alternative approach could be to provide separate requirements applicable only to the risk committee that reflect the highly specialized risk management expertise required of directors serving on that committee. For example, instead of requiring that the risk committee be composed of at least 35% independent directors (where such committee is delegated authority to act on the Board's behalf), the requirement could apply to a smaller number of independent directors, and also explicitly require that other interested persons, such as customers of participants, be represented on the risk committee. The Commission requests comment on whether a more prescriptive approach such as the one described above would be appropriate for the risk committee and what levels of participation by participants, customers of participants, or others would be appropriate. Are there factors that warrant treating the risk committee differently from other Board committees? Should the Commission require the Board to report to the Commission if the Board disagrees with a recommendation of the risk committee? Is the risk committee more or less prone to conflict of interest issues? Are there factors other than conflicts of interest that should be taken into consideration? Is it desirable to have an explicit requirement with respect to customers of participants? If so, how many customers should serve on the risk subcommittee relative to independent directors and participant directors? What definition of customer should be used for these purposes? Are there distinctions that should be made between the different types of customer firms for this purpose?

Another possible alternative approach could be to limit the applicable restrictions on the risk committee to circumstances where a specific range of topics is being addressed. For example, restrictions on participation in a risk committee could be limited to only those circumstances in which a determination about issues such as participant standards and product eligibility were being made. What are the potential advantages or disadvantages of such an approach? Would it be possible to separate activities of a committee based on topics? Are there certain issues that pose more or less of a concern with respect to conflicts of interests?

The Commission also requests comment regarding whether any requirements should be imposed on advisory committees. Would an independence requirement on a purely advisory committee mitigate potential conflicts of interest? Are there circumstances in which a purely advisory committee exercises substantial power over the Board?

The Commission requests comment on the composition of the disciplinary panel of the security-based swap clearing agency. Would the proposed rule be sufficient to address potential conflicts of interest that may interfere with the fair and effective disciplinary processes of a security-based swap clearing agency? Should different restrictions be imposed?

Although independent directors may address some of the conflicts of interest concerns that underlie Section 765 of the Dodd-Frank Act, they may not effectively eliminate all conflicts. The Commission, however, believes that effective governance via a partially independent Board is compatible with the characteristics of security-based swap clearing agencies, and the types of conflicts that may be inherent with respect to such entities.

B. Alternative II: Governance Focus Alternative

As more fully described below, under the Governance Focus Alternative, the Commission is proposing governance restrictions including requiring a majority of independent directors on the Board and voting restrictions that would be applicable only to individual

participants of a security-based swap clearing agency. The Governance Focus Alternative differs from the Voting Interest Focus Alternative in that it provides greater emphasis on requirements regarding the governance arrangements of a security-based swap clearing agency as the primary means to mitigate conflicts of interest. As with the Voting Interest Focus Alternative, the Commission is proposing rules related to the governance of a security-based swap clearing agency and the voting interests held by participants because the Commission believes each contributes to conflict of interest concerns. However, the Voting Interest Focus Alternative places greater emphasis on the ability of participants to hold voting interests in the security-based swap clearing agency than it does on participants' ability to participate in the governance of the security-based swap clearing agency, while the Governance Focus Alternative, as described in more detail below, places greater emphasis on the ability of participants to participate in the governance of the security-based swap clearing agency than it does on the ability of participants on a collective basis to hold a voting interest in the security-based swap clearing agency.

1. Governance Focus Alternative: Voting Limitation

The Governance Focus Alternative would require that a security-based swap clearing agency may not permit a participant, either alone or together with its related persons, to (1) beneficially own, directly or indirectly, any interest in the security-based swap clearing agency that exceeds 5% of any class of securities, or other ownership interest, entitled to vote of such security-based swap clearing agency or (2) directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the security-based swap clearing agency that exceeds 5% of the voting power of any class of securities or other ownership interest of such security-based swap clearing agency.[112] The 5% limitation on participant voting interest is intended to help mitigate conflicts of interest because each individual participant's voting interest would be substantially limited and, therefore, its ability to control the security-based swap clearing agency would also be limited.[113] As discussed previously, the Voting Interest Focus Alternative would permit a higher individual participant voting interest of 20%, but would limit the aggregate voting interests held by all participants to 40%. However, the Voting Interest Focus Alternative would allow a security-based swap clearing agency to have a Board with a majority of directors selected by participants. The Commission believes that the 5% limit per participant, in combination with the requirements related to governance arrangements described below, is sufficiently low that there is no need for the 40% aggregate cap on the voting interests held by all participants.

Furthermore, the Commission notes that the 40% aggregate cap on participant voting interests proposed in the Voting Interest Focus Alternative may restrict the potential formation of participant-owned security-based swap clearing agencies. Some clearing agencies currently registered with the Commission are user-owned or user-controlled institutions that function as quasi-utilities. This structure may provide certain benefits to the participants and the securities markets generally because such clearing agencies generally seek to match the fees charged to participants to the clearing agency's costs and not to maximize profits.[114]

In addition, potential users may have a strong incentive to form a new clearing agency if they believe an existing clearing agency is not effectively serving the security-based swaps market. Not imposing an aggregate cap on participant voting interests in a security-based swap clearing agency could help encourage the formation of new security-based swap clearing agencies and thereby increase the potential for competition among security-based swap clearing agencies. In addition, the 5% voting interest limitation may encourage open access by creating incentives for a larger number of participants to acquire a voting interest in the security-based swap clearing agency. While the Commission has not previously adopted voting limitations or governance rules for registered clearing agencies in the other securities markets, as previously discussed under the Voting Interest Focus Alternative, the security-based swaps market presents different concerns with respect to potential conflicts of interests that warrant additional scrutiny and efforts to mitigate such conflicts.

2. Governance Focus Alternative: Indirect or Affiliate Ownership and Ownership Through Related Persons

The Commission believes that a rule that limits only direct voting interests could be circumvented by holding the interest through an affiliated party or by holding an interest in a controlling entity. Accordingly, similar to the Voting Interest Focus Alternative,[115] the Governance Focus Alternative would address conflicts of interest created by indirect voting interests of the security-based swap clearing agency and would require aggregation of a security-based swap clearing agency participant's voting interest with its related persons'[116] voting interests.[117]

3. Governance Focus Alternative: Divestiture and Voting Restriction Requirement

Similar to the Voting Interest Focus Alternative,[118] the Governance Focus Alternative would require security-based swap clearing agencies to have rules in place for the divestiture of voting interests that exceed the 5% limitation and a mechanism to not give effect to the portion of any voting interest held by a participant in excess of the 5% voting limitation.[119] The Commission believes that this requirement is essential to a security-based swap clearing agency's ability to monitor voting interests by its participants in relation to the proposed voting limitations.

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[112] *See* proposed Rule 701(b)(1) under Regulation MC.

[113] The 5% threshold level for ownership has previously been found by the Commission in other contexts to trigger reporting requirements to the Commission related to the ability to control an organization. *See* Rule 13d–1(a) under the Exchange Act, 17 CFR 240.13d–1(a) ("Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than 5% of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D"). In addition, investors acquiring more than a 5% interest in a company must file a form certifying that they acquired that interest without "the effect of changing or influencing the control of the issuer * * *" Rule 13d–1(c)(1) under the Exchange Act, 17 CFR 240.13d–1(c)(1). *See, also,* Gaf Corp. v. Milstein, 453 F.2d 709 (2d Cir. N.Y. 1971), stating that "[T]he purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control. * * *" *Id.* at 717.

[114] *See, e.g.,* "The US Model for Clearing and Settlement: An Overview of DTCC," available at: *http://www.dtcc.com/downloads/about/US%20Model%20for%20Clearing%20and%20Settlement.pdf.* ("[O]wnership and governance of [The National Securities Clearing Corporation] and [The Depository Trust Company] were from the outset those typical of market utilities.").

[115] *See supra* Section I.A.3.

[116] *See supra* note 92 and accompanying text.

[117] *See* proposed Rule 701(b)(1) under Regulation MC.

[118] *See supra* Section I.A.4.

[119] *See* proposed Rule 701(b)(2) under Regulation MC.

4. Governance Focus Alternative: Majority Independent Board

As discussed previously, the Governance Focus Alternative differs from the Voting Interest Focus Alternative by placing greater emphasis on the governance arrangements of the security-based swap clearing agency. Each alternative approach seeks to strike a balance between the appropriate restrictions imposed on a security-based swap clearing agency relating to governance and voting rights held by participants. Under the Governance Focus Alternative, participants on a collective basis could potentially own all voting interests in a security-based swap clearing agency. While this option allows for potential benefits in terms of participants' ability to form new clearing agencies, it also allows participants' to control 100% of the voting interest in a security-based swap clearing agency, in contrast to the Voting Interest Focus Alternative, which would limit participants to holding no more than 40% of the voting interest. Accordingly, in order to balance the increased voting interest that may be held by participants collectively, the Commission proposes that a greater proportion of the Board be composed of independent directors under the Governance Focus Alternative.

The Governance Focus Alternative is intended to mitigate conflicts of interest by limiting the influence participants may have in the determinations of the Board or in the administration of a security-based swap clearing agency. Specifically, the Governance Focus Alternative would require the Board [120] of a security-based swap clearing agency to be composed of a majority of independent directors.[121] The presence of a majority of independent directors on the Board of a security-based swap clearing agency is intended to reduce the ability of non-independent directors to influence the operation of the security-based swap clearing agency in favor of their own self-interests and to promote open and fair access, product eligibility, and sufficient risk management standards. This should in turn benefit non-participant firms that enter into correspondent clearing arrangements with participants, and SBS exchanges and SB SEFs who will rely on the availability of a security-based swap clearing agency. A majority independent Board requirement is consistent with accepted corporate governance "best practices." [122] Furthermore, requiring a majority of the Board of a security-based swap clearing agency to be independent would still permit the security-based swap clearing agency to provide participants with fair representation in the selection of directors and the administration of the affairs of the security-based swap clearing agency as required under the Exchange Act.[123]

The Commission also proposes that no director may qualify as an independent director unless the Board affirmatively determines that the director does not have a material relationship with the security-based swap clearing agency or any affiliate of the security-based swap clearing agency,[124] or a participant in the security-based swap clearing agency, or any affiliate of a participant in the security-based swap clearing agency.[125] The proposed definitions of "independent director" and "material relationship" are designed to reduce the potential that the Board of the security-based swap clearing agency is controlled by persons who are subject to conflicts of interest.

While the proposal that a majority of the Board be composed of independent directors should help to mitigate certain conflicts of interest, and particularly those conflicts that are most likely to result in an adverse effect on the security-based swap clearing agency, the Commission recognizes that it would not completely eliminate conflicts of interest. Participant directors would still be permitted to serve on the Board. The Commission believes that participants may have operational, risk management, and market expertise that may be useful for effective oversight of a security-based swap clearing agency.

In addition, independent directors themselves may not be free of conflicts of interest. Although the independent directors would not have a material relationship with the clearing agency or any of its participants, they could still be influenced by other sources such as non-participant shareholders of the security-based swap clearing agency. The presence of independent directors may be an effective mechanism to address certain types of conflicts in certain types of institutions but not necessarily in all instances nor for all institutions. The Commission, however, believes that effective governance via a majority independent Board is compatible with the characteristics of security-based swap clearing agencies, and the types of conflicts that may be inherent with respect to such entities.

To help address these concerns, the proposed rules would require each security-based swap clearing agency to establish policies and procedures to require each director, on his or her own initiative or upon request of the security-based swap clearing agency, to inform the security-based swap clearing agency of the existence of any relationship or interest that may reasonably be considered to bear on whether such director is an independent director.[126] This requirement should keep the security-based swap clearing agency informed of the existence of any relationship or interest that may reasonably be considered to bear on whether a director is independent as soon as possible without requiring the security-based swap clearing agency to investigate for such relationships or interest.

5. Governance Focus Alternative: Board Committees

a. Nominating Committee

The Governance Focus Alternative would require security-based swap clearing agencies to create and maintain a nominating committee composed entirely of independent directors.[127] This is consistent with the purpose of the Governance Focus Alternative to place enhanced requirements on the governance arrangements of a security-based swap clearing agency, including the composition of the Board and Board committees, with less emphasis on the requirements with respect to the voting interests held by participants. Non-independent directors on the nominating committee could circumvent the majority independence requirement by nominating a candidate that is subject to their influence. Specifically, directors serving on the nominating committee that are not independent may be more likely to select Board candidates whose views align with such directors' interests instead of the interests of the security-based swap clearing agency or the markets generally. A requirement that

[120] *See supra* note 98.

[121] *See* proposed Rule 701(b)(3)(i) under Regulation MC. *See supra* note 99 for the definition of "director."

[122] *See, e.g.,* James H. Cheek III, *et al.,* Report of the American Bar Association Task Force on Corporate Responsibility (2003); and The Business Roundtable, Principles of Corporate Governance (May 2010).

[123] Section 17A(b)(3)(C) of the Exchange Act requires that the rules of a registered clearing agency assure a fair representation of its shareholders (or members) and participants in the selection of its directors and administration of its affairs. 15 U.S.C. 78q–1(b)(3)(C).

[124] *See supra* note 102 and accompanying text.

[125] *See* proposed Rule 701(b)(3)(ii) under Regulation MC.

[126] *See* proposed Rule 701(b)(3)(iii) under Regulation MC.

[127] *See* proposed Rule 701(b)(4)(i) under Regulation MC.

all directors serving on the nominating committee be independent of participants would address these concerns by limiting participants' control over the nomination process. A fully independent nominating committee may be warranted under the Governance Focus Alternative because the lack of an aggregate cap in this proposal means that participants may collectively hold greater voting interests in selecting the independent directors.

The Governance Focus Alternative would also require that the nominating committee identify candidates for Board membership through a consultative process with the participants of the security-based swap clearing agency consistent with criteria approved by the Board.[128] This should assure that the selection of the independent directors of the Board is conducted in a prudent manner while at the same time allowing participants of the security-based swap clearing agency to have a fair voice in the selection of the directors of the Board.[129]

b. Other Board Committees

The Governance Focus Alternative would require that other Board committees of a security-based swap clearing agency that are delegated authority to act on the Board's behalf, including but not limited to the risk committee, consist of a majority of independent directors similar to the requirement that would be imposed on the Board itself.[130] This requirement should prevent the dilution of the majority Board independence requirement that may result if Board committees that essentially perform the functions of a Board are not themselves subject to a similar requirement. The proposed requirement would also apply to an "advisory committee" to the extent that such a committee is authorized to act on behalf of the Board, including instances where the Board is required to seek approval from the committee before making a determination. However, the Commission preliminarily believes that this majority independence requirement should not extend to a committee that functions in a purely advisory role, because members of those committees are not in a position to exercise powers of the Board or exert influence over the Board by dictating the actions of the Board.

c. Disciplinary Panels

Similar to the Voting Interest Focus Alternative,[131] the Governance Focus Alternative would impose special requirements on the composition of disciplinary panels (or their equivalents) of security-based swap clearing agencies that have not been delegated authority to act on the Board's behalf.[132]

6. Governance Focus Alternative: Request for Comment

The Commission requests comment on all aspects of the 5% participant voting interest limitation. Is the 5% voting limitation appropriate, or should the Commission consider a higher or lower limitation? How does the relative concentration of the security-based swaps market among a small number of large dealers affect whether a 5% limitation is appropriate? Would 5% still allow a relatively small number of participants to effectively dominate the Board of a clearing agency? Should the Commission consider any form of an aggregate cap under this alternative? How likely is it that a security-based swap clearing agency would adopt a utility model, given the status of the security-based swaps market? Would the 5% limit impede the ability of a clearing agency to adopt a utility model? What advantages or disadvantages would such a model have? Are there other conflicts of interest, not discussed in this release, that the Commission should consider generally and specifically with respect to voting interest limitations? Would the proposed restrictions have an effect on the ability to form new security-based swap clearing agencies?

Are there other ways to more narrowly target voting limitations? Should the Commission impose voting restrictions on only the largest participants because those participants control the majority of the security-based swaps market (based on either the volume of transactions cleared at the security-based swap clearing agency or the notional value of the participant's outstanding security-based swap positions)? If such an approach is preferable, what should the threshold be for determining whether a participant is "large"? Should the Commission require the security-based swap clearing agency to consider the participant's volume of cleared transactions at the security-based swap clearing agency, the notional value of the participant's outstanding security-based swap positions at the security-based swap clearing agency, or both? Should the Commission require the security-based swap clearing agency to consider either volume or outstanding notional value of a participant's positions held outside of a security-based swap clearing agency? How often should the Commission require the security-based swap clearing agency to reevaluate its standard? How effectively would such an approach address conflict of interest concerns? What would be the advantages and disadvantages of this approach compared to the approach proposed above? Are there administrative complexities associated with determining and monitoring the point at which a firm reaches large participant status? Are the conflicts of interest concerns regarding all large participants similar or should there be differences in the voting limitations among large participants?

Should the restrictions on voting interests apply to other large entities, such as the Specified Entities listed in Section 765, even if they are not participants in a security-based swap clearing agency? What potential conflicts of interest could result if Specified Entities that are not large participants controlled the voting interest in a security-based swap clearing agency? How should such potential conflicts of interest be addressed?

Should the Commission consider a limitation on the non-voting interests owned by participants? Should the Commission consider a limitation on the voting and non-voting interests held by Specified Entities?

The Commission seeks comment on whether requiring the Board of a security-based swap clearing agency to be composed of a majority of independent directors would improve governance of the security-based swap clearing agency and mitigate potential conflicts of interest. Would a majority independent Board be helpful in mitigating conflicts of interest if the voting interest of a security-based swap clearing agency is owned by participants? If a majority independent Board is not appropriate to mitigate conflicts, what percentage of the Board should be independent? What are the costs and benefits of requiring the Boards of security-based swap clearing agencies to be composed of a majority of independent directors? How do these costs and benefits differ from the proposal that 35% of the Board be composed of independent directors? Would independent directors be likely to have the necessary experience and

[128] *See* proposed Rule 701(b)(4)(ii) under Regulation MC.

[129] *See supra* note 123.

[130] *See* proposed Rule 701(b)(5) under Regulation MC.

[131] *See supra* Section I.A.8.d. and accompanying text.

[132] *See* proposed Rule 701(b)(6) under Regulation MC.

expertise to serve on the Board? Could less experience or expertise negatively affect risk management practices or the efficiency of the clearing agency and, if so, how? If any such experience or efficiency issues exist, how could they be overcome? What are the independent directors' incentives regarding fair and open access, product eligibility, and sound risk management? How are these incentives different from those of participants? Do they result in conflicts of interest? If so, how are the conflicts of interest different from those of participants? How should they be addressed by the Commission?

Should the Commission consider alternative limits, or alternative combinations of limits, on voting interests or independent directors? For example, should the voting interest restrictions of 20% on individual interests and 40% in the aggregate be combined with the requirements for a majority independent Board and a 100% independent nominating committee? Would an alternative combination of requirements related to voting interests and independent directors be more effective? For example, would a higher requirement in each case (*e.g.,* a 10% limit on individual voting interests and a requirement for 60% independent directors) be more effective? Or would other combinations be more effective? Should the Commission reduce the restrictions over time if conflict of interest concerns are lessened as the security-based swaps market develops? For example, if participation in the security-based swaps market becomes more open and includes a broader range of participants, the interests of the participants may become more aligned with those of the clearing agency and the markets generally. Would restrictions on voting interests and governance still be needed in this circumstance? Are there other circumstances where the voting interest and governance restrictions may be reduced or eliminated altogether? If, over time, the security-based swaps market does not become more competitive, should the Commission consider additional governance and voting measures to promote open access and competition? What measures would be appropriate? What standards should the Commission use to determine whether additional restrictions should or should not be imposed?

Could restrictions regarding the governance structure of a security-based swap clearing agency alone be sufficient to address conflict of interest concerns or are both restrictions on governance and voting interests needed? Would participants of a security-based swap clearing agency be able to exercise undue influence over a security-based swap clearing agency through a voting interest even if a majority of the Board is independent? Are requirements related to the governance structure of a security-based swap clearing agency more or less effective than voting limitations at addressing conflicts of interest?

The Commission requests comment on the proposed compositional requirements of the nominating committee. What is the potential effect of requiring a security-based swap clearing agency to have an entirely independent nominating committee? Would requiring an entirely independent nominating committee, which is required to consult with participants of the security-based swap clearing agency, be consistent with the fair representation requirement under the Exchange Act? Should end-users or any other group be given guaranteed rights of participation in the governance of the security-based swap clearing agency? Should the Commission have some oversight of the Board selection process? Should the Commission consider an alternative to a compositional requirement for a nominating committee, such as allowing a security-based swap clearing agency to have a board of trustees responsible for nominating candidates for the Board? If this were a viable alternative, should there be compositional requirements or other limits imposed on the board of trustees? How should such a board of trustees be appointed? Would the alternative of a board of trustees to nominate directors provide greater assurance that independent directors are truly independent not only at the time of their nomination but during their service on the Board as well?

The Commission requests comment on the proposed compositional requirements of committees of the Board under the Governance Focus Alternative. Is the requirement that Board committees that are delegated authority by the Board be composed of a majority of independent directors appropriate? Should there be special requirements relating to the risk committee, or its equivalent, of the Board? The Commission requests comment on the possible alternatives for risk committee governance as discussed in Section IV.A.7. Would the possible alternatives for the risk committee be more or less desirable with respect to the Governance Focus Alternative? Under the Governance Focus Alternative, should the percentage of directors on the risk committee be higher or lower than what is proposed? The Commission also requests comment on whether there are other ways to structure governance arrangements for security-based swap clearing agencies to mitigate potential conflicts of interest.

The Commission requests comment on the composition of the disciplinary panel of the security-based swap clearing agency. Would the proposed rule be sufficient to address potential conflicts of interest that may interfere with the fair and effective disciplinary processes of a security-based swap clearing agency? Should different restrictions be imposed?

C. Existing Standards for Registered Clearing Agencies

In addition to any new rules adopted by the Commission with respect to conflicts of interest at security-based swap clearing agencies, the standards in the Exchange Act that apply to all securities clearing agencies registered with the Commission will apply to security-based swap clearing agencies. The Dodd-Frank Act requires security-based swap clearing agencies to be registered as clearing agencies with the Commission under Section 17A of the Exchange Act.[133] Thus, security-based swap clearing agencies will be required to comply with the standards in Section 17A of the Exchange Act. Some of these standards may be used to address concerns related to conflicts of interest, regardless of whether a security-based swap clearing agency elects the Voting Interest Focus Alternative or the Governance Focus Alternative. As a result, the standards in Section 17A would be used in addition to specific conflict of interest rules adopted under Section 765 of the Dodd-Frank Act.[134]

The Section 17A standards may be used to mitigate conflicts of interest or the effects of conflicts of interest in a

[133] Depository institutions or derivatives clearing organizations that have previously cleared swaps pursuant to an exemption from registration as a clearing agency will be deemed to be registered with the Commission under Section 17A of the Exchange Act. *See* Public Law 111–203, Section 763(*l*).

[134] *See* Section 17A(b)(3) of the Exchange Act, which sets forth the standards for registered clearing agencies. 15 U.S.C. 78q–1(b)(3). *See also* Securities Exchange Act Release No. 16900 ("Standards Release") (June 17, 1980), 20 FR 416 (July 1, 1980). The Standards Release provides guidance on the standards to be used by the Commission's Division of Trading and Markets in connection with the registration of clearing agencies. The standards also serve as staff guidelines to assist clearing agencies in modifying their organizations, capacities, and rules to comply with the clearing agency registration provisions of the Exchange Act.

The Commission is also considering matters related to conflicts of interests as part of broader standards that would be applicable to clearing agencies in association with requirements under Sections 763(b) and 805(a) of the Dodd-Frank Act.

number of ways. As part of the initial registration process, the Commission approves the organizational structure of a clearing agency.[135] The Commission also reviews and approves significant changes to a clearing agency's governance structure after it is registered.[136] In addition, a clearing agency must admit persons such as banks and broker-dealers, and other entities that the Commission may designate by rule, as participants,[137] subject to the participation standards of the clearing agency.[138]

Clearing agencies also may not permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency.[139] These standards in Section 17A help to mitigate concerns related to conflicts of interest by promoting access to and use of a clearing agency by all qualified persons on an equivalent basis.[140] The Section 17A standards also help to prevent a participant from using its influence to amend the rules of the clearing agency in a manner that favors its own institution to the disadvantage of other participants because the rules of a clearing agency may not be applied on a discriminatory basis.[141]

Finally, the Section 17A standards help to mitigate conflict of interest concerns by providing that the rules of a registered clearing agency may not impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. This helps assure that the clearing agency operates in a manner that is consistent with the public interest and is not used by participants or other interested parties to gain an unfair competitive advantage.[142] The Commission staff has previously interpreted these standards as requiring that a clearing agency must justify any anticompetitive effect of membership criteria and that it will evaluate an anticompetitive effect in light of the following factors: (1) The essential nature of the service; (2) the number and type of potential participants denied access to clearance and settlement services; (3) the number of entities providing comparable clearance and settlement services; and (4) the availability of correspondent clearing arrangements to provide indirect access to a clearing agency's services.[143] The Commission believes these factors should also be used to evaluate the anticompetitive effect of the membership standards of security-based swap clearing agencies once they are registered clearing agencies under Section 17A of the Exchange Act.

The Commission requests comment on the application of the standards under Section 17A to security-based swap clearing agencies in conjunction with the proposed rules to address conflicts of interest. Will the proposed rules effectively build on the Section 17A standards? Should the Commission take a more targeted approach by focusing new requirements under Section 765 of the Dodd-Frank Act on Section 17A standards alone, such as by having requirements addressing only membership standards and determinations whether to clear products? Would such an approach sufficiently address conflicts of interests? If not, are the proposed rules sufficient to address potential gaps in the way Section 17A alone would address conflicts of interest with respect to security-based swap clearing agencies? Should additional rules be proposed under Section 17A to further address conflict of interest concerns? Should the Commission extend the application of the proposed rules for security-based swap clearing agencies to all registered clearing agencies? To what extent would competitive pressures in the security-based swaps market, particularly as it continues to develop, help to mitigate conflicts of interest? Would the standards under Section 17A help to promote competition in a way that would help to mitigate conflicts of interest? To what extent does the Commission's oversight of clearing agencies pursuant to the standards under Section 17A alleviate the need for ownership limitations and governance requirements?

V. Discussion of Proposed Rule 702 Under Regulation MC for Security-Based Swap Execution Facilities and National Securities Exchanges That Post or Make Available for Trading Security-Based Swaps

A. Ownership and Voting Limitations

Section 765 requires the Commission to adopt rules to mitigate conflicts of interest, which may include numerical limits on control of, or the voting rights with respect to, any clearing agency that clears security-based swaps, or on the control of any SB SEFs or SBS exchanges. Pursuant to this directive, the Commission is proposing ownership and voting limits for a SB SEF that would apply to any SB SEF participant and for a SBS exchange or facility of a national securities exchange that posts or makes available for trading security-based swaps ("SBS exchange facility") that would apply to any SBS exchange member. Specifically, the Commission proposes that a SB SEF, SBS exchange, or SBS exchange facility shall not permit any SB SEF participant or SBS exchange member, as applicable, either alone or together with its related persons, to: (1) Beneficially own, directly or indirectly, any interest in the SB SEF, SBS exchange, or SBS exchange facility, as applicable, that exceeds 20% of any class of securities, or other

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[135] Section 17A(b)(3)(A) provides in full a clearing agency shall not be registered unless the Commission determines that the "clearing agency is so organized and has the capacity to facilitate the prompt and accurate clearance and settlement of securities transactions and derivative agreements, contracts, and transactions for which it is responsible, to safeguard securities and funds in its custody or control or for which it is responsible, to comply with the provisions of [the Exchange Act] and the rules and regulations thereunder, to enforce (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of [the Exchange Act]) compliance by its participants with the rules of the clearing agency, and to carry out the purposes of [Section 17A of the Exchange Act]." 15 U.S.C. 78q–1(a)(3)(C).

[136] *See* Securities Exchange Act Release Nos. 612194 (December 22, 2009), 74 FR 68883 (December 22, 2009) (File No. SR–FICC–2009–10); 61215 (December 22, 2009), 74 FR 68888 (December 29, 2009) (File No. SR–NSCC–2009–10); and 61216 (December 22, 2009), 74 FR 68877 (December 29, 2009) (File No. SR–DTC–2009–16), notice and order granting accelerated approval of proposed rule changes filed by the clearing agency subsidiaries of the Depository Trust and Clearing Corporation (DTC, NSCC, and FICC) to permit DTCC to nominate non-participant candidates for election to its Board.

[137] 15 U.S.C. 78q–1(b)(3)(B).

[138] *Id. See also* Section 17A(b)(4)(B), which provides that a registered clearing agency may deny participation to, or condition the participation of, any person if such person does not meet such standards of financial responsibility, operational capability, experience, and competence as are prescribed by the rules of the clearing agency. A registered clearing agency may examine and verify the qualifications of an applicant to be a participant in accordance with procedures established by the rules of the clearing agency. 15 U.S.C. 78q–1(b)(4)(B).

[139] 15 U.S.C. 78q–1(b)(3)(F).

[140] *See* Standards Release, *supra* note 134, at 419. All participants utilizing similar clearing agency services, with the exception of participants that are registered clearing agencies for which specialized requirements apply, should be required to comply fully with the clearing agency's internal financial and operational rules such as clearing fund deposits, mark-to-market payments, and margin deposits related to the services used.

[141] *Id* at 418. The provisions in Section 17A recognize that a clearing agency may discriminate among persons in the admission to, or the use of, the clearing agency, by requiring that participants meet certain financial, operational, and other fitness standards. However, Section 17A also requires that sanctioned discriminations must not be unfair. In addition, the Commission must find that clearing agency rules embodying any discriminations are in the public interest and are consistent with the requirements of the Exchange Act.

[142] The standard does not prohibit all burdens on competition. However, if a proposed rule of a clearing agency would impose a burden on competition, the burden must be weighed against the benefits of the rule in achieving the purposes of the Exchange Act. For example, a clearing agency may impose participation standards that have an anticompetitive effect as long as any such anticompetitive effect is justified.

[143] *See* Standards Release, *supra* note 134, at 419.

ownership interest, entitled to vote of such SB SEF, SBS exchange, or SBS exchange facility; or (2) directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the SB SEF, SBS exchange, or SBS exchange facility, as applicable, that exceeds 20% of the voting power of any class of securities or other ownership interest of such SB SEF, SBS exchange, or SBS exchange facility.[144]

The Commission is concerned that if a SB SEF participant or SBS exchange member, either alone or together with its related persons, were to own a significant stake in the SB SEF, SBS exchange, or SBS exchange facility, respectively, the SB SEF participant or SBS exchange member could use its significant ownership interest to influence the operations of the SB SEF, SBS exchange, or SBS exchange facility to unduly derive benefits at the expense of other owners and market participants. The Commission is particularly concerned that a SB SEF participant or SBS exchange member may have financial incentives to limit the level of access to, and the scope of products traded on, these trading venues as a means to impede competition from other market participants. For example, the Commission understands that many of the electronic multi-dealer trading platforms that exist today for OTC derivatives or fixed income products limit the number of dealers from which a customer can request a quote. The Commission believes that a fewer number of dealers participating on a platform or exchange could result in less competition on pricing. The Commission believes that imposing ownership and voting limits, as described above, could mitigate potential conflicts of interest with respect to the level of access to the market and determinations as to which products are traded by limiting the ability of a small group of persons (such as dealers) to control the Board[145] and thus the governance of the SB SEF, SBS exchange, or SBS exchange facility.[146]

Unlike the Voting Interest Focus Alternative or the Governance Focus Alternative for security-based swap clearing agencies, the Commission is not proposing an aggregate 40% voting interest limit collectively on all SB SEF participants (with respect to SB SEFs) and SBS exchange members (with respect to SBS exchanges) or a 5% individual voting interest limit, respectively. The Commission recognizes that, as with security-based swap clearing agencies, the proposed rule would limit, but not eliminate, the ability of a small group of SB SEF participants or SBS exchange members, as applicable, to own a SB SEF, SBS exchange, or SBS exchange facility. Specifically, as few as five entities could own SB SEFs, SBS exchanges, and SBS exchange facilities under this proposal. However, the Commission's concerns with respect to concentration of ownership in security-based swap clearing agencies and SB SEFs, SBS exchanges, and SBS exchange facilities are informed by the differences in the structure for clearing and trading of security-based swaps. The Commission's experience has been that the central clearing model in the securities markets historically has tended toward convergence to a single clearing agency for each type of cleared product, while the market structure for securities trading historically has not necessarily tended toward a similar model.[147] The Commission also notes that security-based swap clearing agencies perform a critical function in mitigating financial risk for security-based swaps market participants. Although SB SEFs, SBS exchanges, and SBS exchange facilities are critical to promoting price transparency and therefore market efficiency, the Commission does not believe that the operation of SB SEFs, SBS exchanges, and SBS exchange facilities would pose the same level of systemic risk as security-based swap clearing agencies. There generally will be a lower barrier to entry with respect to trading platforms because participants of a SB SEF or members of an SBS exchange would not incur the margin, guaranty fund, or other obligations that members of a clearing agency would incur, and thus multiple venues for the trading of security-based swaps are more likely to emerge. Thus, the Commission is not proposing identical ownership requirements for security-based swap clearing agencies and SB SEFs, SBS exchanges, and SBS exchange facilities.

For purposes of calculating a SB SEF participant's or SBS exchange member's ownership and voting interests, the proposed rule would aggregate such person's ownership and voting interests with those of its related persons. When used with respect to a SB SEF, proposed Rule 700(u) under Regulation MC would define the term "related person" to mean: (1) Any affiliate of a security-based swap execution facility participant; (2) any person associated with a security-based swap execution facility participant; (3) any immediate family member of a security-based swap execution facility participant or any immediate family member of the spouse of such person, who, in each case, has the same home as the security-based swap execution facility participant or who is a director or officer of the security-based swap execution facility or any of its parents or subsidiaries; or (4) any immediate family member of a person associated with a security-based swap execution facility participant or any immediate family member of the spouse of such person, who, in each case, has the same home as the person associated with the security-based swap execution facility participant or who is a director or officer of the security-based swap execution facility or any of its parents or subsidiaries.

Further, when used with respect to a SBS exchange or SBS exchange facility, proposed Rule 700(u) under Regulation MC would define the term "related person" to mean: (1) Any affiliate of a member of the national securities exchange that posts or makes available for trading security-based swaps; (2) any person associated with a member of the national securities exchange that posts or makes available for trading security-based swaps; (3) any immediate family member of a member of the national securities exchange that posts or makes available for trading security-based swaps or any immediate family member of the spouse of such person, who, in each case, has the same home as the member of the national securities exchange that posts or makes available for trading security-based swaps or who is a director or officer of the national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or any of its parents or subsidiaries; or (4) any immediate family member of a person associated with a member of the national securities exchange that posts or makes available for trading security-based swaps or any immediate family member of the spouse of such person, who, in each case, has the same home as the person associated with the

[144] *See* proposed Rule 702(b) under Regulation MC.

[145] *See supra* note 98 for the proposed definition of "Board."

[146] The Commission also believes that such limits would further the ability of the SB SEF and SBS exchange to effectively carry out its obligations. Section 763(c) of the Dodd-Frank Act and Section 6 of the Exchange Act, respectively, and, in particular, provide market participants with impartial access to SB SEFs. *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c), and 15 U.S.C. 78f.

[147] The Commission has not made any determinations about whether security-based swap clearing agencies will also tend to converge to a single clearing agency or even a small number of clearing agencies, as the central clearing of security-based swaps is still a developing area.

national securities exchange that posts or makes available for trading security-based swaps or who is a director or officer of the national securities exchange or facility thereof that posts or makes available for trading security-based swaps or any of its parents or subsidiaries. To further the purpose of the proposed limits, the Commission preliminarily believes that it would be important to aggregate the SB SEF participant's or SBS exchange member's ownership and voting interests with the interest of any person with whom such person may be able to act together to influence or control the SB SEF, SBS exchange, or SBS exchange facility.

The proposed rule would restrict indirect as well as direct ownership and voting of a SB SEF, SBS exchange, or SBS exchange facility. Because the proposed rule could be easily circumvented if the Commission were to limit solely direct ownership and voting, the Commission preliminarily believes it would be important to further the purpose of imposing ownership and voting limits to also restrict the indirect ownership and voting interests of SB SEF participants and SBS exchange members. For example, if the Commission simply proposed to prohibit a SB SEF participant from directly owning or voting shares, the participant could hold its ownership interests in the SB SEF through a holding company, thus easily circumventing the intent of the proposed rule. Accordingly, the ownership and voting limits would apply to ownership and voting of interests in a parent company of the SB SEF, SBS exchange, or SBS exchange facility. For example, if the SB SEF were wholly-owned by a holding company, a SB SEF participant would be prohibited from owning or voting more than 20% of the voting interest in the parent company. Finally, the proposed limits also would apply to a SB SEF participant or SBS exchange member that beneficially owns more than 25% of an entity that itself owns more than 20% of a SB SEF, SBS exchange, or SBS exchange facility.[148]

To assure that SB SEFs, SBS exchanges, and SBS exchange facilities maintain an ownership structure consistent with the proposed ownership and voting limits, the Commission proposes that these entities have rules that (1) provide an effective mechanism to divest a SB SEF participant's or SBS exchange member's ownership that, alone or together with its related persons, exceeds 20% and (2) are reasonably designed not to give effect to a SB SEF participant's or SBS exchange member's voting interest that, alone or together with its related persons, exceeds 20%.[149] The Commission believes that in order for the ownership and voting limits to be effective, each SB SEF, SBS exchange, and SBS exchange facility must take measures to reduce a SB SEF participant's or member's ownership interest or not give effect to any voting interest that exceeds the proposed limits. The Commission intends to provide SB SEFs, SBS exchanges, and SBS exchange facilities flexibility in determining how to implement these requirements. Any rules adopted by these trading venues, however, must assure that they have a viable, enforceable mechanism to divest a SB SEF participant or SBS exchange member of any interest held in excess of the 20% limit and to not give effect to the portion of voting interest held in excess of the 20% limit. The Commission also proposes to require each SB SEF, SBS exchange, or SBS exchange facility to have rules to provide a mechanism to obtain information relating to its ownership and voting interests.[150] The Commission believes that a requirement to collect information regarding ownership and voting interests of SB SEF participants and SBS exchange members is essential for registered trading venues to monitor and comply with the proposed ownership and voting limits.[151]

The Commission believes that an ownership and voting limit of 20% is an appropriate threshold. On the one hand, the restriction would limit the ability of a SB SEF participant or SBS exchange member to exert undue influence over the governance of a SB SEF, SBS exchange, or SBS exchange facility, respectively. On the other hand, such an ownership and voting limit should not overly interfere in such an entity's organizational structure or the ability of a SB SEF participant or SBS exchange member to acquire a substantial equity interest in a SB SEF, SBS exchange, or SBS exchange facility, as applicable.[152] Thus, the proposed ownership and voting limits should strike an appropriate balance between the objectives of mitigating conflicts of interest and refraining from unnecessarily hindering the ability of entities to form new trading venues. In addition, there may be incentives to create a new SBS exchange or SB SEF because a SBS exchange or SB SEF may draw significant new business by making available to trade a security-based swap that is required to be cleared under Section 763(a).[153] Furthermore, the risk management and economies of scale issues that may create a barrier to entry with respect to new security-based swap clearing agencies generally would not affect the creation of SBS exchanges or SB SEFs.

While the Commission believes that the proposed 20% ownership and voting limits are appropriate, it also understands that the movement of trading of security-based swaps onto SB SEFs, SBS exchanges, or SBS exchange facilities will foster enhanced transparency and market efficiency. The Commission does not intend to unnecessarily impede the emergence of what could be vital sources of, among other things, liquidity and pricing transparency for security-based swaps. However, imposing on SB SEFs and SBS exchanges ownership and voting limits similar to those that shareholder-owned cash equities and options exchanges have in place could have the unintended consequence of deterring new, competitive trading venues at a time when organized markets for security-based swaps are just beginning to develop. A trading platform that currently trades security-based swaps in the OTC market but would not meet the proposed ownership and voting limits would need to revise its ownership structure if it chooses to become a SB SEF. There could be costs and delays as the potential SB SEF seeks to find one or more additional owners to satisfy the proposed limits, with a possible diminution in the value of the original owner(s)' investment. Moreover, it is possible that imposing these limits may affect the security-based swaps market differently than the cash equities and listed options markets. Ownership and

[148] *See supra* note 93 for the proposed definition of "control."

[149] *See* proposed Rules 702(c)(1) and (2) under Regulation MC.

[150] *See* proposed Rule 702(c)(3) under Regulation MC.

[151] *See supra* Section IV.A.4.

[152] National securities exchanges that may trade security-based swaps currently prohibit a member from owning or voting more than 20% of the exchange, although an exchange's method of calculating the 20% interest, aggregated with any person with whom such person may be able to act together to influence or control an exchange, may vary from the Commission's proposal. *See, e.g.,* Amended and Restated Certificate of Incorporation of BATS Global Markets, Inc., Article FIFTH; Amended and Restated Certificate of Incorporation of NYSE Euronext, Article V.

[153] The counterparties to a transaction in a security-based swap that is required to be cleared under Section 763(a)(2) of the Dodd-Frank Act will be required to execute the transaction on a SBS exchange or on a SB SEF. There is an exception from the execution requirement if no SBS exchange or SB SEF makes the security-based swap available to trade. *See* Public Law 111–203, Section 763(h). The exception from trade execution is also available if the exception from mandatory clearing under Section 763(g) applies. *See* Public Law 111–203, Section 763(g).

voting limits were implemented at national securities exchanges at a time when the trading of exchange-listed securities was fairly well established and competitive. Consequently, a 20% ownership and voting limit may not negatively affect the ability of cash equity and options exchanges to promote competing trading venues but, if applied to the security based-swaps market that is in its infancy, could retard market development.

The Commission is sensitive to arguments against imposing ownership and voting limits for SB SEFs, SBS exchanges, and SBS exchange facilities, some of which were articulated at the Conflicts Roundtable. However, it also understands that the OTC derivatives market is highly concentrated and dealer dominated. Although ownership and voting limits arguably may have a less negative effect on new entrants to the cash equities and options markets and their ability to compete, there may also be less need for such limitations in those markets. In contrast, although ownership and voting limits may more directly affect the ability of SB SEFs and SBS exchanges to start up, the lack of market characteristics to promote competing trading venues for security-based swaps may emphasize the greater need for ownership and voting limits. If the market characteristics for security-based swaps naturally promote dealer domination without robust competing trading venues, there is more need to mitigate the types of concerns that underlie Section 765, such as by imposing ownership and voting limits.[154]

The Commission must weigh the potential implications of imposing ownership and voting limits against imposing other requirements that would allow a dealer-dominated security-based swaps market to continue. As part of the balance between mitigating conflicts of interest without unduly restricting the ability of a competitive market for trading of security-based swaps to emerge, the Commission proposes to limit ownership in SB SEFs, SBS exchanges, and SBS exchange facilities specifically to those interests entitled to vote.[155] Consequently, a SB SEF participant or SBS exchange member would not be prohibited from owning any percentage of a nonvoting interest in a SB SEF, SBS exchange, or SBS exchange facility. In contrast, national securities exchanges generally limit their members from owning more than 20% of any interest, voting or otherwise. However, as discussed above, trading venues for exchange-listed securities are well established and highly competitive. In this regard, the Commission does not believe that it is necessary to propose the same ownership limits as those currently in place at national securities exchanges. Further, the proposed 20% limit on ownership and voting would still allow as few as five entities to own a SB SEF, SBS exchange, or SBS exchange facility. Thus, the proposed limit by itself would not completely prohibit a small number of entities from potentially exerting undue influence over SB SEFs, SBS exchanges, or SBS exchange facilities in a way that could benefit the few to the detriment of others.

The Commission requests comment on all aspects of the proposed ownership and voting limits, including whether it is necessary and appropriate to have ownership and voting limits at all. If commenters believe that it is necessary and appropriate to impose ownership and voting limits to mitigate conflicts of interest, the Commission requests comment on whether the proposed limits are appropriate, or whether they would unduly hinder the development of SB SEFs without serving to mitigate any conflicts.[156] Should the Commission require a voting limit, but not an ownership limit or a different limit for ownership versus voting? Even with the prohibition against owning more than 20% of any interest entitled to vote, a SB SEF participant or SBS exchange member could have sufficient ownership of nonvoting interest, either alone or in addition to voting interest, to exert influence on these trading venues. Should the Commission require the ownership limit to apply to *any* class of equity securities or other ownership interest rather than any class of securities, or ownership interest, entitled to vote?[157] Would the proposed limits impede the number or types of SB SEFs from being established? Should the proposed ownership and voting limits be phased in for SB SEFs to provide a grace period for those entities that would not meet the requirements under Regulation MC?

The Commission also seeks comment on whether the proposed ownership and voting limits would continue to be important as the market for security-based swaps evolves. If multiple SB SEFs emerge as this market develops, would competitive pressures alleviate any of the conflicts of interest that are the basis for the Commission's proposals? In that case, would it be appropriate for the Commission to impose different limits? Should the Commission reduce the restrictions over time, if conflict of interest concerns are lessened as the security-based swaps market develops? For example, if participation in the trading of security-based swaps becomes more open and includes a broader range of participants, and multiple SB SEFs or SBS exchanges evolve to trade the same security-based swaps, would there still be a need to retain ownership and voting limits or are there factors that would allow such limits to be revised? What factors should the Commission consider in assessing whether any ownership and voting limits it may impose on SB SEFs should be revisited?

As mentioned above, each national securities exchange currently prohibits

[154] In the equities market a small group of broker-dealers or single-dealer proprietary firms can and do own alternative trading systems ("ATSs") and thus it can be argued that SB SEFs and SBS exchanges should be permitted to operate similarly. *See* Securities Exchange Act Release No. 60997 (November 13, 2009), 74 FR 61208 (November 23, 2009) (as of November 2009, there were approximately 73 ATSs that are subject to Regulation ATS). However, ATSs exist in the context of a marketplace with robust competition among numerous trading venues. Therefore, ATSs that are owned by one broker-dealer or a small group of broker-dealers, by virtue of their ownership structure alone, generally do not present a concern that they could lessen price competition or market efficiency.

[155] *See supra* note 64.

[156] In the SRO Governance Proposing Release, the Commission proposed a similar 20% ownership and voting limit for members of a national securities exchange. A number of commenters favored this proposal, including several commenters that were national securities exchanges or a facility of a registered securities association. *See, e.g.,* letter from Michael J. Simon, Secretary, ISE, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 ("ISE Comment Letter") ("[The ownership limitation] provides SROs with flexibility, yet recognizes the unique conflicts that could arise if a member were to own a controlling interest in an SRO with regulatory responsibility for the member."); letter from Meyer S. Frucher, Chairman and Chief Executive Officer, Phlx, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 ("Phlx Comment Letter") ("The Exchange unequivocally agrees with the Commission that a significant shareholder could use its voting power to influence the operations of an exchange in a way that adversely affects the mission, integrity or regulatory capacity of the exchange, or otherwise is detrimental to the public interest."); letter from Philip D. DeFeo, Chairman and Chief Executive Officer, Pacific Exchange, Inc. ("PSX"), to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 ("PSX Comment Letter"); letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq Stock Market, Inc., to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 ("Nasdaq Comment Letter"). The Commission notes, however, that the SRO Governance Proposing Release related to national securities exchanges that trade equity securities and listed options and registered securities associations, and the comments received did not address potential conflicts in other contexts.

[157] The CFTC has proposed similar ownership and voting limits for DCMs and registered SEFs, and applies the ownership limit only to any class of equity securities entitled to vote. *See http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister_governance.pdf.*

its members from owning an interest, voting or otherwise, or voting more than 20% (or less) of the exchange or a facility of the exchange.[158] Therefore, the Commission preliminarily does not believe that the proposed rules would have a material effect on an exchange's ability to post or make available for trading security-based swaps. Nevertheless, the Commission requests comment on whether the proposed limits in this rulemaking could affect a national securities exchange's ability or decision to post or make available for trading security-based swaps. Also, given that national securities exchanges currently have limits on ownership and voting by members, would codifying the proposed limits help to further mitigate the types of conflicts of interest that underlie the Dodd-Frank Act for SBS exchanges? Would there be any effect on the willingness of entities to register to become a national securities exchange and trade security-based swaps? What would be the implication, if any, on an exchange that chose to trade security-based swaps through a facility that is a separate legal entity? More generally, for SB SEFs and SBS exchanges or SBS exchange facilities, should ownership and voting be limited to the same threshold or should they be different? If the Commission should take a different approach for ownership and voting, what should that approach be?

As described above, Section 765 enumerates Specified Entities that the Commission should consider in its rulemaking. The Commission understands that, depending on who may be permitted to directly effect transactions on a SB SEF (or is a SBS exchange member), limits on ownership and voting that apply only to SB SEF participants or SBS exchange members could be either over-inclusive or under-inclusive or both, with respect to the Specified Entities. For example, restricting control of a SB SEF based on an entity's direct participation on the SB SEF could capture a person who is not one of the Specified Entities or, conversely, fail to take into consideration a Specified Entity. Accordingly, the Commission requests comment on whether the scope of the proposed ownership and voting limits is appropriate. Should the limits on ownership and voting extend to all or some of the Specified Entities, regardless of their direct participation on the SB SEF or SBS exchange? If so, why? What are the potential conflicts concerns that such Specified Entities may pose? How are conflicts concerns posed by such Specified Entities different from those posed by SB SEF participants or SBS exchange members who are not also Specified Entities? In this regard, the Commission notes that the definition of "related person" would encompass any such entity that is affiliated with such a SB SEF participant or SBS exchange member, although it may not itself be a SB SEF participant or SBS exchange member.

In addition, national securities exchanges generally limit ownership and voting by non-members, as well as members.[159] Specifically, exchanges generally limit each non-member to no more than 40% ownership of the exchange. The limit on ownership by non-members of an exchange is designed in part to provide the Commission and the exchange with the proper tools (such as access to books and records) necessary to carry out the Commission's and the exchange's respective regulatory oversight responsibilities, as well as to mitigate more general conflict concerns between owners' commercial interests and the exchange's regulatory obligations. The Commission requests comment on whether it should impose, as part of this rulemaking, similar limits on ownership and voting. Such an ownership limit would apply to the Specified Entities, to the extent they are not subject to the proposed ownership limit described above. In addition to the requirements of Section 765, the Dodd-Frank Act more generally requires a SB SEF to establish and enforce rules to minimize conflicts of interest in its decision-making process and establish a process for resolving the conflicts of interest. What are the types of conflicts that a person who is not a SB SEF participant or SBS exchange member may pose?

The Commission also requests comment on whether its formulation for calculating the 20% threshold is appropriate. Specifically, the Commission requests comment on all prongs of the definition of "related person," including whether the definition is over-inclusive or under-inclusive. What other method could the Commission use to reach the interest of any person with whom a SB SEF participant or SBS exchange member may be able to act together to influence or control a SB SEF or SBS exchange? Finally, the Commission expects a SB SEF, SBS exchange, and SBS exchange facility to have in place an effective mechanism for enforcing the ownership and voting limits. The Commission requests comment on whether the proposed rules related to divesture of ownership and voting limits are appropriate. Should the Commission explicitly require in the proposed rules specific ways to divest ownership and voting interest of SB SEF participants and SBS exchange members who violate the ownership and voting limits? Is the proposed rule pertaining to obtaining information on ownership and voting interest of SB SEFs, SBS exchanges, and SBS exchange facilities appropriate? Should the Commission require that trading venues collect information pertaining to certain ownership or voting thresholds?

B. Governance Requirements

The Commission is proposing substantive requirements with respect to the governance of SB SEFs, SBS exchanges, and SBS exchange facilities that are designed to address the conflict of interest concerns identified above, including the concern that dealer-owners could unduly influence the governance and operation of a SB SEF or SBS exchange. These governance provisions, as discussed below, should help mitigate conflicts of interest as directed by Section 765 of the Dodd-Frank Act.

1. Board

The Commission proposes that the Board of a SB SEF, SBS exchange, or SBS exchange facility be composed of a majority of independent directors.[160] The presence of a majority of independent directors on the Board should reduce the ability of owner-directors of a SB SEF, SBS exchange, or SBS exchange facility to improperly influence the operation of such entity to their own advantage and to the detriment of other users or potential users of the facility or exchange. A majority independent director requirement should help foster a greater degree of independent decision-making consistent with the objectives of the Dodd-Frank Act and the Exchange Act and should reduce the ability of owners that are participants or members to control key decisions regarding the operation of the SB SEF or SBS exchange and thereby potentially limit

[158] A member has in the past been permitted on a pilot basis to own more than 20% of a facility of an exchange subject to certain terms and conditions. *See* Securities Exchange Act Release Nos. 59281 (January 22, 2009), 74 FR 5014 (January 28, 2009) (order approving on a pilot basis 50% ownership of the New York Block Exchange, a trading facility of NYSE, by BIDS ATS, a member of NYSE). This pilot has since been extended for an additional year and will expire on January 22, 2011 unless further extended or permanently approved. *See* Securities Exchange Act Release No. 61409 (January 22, 2010), 75 FR 4889 (January 29, 2010).

[159] *See supra* Section III.B.

[160] *See* proposed Rule 702(d)(1) under Regulation MC. *See also supra* note 102 and accompanying text for the proposed definition "independent director."

access to, or limit the products made available for trading on, the SB SEF or SBS exchange, which could adversely affect the trading of security-based swaps in regulated markets. Further, the definition of independent director is designed to assure that the independent director would not have a direct economic stake in the SB SEF or SBS exchange, or other relationship that would call into question the impartiality of the director, and thus would not be subject to the conflicts of interest identified above.

SB SEFs and SBS exchanges are intended to serve important roles in providing centralized, transparent trading of security-based swaps and, under Section 763(c) of the Dodd-Frank Act or existing Section 6 of the Exchange Act, as applicable, will have a number of responsibilities.[161] Requiring a majority independent Board should help assure that SB SEFs and SBS exchanges would operate in an impartial manner with respect to these (and other) mandated duties. Moreover, requiring a majority independent Board for SB SEFs and SBS exchanges would be commensurate with the manner in which national securities exchanges generally are governed today [162] and comports with the listing rules of exchanges, which are approved by the Commission.[163]

One of the alternatives the Commission proposes for security-based swap clearing agencies is to require the Board of any security-based swap clearing agency be composed of 35% independent directors. The Commission proposes this 35% independence alternative to address potential concerns that requiring a majority independent Board for security-based swap clearing agencies would affect the Board's ability to effectively perform risk management functions. Security-based swap clearing agencies perform a critical function in mitigating financial risk for security-based swaps market participants. Although critical to promoting price transparency and therefore market efficiency, as noted above, the Commission does not believe that the operation of SB SEFs, SBS exchanges, and SBS exchange facilities would pose the same level of systemic risk as security-based swap clearing agencies because they do not assume the risk of managing open positions or of guaranteeing the settlement of transactions. Thus, the Commission is not making the same proposal with respect to SB SEFs, SBS exchanges, and SBS exchange facilities.

Although a majority independent Board may address conflicts of interest concerns that underlie Section 765 of the Dodd-Frank Act, it may not effectively eliminate all conflicts. The presence of independent directors may be an effective mechanism to address certain types of conflicts in certain types of institutions but not necessarily in all instances nor for all institutions. The Commission, however, does not believe that the characteristics of SB SEFs and SBS exchanges, and the types of conflicts that may be inherent with respect to such entities, pose a set of circumstances that are incompatible with an effective governance via a majority independent Board.

Taking into account these and other concerns, the Commission has considered a less prescriptive governance rule to address conflicts of interest for venues that trade security-based swaps. However, especially because SB SEFs are not SROs and thus their rules are not subject to Commission approval pursuant to Section 19 of the Exchange Act,[164] a principles-based approach to governance may not give the Commission sufficient ability to address potential conflicts in the operation of SB SEFs. Although the Commission, through its authority to approve applications to register as a SB SEF, may be able to ascertain that a SB SEF at the time of its registration has a governance structure that sufficiently would mitigate conflicts of interest, a less prescriptive approach could make it more difficult for the Commission to assure that the SB SEF's governance structure continues to meet the proposed requirements over time.

The Commission welcomes commenters' insights to inform its understanding of the governance of trading venues for security-based swaps. As discussed above, a majority independent Board may not effectively address all conflicts. The Commission therefore seeks comment on all aspects of its proposal for a majority independent Board. Should the Commission adopt a less prescriptive approach to mitigating conflicts of interest in the governance of SB SEFs and SBS exchanges? Are there other approaches that would improve governance and mitigate conflicts of interest? For example, would State laws governing the fiduciary duty owed by corporate board members help to mitigate conflicts of interest or, as noted above, would such laws potentially aggravate the types of conflicts of interest that the Commission is trying to address? Should the Commission consider any additional requirements related to fiduciary duties to either enhance mitigation of conflicts or address deficiencies?

Further, the Commission requests comment on whether requiring the Board of a SB SEF, SBS exchange, or SBS exchange facility to be composed of a majority of independent directors would improve the governance of the SB SEF, SBS exchange, or SBS exchange facility, as applicable, and mitigate conflicts of interest that could arise. The Commission specifically requests comment on whether there are other Board structures that could help mitigate conflicts of interest. If having a majority independent Board is not necessary to mitigate conflicts, but some lesser percentage of independent directors would help address such concerns, what percentage of Board members should be required to be independent? What are the benefits and costs of requiring Boards of SB SEFs, SBS exchanges, and SBS exchange facilities to be composed of a majority of independent directors? Would a majority independent Board help to mitigate conflicts of interest if the ownership of a SB SEF, SBS exchange, or SBS exchange facility is concentrated in a small group of owners (*e.g.,* five owners) rather than a larger group (*e.g.,* greater than ten owners)? Would a majority independent Board help to mitigate conflicts of interest that could arise between the commercial interests of a SB SEF, SBS exchange, or SBS exchange facility or the owners of the SB SEF, SBS exchange or SBS exchange

[161] For SB SEFs, these responsibilities include establishing and enforcing rules with respect to the terms and conditions of the security-based swaps traded or processed on or through the facility and any limitation on access to the facility; trading procedures to be used in entering and executing orders traded on SB SEFs; and monitoring trading in SB SEFs to prevent manipulation, price distortion, and disruptions of the settlement process through surveillance, compliance and disciplinary practices and procedures. *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c).

[162] *See supra* Section III.B. Currently, the governance structure of a facility of an exchange that is a separate legal entity from the exchange and that is not a wholly-owned subsidiary of the exchange is not subject to any specific board or committee compositional requirements. Given the nature of the conflict concerns for the trading of security-based swaps and the structure of the security-based swaps market—namely, the dominance by a small group of dealers and the concern with respect to undue influence in the operation of the SB SEF or SBS exchange—the Commission believes that it is necessary and appropriate to impose the same board and committee compositional requirements on a facility of an exchange if that facility posts or makes available for trading security-based swaps.

[163] *See* Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003) (order approving File Nos. SR–NYSE–2002–33, SR–NASD–2002–77, SR–NASD–2002–80, SR–NASD–2002–138, SR–NASD–2002–139, and SR–NASD–2002–141).

[164] 15 U.S.C. 78s.

facility and the regulatory responsibilities of the SB SEF or SBS exchange? Are there experience or efficiency issues if a majority of the Board must be composed of independent directors? Are there remedies for overcoming any such experience or efficiency issues? [165]

The Commission also notes that currently, for national securities exchanges, at a minimum, the number of non-industry directors should equal or exceed the number of industry directors.[166] The Commission requests comment on whether requiring a majority independent Board could further mitigate conflicts for SBS exchanges or whether the current standards exchanges have in place would sufficiently address the conflict concerns with respect to exchanges that would post or make available for trading security-based swaps. Further, the Commission requests comment as to whether the requirement for Board composition should be different for SB SEFs and SBS exchanges and, if so, why and how?

The Commission also requests comment on the proposed definitions of "independent director" and "material relationship." [167] Are the definitions of "independent director" and "material relationship" appropriate? If not, how should they be defined? The proposed rule provides circumstances that would preclude a finding that a director is independent.[168] The Commission requests comment on whether this approach is appropriate or whether the Commission should take a less prescriptive approach. The Commission also notes that the proposed rule precludes a director from being deemed independent if he or she has received from the SB SEF, SBS exchange, or SBS exchange facility within the past three years payments that reasonably could affect his or her independent judgment or decision-making, excluding remunerations for Board or Board committee services. The Commission requests comment on whether it is appropriate to exclude compensation for Board or Board committee service from disqualifying a director as an independent director. Are there circumstances or levels of compensation that should disqualify a candidate from being deemed independent? The Commission also requests comment on whether, instead of independence requirements, it should require that the number of "non-industry" directors equal or exceed the number of "industry" directors, as such terms are generally defined by the exchanges.[169] Are there other types of affiliations that the Commission should be concerned about that are not addressed by the proposed definitions of "independent director" or "material relationship"?

The Commission is not proposing that the Board composition requirement apply to parent companies of a SB SEF, SBS exchange, or SBS exchange facility.[170] In other words, the Commission is not proposing to require a holding company that wholly owns, or entities that control, a SB SEF, SBS exchange, or SBS exchange facility to have a majority independent Board.[171] The Commission preliminarily believes that the composition of the Board of a parent that wholly owns or controls a SB SEF, SBS exchange, or SBS exchange facility does not raise conflicts concerns that require Commission rulemaking. The Commission, however, requests comment on whether the majority independent Board requirement should apply to an entity that owns and controls a SB SEF, SBS exchange, or SBS exchange facility.

2. Regulatory Oversight Committee

In addition to a majority independent Board, the Commission proposes that a SB SEF or SBS exchange establish a ROC that is composed solely of independent directors to oversee the SB SEF's obligations under Section 763(c) of the Dodd-Frank Act or the SBS exchange's regulatory oversight responsibilities under Section 6 of the Exchange Act, respectively.[172] This requirement also would apply to a national securities exchange that posts or makes available for trading security-based swaps through a facility of the exchange.[173] The ROC would oversee the regulatory program on behalf of the Board. Specifically, the Commission expects that a ROC, among other things, would monitor a SB SEF's or SBS exchange's regulatory program for sufficiency, effectiveness, and independence; oversee all facets of the regulatory program; review the size and allocation of the regulatory budget and resources; and review regulatory proposals and advise the Board as to whether and how such changes may affect regulation. The proposed rule also would require that any recommendation of the ROC that is not adopted or implemented by the Board be reported promptly to the Commission.[174]

The proposed provisions relating to the ROC should help limit the ability of owners of the SB SEF and SBS exchange to unduly influence the operation of these entities, and thus would further the objectives of good governance and mitigation of conflicts of interest that underlie Section 765 of the Dodd-Frank Act. A ROC is intended to have an important role in assuring that a SB SEF or SBS exchange carries out its obligations in an even-handed and effective manner and that its oversight functions are adequately funded.

Although the Commission encourages national securities exchanges to have a wholly independent ROC, it has not in

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[165] The SRO Governance Proposing Release proposed that the board of a national securities exchange or national securities association be composed of a majority of independent directors. *See* SRO Governance Proposing Release, *supra* note 59. A number of commenters, particularly national securities exchanges, favored this proposal. *See, e.g.,* PSX Comment Letter, *supra* note 156; Letter from Anthony K. Stankiewicz, Esq., Vice President, Legal and Governance, BSE, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 (supporting the majority independent board requirement but objecting to the definition of independence) ("BSE Comment Letter"); Letter from Mary Yeager, Assistant Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 ("NYSE Comment Letter"). A few commenters objected to it as being an unnecessary requirement to mandate for all exchanges. *See, e.g.,* ISE Comment Letter, *supra* note 156; Letter from William J. Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, Incorporated, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 ("CBOE Comment Letter"). The Commission notes, however, that the SRO Governance Proposing Release related to national securities exchanges that trade equity securities and listed options and registered securities associations, and the comments received did not address potential conflicts in other contexts.

[166] *See supra* Section III.B.

[167] *See* proposed Rules 700(j) and (*l*) under Regulation MC.

[168] *See* Section 303A.02 of the NYSE Listed Company Manual and Nasdaq Rule 5605(a)(2), both of which contain specific circumstances that, if satisfied, would preclude a determination that the director is independent.

[169] *See supra* note 66.

[170] If the parent company of a SB SEF, SBS exchange or SBS exchange facility was itself a regulated entity that is subject to the Exchange Act and rules and regulations thereunder, then it would comply with any requirements that it is subject to in that capacity.

[171] The CFTC has proposed to apply a "public director" requirement to parent companies that operate DCMs and SEFs. *See http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister_governance.pdf.*

[172] *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c), and 15 U.S.C. 78(f). *See also* proposed Rule 702(e)(1) under Regulation MC.

[173] Proposed Rule 702(e) under Regulation MC does not explicitly include a SBS exchange facility. A facility that posts or makes available for trading a security-based swap would do so under the registration of an exchange of which it is a facility. Therefore, the exchange is deemed the statutory entity posting or making available for trading the security based swap and is responsible for the regulatory oversight of the facility. Accordingly, the exchange whose facility posts or makes available for trading a security-based swap must itself establish the requisite ROC.

[174] *See* proposed Rule 702(e)(2) under Regulation MC.

the past required them to do so.[175] As mentioned above, however, the conflict concerns that Section 765 is intended to address are not entirely analogous to those posed by national securities exchanges. Rather, there is a heightened concern regarding conflicts of interest for trading venues of security-based swaps because a small group of dealers may exert undue influence to control the level of access to, and the scope of products traded on such venues. Further, while SB SEFs do not possess the full range of self-regulatory obligations that exchanges have, they nonetheless have a number of regulatory duties that are set forth in the core principles for SB SEFs contained in Section 763(c) of the Dodd-Frank Act.[176] Thus, it appears that a need for a wholly independent ROC may be greater for SB SEFs and SBS exchanges than for other registered national securities exchanges.[177]

The Commission also recognizes that, as mentioned above, an independent director, who by definition would be outside the management of a SB SEF or SBS exchange and not a SB SEF participant or SBS exchange member may not have access to the same amount or types of information as non-independent directors. Therefore, a ROC composed solely of independent directors may need to rely on management or non-independent directors for information, with attendant biases of information from such sources. If directors on a ROC, moreover, lack necessary information or are otherwise not sufficiently knowledgeable, the committee's effectiveness as a whole may be compromised. Such ROC may defer to management's expertise or the expertise of non-independent directors on the Board. Further, as mentioned above, independent directors may have their own biases that could compromise the structural protections intended by a wholly independent ROC. Therefore, the Commission seeks comment on the proposal relating to the composition and duties of the ROC. Would the establishment of a fully independent ROC help mitigate the identified conflicts of interest? Are there particular circumstances under which a ROC should be permitted to have non-independent directors? If so, please identify them.

Separately, the Commission requests comment on whether it should specify in the proposed rule the duties of the ROC. If so, what should be the scope of the ROC's duties? For example, should a ROC be required to oversee decisions as to which entities have access to the trading facility and under what circumstances, or which products are made available for trading? Is it appropriate to require that the Board submit to the Commission any recommendation of the ROC that it does not adopt or implement? Would this requirement help assure good governance that may mitigate conflicts? Should such reports be required to be submitted promptly to the Commission? Would a different time period be more appropriate? For instance, should such reports instead be required to be submitted semi-annually or, for SB SEFs, should they be incorporated as part of the annual report of the Chief Compliance Officer, which is required pursuant to core principle 14 under Section 763(c) of the Dodd-Frank Act? Are there reasons, consistent with mitigation of conflicts, why SB SEFs and SBS exchanges should be treated differently with respect to the proposal to require a fully independent ROC? Are there other ways in which material information pertaining to the ROC's ability to carry out its duties effectively can be brought to the Commission's attention?

3. Other Board Committees

The Commission is proposing compositional and other requirements with respect to various other Board committees. In this regard, proposed Rule 702(f)(1) under Regulation MC would require that the nominating committee of a SB SEF, SBS exchange, or SBS exchange facility be composed solely of independent directors. The proposed requirement for the Board of the SB SEF, SBS exchange, or SBS exchange facility to be composed of a majority of independent directors could be undercut if the nominating committee were dominated by persons that had an ownership interest in these entities, were affiliated with such owners, or were selected by the owner-directors or their affiliates. Further, the proposed rule would require that any committee of the Board that is delegated the authority to act on the Board's behalf, such as any executive committee, also must be composed of a majority of independent directors.[178] This proposed provision extends to Board committees that are authorized to act on behalf of the Board the compositional requirement proposed for the full Board and is designed to assure that the SB SEF, SBS exchange or SBS exchange facility would not subvert the proposed majority Board independence standard by delegating the Board's duties to a committee that does not have the same majority independence standard.

With respect to a wholly independent nominating committee, the Commission recognizes that the proposal may not sufficiently mitigate concerns that certain shareholders may be able to influence or control the director nominating process and thus undermine the intent of a majority independent Board. As discussed above, an independent director may not truly be independent from the influence of, or bias toward, a large shareholder or group of shareholders, other non-independent directors, or even from management. Consequently, if the nominating committee is composed of enough directors who are subject to such influence or bias, the palliative purpose of requiring a wholly independent nominating committee could be compromised. Accordingly, the Commission requests comment on

[175] In the SRO Governance Proposing Release, the Commission proposed to require SROs to have a ROC and to require that all members of such committee be independent. *See* SRO Governance Proposing Release, *supra* note 59. Some commenters generally favored the requirement of a ROC. *See, e.g.,* PSX Comment Letter, *supra* note 156; CBOE Comment Letter, *supra* note 165. However, a number of commenters objected to the requirement that certain board committees, including the ROC, be composed solely of independent directors. *See, e.g.,* Phlx Comment Letter, *supra* note 156 ("To impose this requirement on all Standing Committees would potentially exclude persons with the most experience and knowledge from serving on these committees."); CBOE Comment Letter, *supra* note 165; letter from Neal Wolkoff, Acting Chief Executive Officer, the American Stock Exchange LLC, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 ("[A] number of the exchanges may find it difficult to find enough qualified independent directors with sufficient expertise to satisfy all of these committees."); letter from the Archipelago Exchange, BSE, the Chicago Stock Exchange, ISE, the Nasdaq Stock Market, and Phlx, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005 ("[As] a result of the potential loss of flexibility, we disagree with the mandated requirement for specific committees composed exclusively of directors that meet the [Commission's] proposed definition of independence."). The Commission notes, however, that the SRO Governance Proposing Release related to national securities exchanges that trade equity securities and listed options and registered securities associations, and the comments received did not address potential conflicts in other contexts.

[176] *See supra* note 54.

[177] Some exchanges have voluntarily created ROCs. *See, e.g.,* Securities Exchange Act Release Nos. 51149 (February 8, 2005), 70 FR 7531 (February 14, 2005) (order approving demutualization of the Chicago Stock Exchange ("CHX")) (at the time of the demutualization, CHX proposed to have, and currently has, majority public directors on its ROC) and 62158 (May 24, 2010), 75 FR 30082 (May 28, 2010) (order approving the demutualization of CBOE) (CBOE's ROC is composed solely of non-industry directors).

[178] *See* proposed Rule 702(f) under Regulation MC. This proposed provision would not apply to the ROC or the nominating committee since the proposals would require the ROC and the nominating committee to be composed solely of independent directors.

whether it should prescribe or limit the manner in which a SB SEF, SBS exchange, or SBS exchange facility could appoint the nominating committee. Should the Commission consider an alternative to a compositional requirement for a nominating committee, such as allowing a SB SEF, SBS exchange, or SBS exchange facility to have a board of trustees responsible for nominating candidates for the Board? If this were a viable alternative, should there be compositional requirements or other limits imposed on the board of trustees? How should such a board of trustees be appointed? Would the alternative of a board of trustees to nominate directors provide greater assurance that independent directors are truly independent not only at the time of their nomination but during their service on the Board as well?

Conversely, the Commission also notes that dealer-owners that are Board members would not be able to serve on a wholly independent nominating committee and thus would not have a voice in the process of nominating candidates for Board seats. This would mean that the nominating committee would not have access to the dealer-owners' potentially valuable insights with respect to qualified candidates for either independent or non-independent director positions. Accordingly, the Commission invites commenters to suggest the appropriate compositional requirements for the nominating committee and explain their views. Should the Commission instead require a majority independent nominating committee? Would a majority independent nominating committee be consistent with the proposal's goal to mitigate conflicts for SB SEFs and SBS exchanges? [179]

SB SEFs are not subject to "fair representation" requirements, like national securities exchanges, which must assure their members "fair representation" in the selection of directors and the administration of the exchange's affairs.[180] Should the Commission adopt additional compositional requirements to provide SB SEF participants a guaranteed voice in the selection of the SB SEF's directors and the administration of its affairs? [181] For example, should the Commission require that the nominating committee consult with participants in the SB SEFs or SBS exchanges, as applicable? Or, should the Commission require that the participants in the SB SEFs or SBS exchanges select a certain percentage of directors? If so, should the Commission also limit the ability of owner participants (such as dealers) to participate in this process? If that is the case, should any such limitation depend on whether ownership is concentrated in a small number of dealers? Should end users also be given guaranteed rights of participation in the governance of the SB SEF?

The Commission also seeks comment on whether the proposed compositional requirements relating to any committee that is delegated the authority to act on behalf of the Board are appropriate and whether there are any other areas in which the Commission should propose compositional requirements for SB SEF and SBS exchange committees. For example, the Commission requests comment on whether it should require any SB SEF, SBS exchange, or SBS exchange facility committee that determines which security-based swaps will trade on the SB SEF or SBS exchange, respectively, be composed of majority independent directors, or require participation by other groups on such committee. Should the ROC be required to oversee decisions regarding access to the SB SEF and regarding which security-based swaps are made available to trade on the SB SEF?

4. Disciplinary Process

As noted above, the Commission historically has required that national securities exchanges' disciplinary panels be balanced and include industry member representation.[182] Proposed Rule 702(g) under Regulation MC would require that any disciplinary process of a SB SEF and SBS exchange shall preclude any group or class of persons that is a SB SEF participant or SBS exchange member from dominating or exercising disproportionate influence. In other words, to the extent that there is more than one type of group or class of persons that are participants or members in a SB SEF or SBS exchange, as applicable, the composition of any disciplinary panel should not allow one group or class to have representation on the disciplinary panel that is out of proportion as compared to other groups or classes of persons that are participants in the SB SEF or SBS exchange. In addition, any panel that is responsible for disciplinary decisions, and any appeals body, must include at least one independent director.[183] These proposed provisions should help mitigate conflicts of interest in the SB SEF's and SBS exchange's disciplinary process. This requirement also would apply to a national securities exchange that posts or makes available for trading a security-based swap through its facility.[184]

The Commission seeks comment on the proposal relating to requirements of the disciplinary process, including the compositional requirements. Should any disciplinary panel also be required to include representatives selected by SB SEF participants or SBS exchange members, as applicable? Would the proposed provisions help to mitigate the identified conflicts of interest? Should any other persons be precluded from dominating the disciplinary process? Are there any additional provisions that should be proposed to mitigate conflicts of interest in the disciplinary process? [185] The Commission also requests comment on whether the Commission's proposal would meaningfully supplement or enhance the requirements that SBS exchanges, as national securities exchange, already have in place with respect to the disciplinary process.

VI. Discussion of Exemptive Authority Pursuant to Section 36 of the Exchange Act

The Commission pursuant to Section 36 of the Exchange Act may grant an exemption from any rule or any provision of any rule under Regulation MC. Any such exemption could be subject to conditions and could be revoked by the Commission at any time.

[179] The SRO Governance Proposing Release proposed that certain committees, including the nominating committee, be composed solely of independent directors. *See* SRO Governance Proposing Release, *supra* note 59. Some commenters favored this requirement. *See, e.g.,* PSX Comment Letter, *supra* note 156. A number of commenters, particularly national securities exchanges, objected to the requirement that certain board committees be composed solely of independent directors. *See supra* note 175.

[180] *See* Section 6(b)(3) of the Exchange Act, 15 U.S.C. 78f(b)(3).

[181] As discussed above, Section 763(c) of the Dodd-Frank Act sets forth 14 core principles that SB SEFs must satisfy, including one relating to conflicts of interest, and provides the Commission with rulemaking authority with respect to implementation of these core principles. As the Commission has not yet proposed rules regarding the requirements and operation of a SB SEF, including the scope of trading on and which entities would be allowed to directly access a SB SEF, the Commission may determine that it is more appropriate to propose participant representation requirements, if any, in its broader rulemaking relating to SB SEFs.

[182] *See supra* Section III.B.

[183] *See* proposed Rule 702(h) under Regulation MC.

[184] *See supra* note 173. Similar to the requirement pertaining to the ROC, the exchange, not the facility, bears the responsibility of disciplining its members. *See* Section 6 of the Exchange Act. Consequently, proposed Rule 702(h) does not explicitly mention SBS exchange facility. However, a national securities exchange that posts or makes available for trading a security-based swap through its facility must also comply with the requirements of proposed Rule 702(h) under Regulation MC.

[185] *See supra* note 181.

Generally, the Commission would consider granting an exemption where the exemption is necessary or appropriate in the public interest and consistent with the protection of investors. For example, the SBS exchange, SB SEF, or security-based swap clearing agency might be unable, on a temporary basis and for reasons beyond its control, to comply with one of the rules under Regulation MC. The Commission could also grant an exemption where the SBS exchange, SB SEF, or security-based swap clearing agency demonstrated that it established alternative means to effectively mitigate conflicts of interest as contemplated under Regulation MC and that it would otherwise be unable to comply with the requirements under Regulation MC, including as a start-up SB SEF, SBS exchange, or security-based swap clearing agency. The Commission in its sole discretion would determine whether to grant or deny a request for an exemption. In addition, the Commission could revoke an exemption at any time, including if the SBS exchange, SB SEF, or security-based swap clearing agency could no longer demonstrate that such exemption is necessary or appropriate in the public interest, or is consistent with the protection of investors.

The Commission requests comment on all aspects of the exemptive authority. Would such exemptive authority be useful to facilitate the purposes of Section 765? If so, in what circumstances should the Commission grant exemptions? Should exemptions only be granted in limited circumstances? Should the Commission potentially consider granting exemptions from all rules under Regulation MC or are exemptions only warranted for specific rules or specific entities? For example, should exemptions only be available with respect to the voting interest restrictions applicable to security-based swap clearing agencies? What specific factors should the Commission consider in determining whether to grant an exemption? Are there cases where exemptions may not be appropriate and should not be considered?

VII. Effective and Compliance Date

The Commission is required to adopt rules under Section 765 within 180 days of enactment of Title VII. However, certain of the rules the Commission is proposing today would apply to SB SEFs, which will be the subject of new definitional rules that are required under the Dodd-Frank Act to be completed by July 15, 2011. Accordingly, the Commission is proposing that provisions of Regulation MC as applicable to SB SEFs would become effective sixty (60) days after July 15, 2011. All other provisions of the rules under Regulation MC would become effective sixty (60) days after the final rules are published in the **Federal Register**.

The Commission recognizes that existing entities may need a transitional period to implement any final rules. Accordingly, the Commission is proposing to permit the phase-in implementation of the rules under Regulation MC over two (2) years or two regularly-scheduled Board elections. The phase-in implementation would apply to existing exchanges, clearing agencies, or other institutions that apply to register as a SBS exchange, SB SEF, or security-based swap clearing agency. However, the Commission expects that entities that are newly created in order to establish a SBS exchange, SB SEF, or security-based swap clearing agency would fully comply with the final rules.

The Commission requests comment on (i) the timing of effectiveness for the final rules, and (ii) the length and applicability of the implementation period.

VIII. General Request for Comments

The Commission seeks comment on the proposed rules that are intended to mitigate conflicts of interest with respect to security-based swap clearing agencies, SB SEFs, SBS exchanges, and SBS exchange facilities, on any additional or different provisions that would mitigate conflicts of interest for these entities, and on any other matters that might have an implication on the proposals. The Commission particularly requests comment from the point of view of entities that plan to register as security-based swap clearing agencies or SB SEFs and from national securities exchanges that plan to become SBS exchanges or create SBS exchange facilities; entities operating platforms that currently trade or clear security-based swaps; broker-dealers, financial institutions, major security-based swap participants, and other persons that trade security-based swaps; and end-users generally.

The Commission invites commenters to address whether the proposed rules are appropriately tailored to achieve the goal of mitigating conflicts of interest in the ownership and governance of security-based swap clearing agencies, SB SEFs, SBS exchanges, and SBS exchange facilities, including with respect to the administration of these entities' regulatory activities. The Commission also requests comment on the necessity and appropriateness of mandating ownership and voting limitations for security-based swap clearing agencies, SB SEFs, SBS exchanges, and SBS exchange facilities and on whether there are other means to achieve the statutory mandate of Section 765 of the Dodd-Frank Act.

The Commission is proposing governance requirements for security-based swap clearing agencies, SB SEFs, SBS exchanges, and SBS exchange facilities that are designed to mitigate conflicts of interest. The Commission requests comment on whether the governance requirements, by themselves, would be enough to mitigate conflicts.

The Commission requests comment on the two alternative proposals for security-based swap clearing agencies. Are there other alternatives that would more effectively mitigate conflicts of interest? Should security-based swap clearing agencies be permitted to choose between alternatives at all? The Commission may determine to adopt only one of the proposed alternatives as a final rule. If only one alternative were to be adopted as a final rule, which one should it be? Should any of the provisions of the proposed alternatives be revised? The Commission may combine aspects of each proposed alternative rule (with or without modifications) and adopt them as a single final rule. If that approach is taken, which aspects of each alternative should be combined? For example, should the voting interest restrictions in Rule 701(a) be combined with the governance restrictions in Rule 701(b) to create a stronger rule to mitigate conflicts of interest at security-based swap clearing agencies? As compared to each other, how is each alternative likely to affect access and risk management at security-based swap clearing agencies? How will each alternative affect and be affected by developments in the market, including the prospect of future competition?

The Commission also requests comment on the impact on competition the two alternative proposals might have. The Voting Interest Focus Alternative and the Governance Focus Alternative are designed to address the unique conflict of interest issues at security-based swap clearing agencies. The Commission requests comment on whether imposing voting interest and governance limitations could have the unintended consequence of deterring new, competitive security-based swap clearing agencies at a time when central clearing for security-based swaps is still developing. A security-based swap clearing agency that currently clears security-based swaps but would not

meet the proposed voting interest limits would need to revise its ownership structure. There could be costs and delays as the security-based swap clearing agency seeks to find one or more additional owners to satisfy the proposed limits, with a possible diminution in the value of the original owner(s)' investment.

The Commission is sensitive to arguments against imposing ownership and voting limits for security-based swap clearing agencies, some of which were articulated at the Conflicts Roundtable. However, it also understands that the OTC derivatives market is highly concentrated and dealer dominated. As a result, voting interest and governance restrictions may be necessary at security-based swap clearing agencies where they have not been necessary at other securities clearing agencies. Access to central clearing services will be crucial for most firms that will actively trade in security-based swaps that are required to be cleared. Although the proposed restrictions may have the effect of creating barriers to potential security-based swap clearing agencies (and thus market participants could have fewer clearing agencies to choose from) the incentives of independent directors will likely promote increased access to central clearing for market participants. In contrast, although ownership and voting limits may more directly affect the ability of SB SEFs and SBS exchanges to start up, the lack of market characteristics to promote competing trading venues for security-based swaps may emphasize the greater need for ownership and voting limits. If the market characteristics for security-based swaps naturally promote dealer domination without robust competing trading venues, there is more need to mitigate the types of concerns that underlie Section 765, such as by imposing ownership and voting limits.[186]

The CFTC is adopting rules to mitigate conflicts of interest for derivatives clearing organizations that clear swaps, swap execution facilities and boards of trade designated as a contract markets that post swaps or make swaps available for trading as required under Section 726 of the Dodd-Frank Act. Understanding that the Commission and the CFTC regulate different products and markets and, as such, appropriately may be proposing alternative regulatory requirements, the Commission requests comments on the impact of any differences between the Commission and CFTC approaches to the mitigation of conflicts of interest. Specifically, would the regulatory approaches under the Commission's proposed rulemaking pursuant to Section 765 of the Dodd-Frank Act and the CFTC's proposed rulemaking pursuant to Section 726 of the Dodd-Frank Act result in duplicative or inconsistent efforts on the part of market participants subject to both regulatory regimes or result in gaps between those regimes? If so, in what ways do commenters believe that such duplication, inconsistencies, or gaps should be minimized? Do commenters believe the approaches proposed by the Commission and the CFTC to mitigate conflicts of interest are comparable? If not, why? Do commenters believe there are approaches that would make the mitigation of conflicts of interest more comparable? If so, what? Do commenters believe that it would be appropriate for the Commission to adopt an approach proposed by the CFTC that differs from the Commission's proposal? Is so, which one? The Commission requests commenters to provide data, to the extent possible, supporting any such suggested approaches.

In addition, the Commission seeks comment regarding any potential implication of the proposals on users of any security-based swap clearing agencies, SB SEFs, and SBS exchanges, other market participants, and the public generally. The Commission seeks comment on the proposals as a whole, including their interaction with the other provisions of the Dodd-Frank Act. The Commission seeks comment on whether the proposals would help achieve the broader goals of increasing transparency and accountability in the OTC derivatives market.

Commenters should, when possible, provide the Commission with empirical data to support their views. Commenters suggesting alternative approaches should provide comprehensive proposals, including any conditions or limitations that they believe should apply, the reasons for their suggested approaches, and their analysis regarding why their suggested approaches would satisfy the statutory mandate contained in Section 765 of the Dodd-Frank Act regarding mitigation of conflicts of interest.

IX. Paperwork Reduction Act

The proposed rules contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[187] The titles for these collections are Rule 701 of Regulation MC, both in the Voting Interest Focus Alternative and the Governance Focus Alternative, and Rule 702 of Regulation MC.

The Commission has submitted the information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11.

A. Summary of Collection of Information

1. Security-Based Swap Clearing Agencies

Proposed alternative Rule 701(a)(2) under Regulation MC would require security-based swap clearing agencies to have rules that would: (1) Provide for an effective mechanism to divest any participant of any interest owned in excess of the proposed 20% ownership limit; (2) not give effect to the portion of any voting interest held by one participant in excess of the proposed 20% voting limit; (3) not give effect to the portion of any voting interest among all security-based swap clearing agency participants owned in the aggregate in excess of the proposed 40% ownership limit; and (4) provide an effective mechanism for the security-based swap clearing agency to obtain information relating to the voting interests in such entity. Alternative Rule 701(b)(2) under Regulation MC would require security-based swap clearing agencies to have rules that would: (1) Provide for an effective mechanism to divest any participant of any interest owned in excess of the proposed 5% ownership limit; (2) not give effect to the portion of any voting interest held by one participant in excess of the proposed 5% voting limit; and (3) provide an effective mechanism for the security-based swap clearing agency to obtain information relating to the voting interests in such entity. Each security-based swap clearing agency must comply with one of the alternatives. Establishing such rules would result in a paperwork burden for a security-based swap clearing agency. In addition, if the security-based swap clearing agency was to request to receive ownership and voting information from participants

[186] In the equities market a small group of broker-dealers or single-dealer proprietary firms can and do own alternative trading systems ("ATSs") and thus it can be argued that SB SEFs and SBS exchanges should be permitted to operate similarly. *See* Securities Exchange Act Release No. 60997 (November 13, 2009), 74 FR 61208 (November 23, 2009) (as of November 2009, there were approximately 73 ATSs that are subject to Regulation ATS). However, ATSs exist in the context of a marketplace with robust competition among numerous trading venues. Therefore, ATSs that are owned by one broker-dealer or a small group of broker-dealers, by virtue of their ownership structure alone, generally do not present a concern that they could lessen price competition or market efficiency.

[187] 44 U.S.C. 3501 *et seq.*

pursuant to Rule 701(a) or (b), the request would be a collection of information.

2. SB SEFs, SBS Exchanges, and SBS Exchange Facilities

Proposed Rule 702(c) under Regulation MC would require SB SEFs, SBS exchanges, and SBS exchange facilities to have rules that would: (1) Provide for an effective mechanism to divest any participant or member, as applicable, of any interest owned in excess of the proposed 20% ownership limit; (2) not to give effect to the portion of any voting interest help by one or more participants or members, as applicable, in excess of the proposed 20% voting limit; and (3) provide an effective mechanism for the SB SEF, SBS exchange or SBS exchange facility to obtain information relating to ownership and voting interests in such entity. Establishing such rules would result in a paperwork burden for a SB SEF, SBS exchange, or SBS exchange facility, as applicable. In addition, if a SB SEF, SBS exchange, or SBS exchange facility were to request to receive ownership and voting information from participants or members pursuant to Rule 702(c) that would be a collection of information.

Proposed Rule 702(e) under Regulation MC would require SB SEFs and SBS exchanges to establish a ROC that is composed solely of independent directors,[188] to oversee the SB SEF's and SBS exchange's obligations under Section 763(c) of the Dodd-Frank Act and Section 6 of the Exchange Act, respectively.[189] The proposed rule would require that any recommendation of the ROC that is not adopted or implemented by the SB SEF's or SBS exchange's Board be reported promptly to the Commission.

B. Proposed Use of Information

1. Security-Based Swap Clearing Agencies

The purpose of the collection of information in proposed Rule 701(a) or (b) under Regulation MC is to enable a security-based swap clearing agency to monitor voting interests with respect to the security-based swap clearing agency, and enable the security-based swap clearing agency to take necessary action if the voting interests by a participant or group of participants in the security-based swap clearing agency exceed those allowed under proposed Rule 701(a) or (b).

2. SB SEFs, SBS Exchanges, and SBS Exchange Facilities

The purpose of the collection of information in proposed Rule 702(c) under Regulation MC is to enable a SB SEF, SBS exchange, or SBS exchange facility to monitor voting interests with respect to such entity, and enable the SB SEF, SBS exchange, or SBS exchange facility, as applicable, to take necessary action if the ownership or voting rights by a participant or member or group of participants or members, as applicable, exceed those allowed under proposed Rule 702(b).

The purpose of the collection of information in proposed Rule 702(e) under Regulation MC is to provide the Commission with information regarding the instances in which the SB SEF or SBS exchange does not adopt or implement a recommendation of the ROC, which would help the Commission in its oversight of SB SEFs and SBS exchanges. The information collection also should promote sound regulatory policies and foster the effectiveness of the ROC by putting the SB SEF or SBS exchange on notice that the Commission must be apprised promptly of any recommendation that is made by the ROC that is not adopted or implemented.

C. Respondents

1. Security-Based Swap Clearing Agencies

The collection of information associated with the proposed Rule 701(a) and (b) under Regulation MC would apply to security-based swap clearing agencies. Currently, four clearing agencies are authorized to clear credit default swaps, including security-based swaps,[190] pursuant to temporary conditional exemptions under Section 36 of the Exchange Act.[191] The obligation to centrally clear security-based swap transactions is a new requirement under Title VII of the Dodd-Frank Act. Based on the fact that there are currently four clearing agencies authorized to clear security-based swaps and that there could conceivably be one or two more in the future,[192] the Commission preliminarily estimates that four to six clearing agencies may seek to clear security-based swaps and be subject to the information collection requirements in proposed Rule 701(a) or (b). The Commission is using the higher estimate of six for the PRA analysis.

2. SB SEFs, SBS Exchanges, and SBS Exchange Facilities

The collection of information associated with the proposed Rule 702(c) under Regulation MC would apply to SB SEFs, SBS exchanges, and SBS exchange facilities. In the Dodd-Frank Act, Congress defined for the first time a SB SEF and mandated the registration of these new facilities.[193] Based on conversations with the CFTC and industry sources, the Commission preliminarily believes that approximately 10–20 entities could seek to become SB SEFs and thus be subject to the collection of information requirement of proposed Rule 702(c). The Commission is using the higher estimate of 20 SB SEFs for this PRA analysis. In addition, there are currently 15 national securities exchanges that could be subject to the collection of information requirement of Rule 702(c).[194] To provide an estimate that is not under-inclusive, the Commission preliminarily estimates that all 15 of the currently registered national securities exchanges could become SBS exchanges or could create a separate legal entity that would be a facility of the exchange to trade security-based swaps.

The collection of information associated with the proposed Rule 702(e) under Regulation MC would apply to SB SEFs and SBS exchanges. Based on the estimates noted above, to provide an estimate that is not under-inclusive, the Commission preliminarily believes that 20 SB SEFs and 15 SBS exchanges or SBS exchange facilities would be subject to the collection of information requirement of Rule 702(e).

[188] Proposed Rule 702(e) under Regulation MC does not explicitly include SBS exchange facilities because the exchange whose facility posts or makes available for trading a security-based swap must itself establish the requisite ROC. *See supra* note 173.

[189] *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c). Specifically, the ROC would oversee the SBS exchange's and SB SEF's regulatory program on behalf of the Board and the Board would be required to delegate sufficient authority, dedicate sufficient resources, and allow sufficient time for the ROC to fulfill its mandate.

[190] Of the four clearing agencies granted temporary exemptions from registration, only three have cleared products that are classified as security-based swaps under Title VII of the Dodd-Frank Act.

[191] 15 U.S.C. 78mm.

[192] The Commission does not expect there to be a large number of clearing agencies that clear security-based swaps, based on the significant level of capital and other financial resources necessary for the formation of a clearing agency.

[193] *See* Sections 763(a) and 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(a) and (c).

[194] The 15 national securities exchanges are: BATS Exchange, Inc.; BATS Y–Exchange, Inc.; Chicago Board Options Exchange, Incorporated; Chicago Stock Exchange, Inc.; C2 Options Exchange, Incorporated, EDGA Exchange, Inc., EDGX Exchange, Inc., International Securities Exchange, LLC; The NASDAQ Stock Market LLC; NASDAQ OMX BX, Inc.; NASDAQ OMX PHLX, Inc.; National Stock Exchange Inc.; New York Stock Exchange LLC; NYSE Amex LLC; and NYSE Arca, Inc.

D. Total Annual Reporting and Recordkeeping Burdens

1. Security-Based Swap Clearing Agencies

Proposed Rule 701(a) would require security-based swap clearing agencies to have rules that would: (1) Provide for an effective mechanism to divest any participant of any interest owned in excess of the proposed 20% ownership limit; (2) not give effect to the portion of any voting interest held by one participant in excess of the proposed 20% voting limit; (3) not give effect to the portion of any voting interest among all security-based swap clearing agency participants owned in the aggregate in excess of the proposed 40% ownership limit; and (4) provide an effective mechanism for the security-based swap clearing agency to obtain information relating to the voting interests in such entity. Proposed Rule 701(b) would require security-based swap clearing agencies to have rules that would: (1) Provide for an effective mechanism to divest any participant of any interest owned in excess of the proposed 5% ownership limit; (2) not give effect to the portion of any voting interest held by one participant in excess of the proposed 5% voting limit; and (3) provide an effective mechanism for the security-based swap clearing agency to obtain information relating to the voting interests in such entity. Each security-based swap clearing agency must comply with one of the alternatives.

Establishing such rules would result in a paperwork burden for a security-based swap clearing agency. The Commission preliminarily believes that there would be a one-time paperwork burden of 15 hours per entity associated with the drafting and implementation of any such rules by the security-based swap clearing agency for a total of 90 hours (15 hours × 6 respondents).

Any collection of information by a security-based swap clearing agency from a participant that has a voting interest in the security-based swap clearing agency would differ depending upon the number of shareholders or other owners of voting interests that are participants in the security-based swap clearing agency. Accordingly, the number of responses per year that would be generated by proposed Rule 701(a) or (b) under Regulation MC would vary by security-based swap clearing agency. At this point, however, currently only the largest fourteen dealer firms are participants that clear security-based swaps at such clearing agencies. The Commission believes that it would be reasonable for security-based swap clearing agencies to collect information related to the voting interests held by participants on a quarterly basis. This would provide the security-based swap clearing agency with sufficiently current information regarding participants' voting interests in the security-based swap clearing agency and allows the security-based swap clearing agency to review the information at a single point in time. Accordingly, the Commission preliminarily estimates that each security-based swap clearing agency would request information approximately 4 times per year from approximately 14 participants.

The Commission also estimates that the preparation and sending of each of the 4 requests for information would require approximately 4 hours and reviewing the responses to each of the 4 requests for information would require 10 hours. This would result in a total annual reporting and recordkeeping burden of 56 hours ((4 requests × 4 hours) + (4 requests × 10 hours)) for each security-based swap clearing agency, and a total annual burden for all security-based swap clearing agencies of 336 hours (56 hours × 6 clearing agencies). The Commission preliminarily estimates that each participant would require 1 hour to prepare and send the security-based swap clearing agency its response to the request, for a total annual reporting and recordkeeping burden for each participant of each security-based swap clearing agency of 4 hours (4 requests × 1 hour) and a total annual burden for all participants in all 6 security-based swap clearing agencies of 336 hours (14 participants × 4 hours × 6 security-based swap clearing agencies) thereby resulting in a total estimated annual burden for all security-based swap clearing agencies and participants of 672 hours (336 hours for all participants + 336 hours for all security-based swap clearing agencies). The Commission requests comment on these estimates.

The Commission estimates that the total paperwork burden resulting from the proposals relating to security-based swap clearing agencies is 762 hours for an initial paperwork burden and 672 hours thereafter.[195]

2. SB SEFs, SBS Exchanges, and SBS Exchange Facilities

Proposed Rule 702(c) would require SB SEFs, SBS exchanges, and SBS exchange facilities to have rules that would provide for an effective mechanism to divest any participant or member, as applicable, of any interest owned in excess of the proposed 20% ownership limit; that would not give effect to the portion of any voting interest held by one or more participants or members, as applicable, in excess of the proposed 20% voting limit; and that would provide an effective mechanism for the SB SEF, SBS exchange, or SBS exchange facility to obtain information relating to ownership and voting interests in such entity. Establishing such rules or policies and procedures, as applicable, would result in a paperwork burden for a SB SEF, SBS exchange, or SBS exchange facility, as applicable. The Commission preliminarily believes that there would be a one-time paperwork burden of 15 hours per entity associated with the drafting and implementation of any such rules by the SB SEF, SBS exchange, or SBS exchange facility, as applicable, for a total of 525 hours (15 hours × 35 respondents).

The number of responses per year that would be generated by requests by a SB SEF, SBS exchange, or SBS exchange facility, as applicable, for ownership or voting information from participants or members that are owners of securities entitled to vote or otherwise have a voting interest in the SB SEF, SBS exchange, or SBS exchange facility would depend upon the number of owners of voting securities that are participants or members. Assuming that all classes of securities entitled to vote are owned or otherwise controlled by participants or members, the minimum number per SB SEF, SBS exchange, or SBS exchange facility would be 5. Based on the Commission's understanding of the ownership structures and voting rights of existing entities that may register as SB SEFs, and its understanding of the ownership structures and voting rights of existing national securities exchanges, the Commission preliminarily estimates that each SB SEF, SBS exchange, or SBS exchange facility on average would request information from approximately 20 participants or members, as applicable. The Commission believes that it would be reasonable for a SB

[195] The aggregate initial paperwork burden is calculated as follows: 90 hours (one time paperwork burden for security-based swap clearing agencies to establish rules to divest any ownership interest in excess of the limit and not to give effect to any portion of the voting interests in excess of the limit) + 336 hours (annual burden for security-based swap clearing agencies to prepare and send requests for voting information) + 336 hours (annual burden for participants of security-based swap clearing agencies to prepare and send responses to requests for voting information) = 762 hours. After the initial year, the paperwork burden is calculated as follows: 762 hours (total paperwork burden resulting from the proposals relating to security-based swap clearing agencies) − 90 hours (one-time paperwork burden for security-based swap clearing agencies) = 672 hours.

SEF, SBS exchange, or SBS exchange facility to collect information on ownership and voting rights on a quarterly basis. Accordingly, the Commission preliminarily estimates that each SB SEF, SBS exchange, or SBS exchange facility would request information approximately 4 times per year from approximately 20 participants or members.

The Commission estimates that the preparation and sending of each of the 4 requests for information would require approximately 4 hours, and reviewing the responses to each of the 4 requests for information would require 10 hours. This would result in a total annual reporting and recordkeeping burden of 56 hours ((4 requests × 4 hours) + (4 requests × 10 hours)) for each SB SEF, SBS exchange, or SBS exchange facility, as applicable, and a total annual burden for all SB SEFs, SBS exchanges, and SBS exchange facilities of 1,960 hours (56 hours × 35 respondents). The Commission preliminarily estimates that each participant or member would require 1 hour to prepare and send the response to the request, for a total annual reporting and recordkeeping burden for each participant or member of 4 hours (4 requests × 1 hour) and a total annual burden for all participants or members of 2,800 hours (700 participants or members × 4 hours). The Commission requests comment on these estimates.

The Commission preliminarily believes that the collection of information burden imposed by proposed Rule 702(e) under Regulation MC would be minimal. The Commission estimates that a representative of the Board of a SB SEF or SBS exchange would spend no more than one hour to complete the required notice to the Commission. This figure includes the time to prepare, review, and electronically submit such notice to the Commission. The Commission expects to establish an electronic mailbox for these notices and would identify the address if the Commission were to adopt this specific proposal. Although the Commission preliminarily believes that the Board of a SB SEF or SBS exchange often would adopt or implement the recommendations of its ROC, the Commission preliminarily believes that the Board of a SB SEF or SBS exchange could occasionally decide not to adopt such recommendations. Although the Commission expects that this would be an infrequent occurrence, the Commission preliminarily estimates that a Board could decide not to adopt a ROC recommendation up to 12 times per year. This estimate assumes that the Board of a SB SEF or SBS exchange would meet at least once per month and would decide each time that it meets not to adopt a ROC recommendation. Therefore, the Commission estimates that the total reporting burden under the proposed Rule 702(e) for all SB SEFs and SBS exchanges combined would be 420 hours.[196]

The Commission estimates that the total paperwork burden resulting from the proposals relating to SB SEFs, SBS exchanges or SBS exchange facilities is 5,705 for an initial paperwork burden and 5,180 thereafter.[197]

E. Retention Period of Recordkeeping Requirements

1. Security-Based Swap Clearing Agencies

Security-based swap clearing agencies will be required to be registered with the Commission following the effective date of Title VII of the Dodd-Frank Act.[198] Accordingly, once registered with the Commission, security-based swap clearing agencies would be required to retain any collection of information pursuant to proposed Rules 701(a) or (b) under Regulation MC as applicable, in accordance with, and for the periods specified in Rule 17a–1 under the Exchange Act.[199] Retention and recordkeeping requirements have not been established for security-based swap clearing agencies before the effective date of Title VII; however, security-based swap clearing agencies may be required to retain records and information collected pursuant to proposed Rules 701(a) or (b) similar to the current recordkeeping requirements in Rule 17a–1.

2. SB SEFs, SBS Exchanges, and SBS Exchange Facilities

Although recordkeeping and retention requirements have not yet been established for SB SEFs under new Exchange Act provisions added by the Dodd-Frank Act, the Commission is authorized to adopt such rules.[200] In addition, the recordkeeping and reporting core principle applicable to SB SEFs, as set forth in Section 763(c) of the Dodd-Frank Act, requires a SB SEF to maintain records of all activities relating to the business of the facility, including a complete audit trail, in a form and manner acceptable to the Commission for a period of five years.[201] Therefore, for purposes of this PRA, the Commission assumes that a SB SEF would be required to retain any collection of information pursuant to proposed Rules 702(c) and 702(e) under Regulation MC, as applicable, for a period of not less than five years. Should the Commission propose rules to implement the recordkeeping and reporting core principle for SB SEFs, it would include any collection of information burden with respect to any proposed recordkeeping and retention rules for SB SEFs in such rulemaking.

All registered national securities exchanges must currently comply with the recordkeeping and reporting requirements in Rule 17a–1 under the Exchange Act.[202] Therefore, SBS exchanges would be required to retain any collection of information pursuant to proposed Rules 702(c) and 702(e), as applicable, in accordance with, and for the periods specified in, Rule 17a–1 under the Exchange Act.

F. Collection of Information Is Mandatory

1. Security-Based Swap Clearing Agencies

The collection of information under proposed alternative Rules 701(a) and (b) under Regulation MC would be

[196] (20 (estimated number of SB SEFs subject to the collection of information under the proposed Rule 702(e)) + 15 (estimated number of SBS exchanges subject to the collection of information under the proposed Rule 702(e))) × 12 (estimated number of notices prepared annually by each SB SEF pursuant to the proposed Rule 702(e)) × 1 hour (estimate of total time to complete, review, and prepare required notice) = 420 hours.

[197] The aggregate initial paperwork burden is calculated as follows: 525 hours (one-time paperwork burden for SB SEFs, SBS exchanges and SBS exchange facilities to establish rules to divest any ownership interest in excess of, and to not give effect to any portion of voting interests in excess of, the proposed 20% limit) + 1,960 hours (annual burden for SB SEFs, SBS exchanges and SBS exchange facilities to prepare and send requests for ownership and voting information) + 2,800 hours (annual burden for participants to prepare and send responses to requests for ownership and voting information) + 420 hours (annual burden for SB SEFs and SBS exchanges to prepare and submit notices pursuant to proposed Rule 702(e)(2)) = 5,705 hours. After the initial year, the paperwork burden is calculated as follows: 5,705 hours (total paperwork burden resulting from the proposals relating to SB SEFs, SBS exchanges and SBS exchange facilities)—525 hours (one-time paperwork burdens for SB SEFs, SBS exchanges and SBS exchange facilities) = 5,180 hours.

[198] New Exchange Act Section 17A(g) provides that it shall be unlawful for a clearing agency, unless registered with the Commission, directly or indirectly to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a clearing agency with respect to a security-based swap. 15 U.S.C. 78q–1(g).

[199] 17 CFR 240.17a–1.

[200] As discussed above, Section 763(c) of the Dodd-Frank Act sets forth 14 core principles that SB SEFs must satisfy, including one relating to recordkeeping and reporting, and provides the Commission with rulemaking authority with respect to implementation of these core principles. *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c).

[201] *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c).

[202] 17 CFR 240.17a–1.

mandatory. The collection of information under proposed Rules 701(a) and (b) would be required from participants in a security-based swap clearing agency upon request from the security-based swap clearing agency. The collection of information would allow the security-based swap clearing agency and the Commission to determine whether the requirements in proposed Rules 701(a) and (b) regarding limitations on voting interests are met.

2. SB SEFs, SBS Exchanges, and SBS Exchange Facilities

The collection of information under proposed Rule 702(c) under Regulation MC would be mandatory. The collection of information would allow the SB SEF, SBS exchange, or SBS exchange facility as applicable, and the Commission to determine whether the requirements in proposed Rule 702(c) regarding limitations on ownership and voting rights are met and enable the SB SEF, SBS exchange, or SBS exchange facility, as applicable, to take necessary action if the ownership or voting rights by a participant or group of participants exceed those allowed under proposed Rule 702(b).

The collection of information under proposed Rule 702(e) under Regulation MC would be mandatory and permit the Commission to collect accurate information about the regulatory program of SB SEFs and SBS exchanges. Specifically, the collection of information would allow the Commission to stay informed about the recommendations of the ROC that are not followed by the SB SEF or SBS exchange and the SB SEF's or SBS exchange's reasons for not adopting such recommendations.

G. Responses to Collection of Information Will Not Be Kept Confidential

1. Security-Based Swap Clearing Agencies

Other than information for which a security-based swap clearing agency requests confidential treatment and which may be withheld from the public in accordance with the provisions of 5 U.S.C. 522, the collection of information pursuant to the proposed Rules 701(a) and (b) would not be confidential and would be publicly available.

2. SB SEFs, SBS Exchanges, and SBS Exchange Facilities

Other than information for which a SB SEF, SBS exchange or SBS exchange facility requests confidential treatment and which may be withheld from the public in accordance with the provisions of 5 U.S.C. 522, the collection of information pursuant to the proposed Rules 702(c) and (e) would not be confidential and would be publicly available.

H. Request for Comment

Pursuant to 44 U.S.C. 3505(c)(2)(B), the Commission solicits comment to:

1. Evaluate whether the proposed collection of information is necessary for the performance of the functions of the agency, including whether the information shall have practical utility;

2. Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information;

3. Enhance the quality, utility, and clarity of the information to be collected; and

4. Minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, OMB, Room 3208, New Executive Office Building, Washington, DC 20503; and (2) Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE., Washington, DC 20549–1090 with reference to File No. S7–27–10. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The Commission has submitted the proposed collection of information to OMB for approval. Requests for the materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–27–10, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, Station Place, 100 F Street, NE., Washington, DC 20549–0213.

X. Cost-Benefit Analysis

Congress has required the Commission to implement rules under Section 765 of the Dodd-Frank Act to mitigate conflicts of interest in the security-based swaps market. The proposed rules under Regulation MC are designed to enhance, through mitigation of conflicts of interest, the benefits of having security-based swaps cleared through a security-based swap clearing agency and traded on a SB SEF or SBS exchange. The proposed rules, however, are also likely to impose costs on security-based swap clearing agencies, SB SEFs, and SBS exchanges. The Commission is sensitive to the costs and benefits that would result from the proposed rules and has identified certain costs and benefits of these proposals, as described below.

A. Background

The proposed governance and ownership and voting rules are intended to reduce conflicts of interest in security-based swap clearing agencies, SB SEFs, and SBS exchanges. Ownership and voting limitations and other governance rules are designed to limit the influence of any single market participant or a group of participants in the operation of security-based swap clearing agencies, SB SEFs, and SBS exchanges and thus reduce the risk that conflicts of interest would negatively affect the operation of these entities and the security-based swaps market.[203] However, since the OTC swaps marketplace regulated under Title VII likely would change significantly after the effective date of the Dodd-Frank Act and the Commission's rules promulgated thereunder, it is difficult to quantify the costs and benefits that the proposed rules may create. These issues are discussed more fully below.

B. Security-Based Swap Clearing Agencies

The Commission has granted exemptions from Section 17A of the Exchange Act to five entities to act as clearing agencies for security-based swaps.[204] The first cleared CDS transaction pursuant to the exemptive orders was cleared on March 9, 2009. Security-based swap clearing is, therefore, in an emergent stage and empirical evidence on how the security-based swaps market will develop following the effective date of the Dodd-Frank Act and rules thereunder is scarce. However, the number of security-based swap clearing agencies may converge in the long run to a very small number or even a single security-based swap clearing agency.[205] This is

[203] The Commission pursuant to Section 36 of the Exchange Act may grant an exemption from any rule or any provision of any rule under Regulation MC. Any such exemption could be subject to conditions and could be revoked by the Commission at any time. *See supra* Section VI for a discussion of the Commission's exemptive authority under Section 36 of the Exchange Act.

[204] *See* CDS Clearing Exemption Orders, *supra* note 17.

[205] *See, e.g.,* Darrell Duffie and Haoxiang Zhu, "Does a Central Clearing Counterparty Reduce Counterparty Risk?" Stanford University Working Paper, March 2010; Craig Pirrong, 2009, "The

because of the potential for efficiency gains through convergence given that central clearing of securities is characterized by large fixed costs and benefits to participants associated with consolidating portfolios. Alternatively, competitive forces may result in use of a larger number of security-based swap clearing agencies, particularly if the security-based swap clearing agencies specialize in clearing particular types of security-based swaps or if they clear security-based swaps only in certain jurisdictions.[206]

1. Costs and Benefits Related to Ownership Restrictions in Security-Based Swap Clearing Agencies

Restrictions on the voting interests held by clearing participants may affect the number of potential clearing participants and may also affect the level of their participation in clearing security-based swaps. The 20% individual voting limitation on security-based swap clearing agencies and the 40% aggregate voting limitation on security-based swap clearing agencies, under the proposed Voting Interest Focus Alternative, and the 5% individual voting limitation under the Governance Focus Alternative, are intended to keep participants from exercising undue influence over the security-based swap clearing agency and to lessen the likelihood of anti-competitive behavior. One particular concern is that without a limitation on voting interests, large dealers may control a security-based swap clearing agency and set standards—such as a heightened capital threshold for participation or a requirement that participants have execution capabilities—to limit participation by non-owner dealers or brokers and increase or protect their market share and potentially influence market prices. Hence, a potential benefit of voting limitations may be the preservation of non-owner dealers' access to central clearing and promotion of competition that results in lower costs to market participants. The proposed limitations in both the Voting Interest Focus Alternative and the Governance Focus Alternative are designed to achieve this result.

Another potential benefit of the imposition of a limitation on voting interests is the chance that a broader group of participants would have the ability to reduce their risk exposure as greater levels of central clearing is encouraged if the risks at the clearing agency are managed appropriately. Clearing agencies decrease systemic risk by mutualizing losses [207] and netting otherwise bilateral obligations. There may, however, at times be a trade-off between a clearing agency's risk management and its participation standards. It likely would be beneficial if the voting restrictions proposed by Rules 701(a) and (b) under Regulation MC in each of the Voting Interest Focus Alternative and the Governance Focus Alternative lead to increased market participation. Conversely though, to the extent that such market participation goes beyond prudent levels, it may create more systemic risk at the security-based swap clearing agency. For example, lessening capital requirements to increase participation beyond a prudent level may increase the overall risk of clearing operations, while increasing capital requirements for clearing members without an adequate basis may needlessly exclude some smaller dealers or other firms from participation and thereby create market inefficiencies.[208]

Non-participant shareholders may also have an incentive to permit more clearing agency participation than clearing agency participant shareholders would. Non-participant shareholders benefit from increased membership to the extent that additional revenues are generated and therefore have an incentive to promote increased use of central clearing both in terms of number of participants and the scope of products cleared. This could potentially reduce systemic risk by making more OTC products eligible for central clearing. In addition, non-shareholder participants have an incentive to promote appropriate risk management because a financial loss to the clearing agency would devalue their investment. For example, security-based swap clearing agencies may put their own capital or surplus funds at risk in the event of a default. In addition, clearing agencies face reputational risk associated with a member default that would likely negatively affect the value of shareholders' shares. This aligns the interests of shareholders with appropriate risk management of a clearing agency. However, non-participant shareholders may not face the same potential of downside risk as clearing agency participants. For example, non-participant shareholders do not bear certain costs associated with increased risk since the clearing agency losses are shared by the clearing agency participants. To the extent that non-participant shareholders use their control to maximize revenues of the clearing agency without full consideration of the total clearing agency risks, the potential cost is that suboptimal clearing agency participation standards will be developed. All directors have a fiduciary duty to the security-based swap clearing agency and its shareholders, however, they also have a duty to oversee the security-based swap clearing agency's compliance with the requirements in the Exchange Act and the rules and regulations thereunder. In certain circumstances, independent directors could give greater emphasis to profit-maximizing initiatives and fail to give sufficient consideration to the related risk management issues.

Another potential cost of ownership and voting limitations, notwithstanding the fact that the market structure may converge in the long-run to a single security-based swap clearing agency, is the potential effect on competition among alternative security-based swap clearing agency venues. Under the Voting Interest Focus Alternative, a 20% individual participant voting limit and a 40% aggregate participant voting limit restricts the ability of any single dealer or small group of dealers to own a security-based swap clearing agency, but it may also reduce the potential number of investors that would be willing to devote resources to form a security-based swap clearing agency. This potentially diminishes the likelihood for a long-term market structure with multiple clearing agencies. Conversely, the Governance Focus Alternative would not impose an aggregate cap and would allow the voting interests in a security-based swap clearing agency to be owned entirely by participants. This would facilitate the formation of security-based swap clearing agencies by potential users and promote greater competition among security-based swap clearing agencies.

In addition, if a participant is subject to restrictions regarding the amount of voting interest it may own in a security-based swap clearing agency, then it may forgo a potential investment opportunity, unless it is willing to invest in non-voting shares of the security-based swap clearing agency. The effect of these restrictions is

Economics of Clearing in Derivatives Markets: Netting, Asymmetric Information, and the Sharing of Default Risks Through a Central Counterparty," Working paper, University of Houston.

[206] The central clearing of security-based swaps is still developing and the Commission has not made any determinations about the number of security-based swap clearing agencies that may be used by market participants. However, it is important that emerging security-based swap clearing agencies have the opportunity to compete with existing security-based swap clearing agencies.

[207] *See, e.g.,* Ice Trust Overview, p. 7 (available at *https://www.theice.com/publicdocs/clear_us/ICE_Trust_Overview.pdf*).

[208] *See supra* Section II.A.2.a.

different with respect to individual participants under the Governance Focus Alternative, which limits any one participant's voting interest in a security-based swap clearing agency to 5%, than it is under the Voting Interest Focus Alternative, which limits any one participant's voting interests to 20% and has an aggregate voting interest limit of 40%. In the case of an ownership position in excess of regulator's restrictions, the owner would have to divest a portion of its voting shares in order to meet the regulatory requirement. The potential foregone benefits include profits generated from clearing activities that are distributed to owners as well as any private ownership benefits from directing the clearing operations, which include activities discussed above with respect to conflicts of interest. While it is difficult to assess the value of these investment opportunities, the 2010 six-month data from consolidated reports of condition and income from the Federal Financial Institutions Examinations Council of the largest security-based swap clearing agency provides a snapshot of the magnitude of current profits being generated.[209]

Moreover, as previously discussed in the PRA section, proposed Rules 701(a) and (b) under Regulation MC would require a security-based swap clearing agency to have an effective mechanism to obtain information relating to voting interests in the security-based swap clearing agency by any participant in the security-based swap clearing agency. It was estimated that these obligations would result in a total annual burden for all security-based swap clearing agencies of 336 hours plus a total annual reporting and recordkeeping burden for all participants of 336 hours. It was also estimated that there would be a 90 hour one-time paperwork burden for security-based swap clearing agencies to establish rules to divest any ownership interest in excess of the limit and not to give effect to any portion of the voting interests in excess of the limit. Assuming an hourly cost of $291 for a compliance attorney [210] to meet these requirements, this would result in an overall estimated initial annual cost of $221,742 and an annual cost thereafter of $195,552 for participants and security-based swap clearing agencies collectively.[211]

Under the Voting Interest Focus Alternative, proposed Rule 701(a) in Regulation MC would require the security-based swap clearing agency to have rules requiring a participant to divest voting interest greater than the 20% threshold and rules reasonably designed not to give effect to a voting interest of a participant greater than the 20% threshold or voting interests of participants considered in the aggregate with any other participants greater than the 40% threshold. This proposed rule would impose a cost on the security-based swap clearing agency to initiate the divestiture or not give effect to the voting rights that surpass the stated threshold. Particularly in the case of the aggregate participant voting limitation, the security-based swap clearing agency would have to develop standards regarding how to allocate the voting interest for which it will give effect if the aggregate voting interest is above the 40 percent threshold.

Similarly, under the Governance Focus Alternative, proposed Rule 701(b) in Regulation MC would impose a cost on the security-based swap clearing agency to require the divestiture or not give effect to the voting rights that surpass the stated threshold of 5 percent. However, because there is not a proposed limit on participants' aggregate voting interests under the Governance Focus Alternative, the security-based swap clearing agency would not have to adopt rules for allocating voting interests in the case of a divestiture.

2. Costs and Benefits Related to Independence Requirements for Security-Based Swap Clearing Agencies

Potential conflicts of interest also exist between participants of a security-based swap clearing agency and the public interest. Even when the influence of any single dealer is limited through voting restrictions, economic incentives could align several dealer participants in a way that may be costly to investors. For instance, in order for a product to be required to trade through an SB SEF or SBS exchange, it must be deemed eligible for clearing at a clearing agency. A dealer-controlled security-based swap clearing agency may have an incentive to limit the products deemed eligible for clearing because then such a product would remain viable in the OTC markets, in which the dealers have a significant financial stake.[212] Products that are eligible for clearing that are not cleared do not have the price transparency or investor accessibility that they would otherwise have, increasing market participant costs paid by investors. As a result, there are potential incentives for security-based swap clearing agency participants to coordinate in ways that voting restrictions cannot address. Representation by independent directors would provide views and influence that by design are not subject to these conflicts.

Proposed Rule 701(b)(3) in Regulation MC of the Governance Focus Alternative would require that a majority of directors must be independent. As a result, participants could not directly control the Board regardless of their voting interests. To further the goal of majority independence on the Board, proposed Rule 701(b)(4) under Regulation MC in the Governance Focus Alternative would require a security-based swap clearing agency to establish a nominating committee composed solely of independent directors. Since many of the Board decisions come from committees and conflicts may be prevalent or even more pronounced in these situations, proposed Rule 701(b)(5) under Regulation MC in the Governance Focus Alternative would require that if any committee, including but not limited to a risk committee, has authority to act on behalf of the Board, that committee must also be composed of a majority of independent directors. This would help prevent important decisions from escaping the view of a majority of independent directors. To the extent that independent directors reduce the likelihood that one group of participants coordinate decision-making in such a way that is detrimental to the security-based swap clearing agency as a whole, it would serve to benefit the security-based swap clearing agency and the market generally.

The Voting Interest Focus Alternative would require 35%, rather than a majority, of the Board be composed of independent directors. While director independence is widely believed to be a catalyst for improved governance, there is no conclusive empirical evidence to support the view that a majority of independent directors benefits shareholder profits.[213] It also is often argued that the presence of inside

[209] ICE Trust's profits for the first six months of 2010 were $1,325,000, which would represent an annual profit of $2,650,000. FFIEC Central Data Repository's Public Data Distribution, *https://cdr.ffiec.gov/public/Default.aspx.*

[210] The hourly rate for the compliance attorney is from SIFMA's *Management & Professional Earnings in the Securities Industry 2009,* modified by the Commission's staff to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[211] Overall initial annual cost for participants and clearing agencies information requirements = (336 hours + 336 hours + 90 hours) × $291 = $221,742. Overall subsequent annual cost for participants and clearing agencies information requirements = (336 hours + 336 hours) × $291 = $195,552.

[212] *See, generally,* Darrell Duffie, "How Should We Regulate Derivatives Markets?" Pew Financial Reform Project, Briefing Paper #5, 2009.

[213] However, the Commission recognizes that the industry widely accepts a majority of independent directors as "best practices." *See supra* note 122.

affiliated board members is important in facilitating the flow of material information to independent directors so that they may come to informed decisions.[214] This may be especially important for a security-based swap clearing agency because it provides highly specialized and technical services. The imposition of a Board structure that precludes the likely owners of a security-based swap clearing agency—dealers—from gaining a majority may have a negative effect on the operations of the security-based swap clearing agency if independent directors do not have commensurate qualifications or skills as participant directors. There could be significant costs associated with educating independent directors about the clearance and settlement process and the complex risk management issues that must be considered by the Board. This could slow the Board or committee processes, at least initially. Clearing and settlement is a highly specialized area and it may be difficult to find independent directors with relevant experience. As a result, independent directors may defer to industry directors or to the officials of the clearing agency, who have more knowledge and experience, thereby undermining the benefits of requiring independence.

In the context of wholly independent committees, such as a nominating committee, the independent directors may become reliant on executive directors and other employees of the security-based swap clearing agency to inform their decision-making due to their lack of expertise in clearing and settlement. If management fails to keep the directors on wholly independent committees fully informed, the independent directors on such committees fail to seek sufficient information from management to make informed decisions, or management fails to give independent directors adequate resources to make effective decisions, there could be costs to the security-based swap clearing agency. On the other hand, if management fully apprises the directors on wholly independent committees of necessary information and the independent directors have sufficient resources and are fully engaged with respect to their duties, there would be benefits to the security-based swap clearing agency.

In addition, the effectiveness of the Board can depend on the personalities and personal traits, as well as the qualifications, of the persons serving on the Board. Independent directors that take the time to understand the operations and programs of a security-based swap clearing agency and to ask probing questions of management are more likely to be effective independent directors. However, independent directors would unlikely be able to acquire the specific risk management expertise related to clearance and settlement if they do not have relevant experience prior to serving on the Board. In addition, because independent directors would not be employed by or participants in the security-based swap clearing agency, they may often need to rely on management or other directors to keep fully informed. There could be costs to the security-based swap clearing agency if one or more independent directors is ineffectual because he or she did not fully understand the operations or risk management procedures of the security-based swap clearing agency. Thus, imperfect decisions by independent directors could result in costs to the security-based swap clearing agency. This may potentially be more likely where the majority of the Board is required to be independent. On the other hand, independent directors who have relevant expertise, are engaged in carrying out their director duties, and who grasp the issues confronting the security-based swap clearing agency could be very beneficial to the security-based swap clearing agency because they could bring an outside perspective and fresh insights and ideas to the security-based swap clearing agency.

The proposed governance requirements under both the Voting Interest Focus Alternative and the Governance Focus Alternative could impose other costs on security-based swap clearing agencies. An entity that plans to register as a security-based swap clearing agency may need to revise the composition of its Board if the Board currently is not composed of 35% or a majority of independent directors. Moreover, security-based swap clearing agencies may have to restructure their nominating committees as well as other committees that are authorized to act for the Board. In this regard, security-based swap clearing agencies could face difficulties locating qualified individuals to serve as independent directors, particularly because security-based swaps trading is complex and the pool of qualified candidates may be limited. There also may be costs in educating independent directors to become familiar with the manner in which these security-based swaps are traded and the new regulatory structure governing security-based swaps, which could slow Board processes at least initially. These costs would be greater under the Governance Focus Alternative, which requires a higher percentage of independent directors on the Board and on the committees.

The proposed governance requirements could impose other costs on security-based swap clearing agencies. A security-based swap clearing agency may incur costs as a result of the requirement to include 35% or a majority of independent directors on its Board and a similar or heightened requirement with respect to committees authorized to act on behalf of the Board. Any such costs are likely to be incurred in connection with conducting a search for independent directors with the necessary qualifications and expertise to serve on the Board of a security-based swap clearing agency. The actual cost for each security-based swap clearing agency may vary based on the current governance arrangements and practices of the security-based swap clearing agencies. In addition, if a security-based swap clearing agency is required to conduct a search for independent directors, the costs incurred by the security-based swap clearing agency may vary based on whether it has the resources to conduct its own search or has to retain an outside consultant. The Commission preliminarily estimates that those security-based swap clearing agencies that must rely on a recruitment specialist to secure an independent director could incur a cost of approximately $68,000 per director.[215]

C. SB SEFs and SBS Exchanges

Currently, there are no trading venues that are registered with the Commission as SB SEFs, and no national securities exchanges that currently post or make available for trading security-based swaps. Based on the Dodd-Frank Act's definition, a SB SEF could include a trading platform with participating dealers.[216] SB SEFs are conceptually

[214] *See* M. Harris and A. Raviv, 2007, "A Theory of Board Control and Size," The Journal of Finance; R. Adams and D. Fererria, 2008, "A Theory of Friendly Boards," The Journal of Finance, vol. 62(1) pp. 217–250.

[215] The Commission is basing this estimate on a recent study noting that the retainer fee for outside directors is on average $67,624. *See http://www.hewittassociates.com/_MetaBasicCMAssetCache_/Assets/Articles/2010/2010_Outside_Director_Compensation.pdf*. The Commission believes that this amount could serve as a proxy for the amount of any fee to be charged by a recruitment firm that would conduct a national search for an independent director.

[216] Section 763(c) of the Dodd-Frank Act sets forth 14 core principles that SB SEFs must satisfy and provides the Commission with rulemaking authority with respect to implementation of these core principles. The Commission expects to address the issue of what is a SB SEF in a separate rulemaking under Section 763(c) of the Dodd-Frank

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similar to alternative trading systems and national securities exchanges in the equity and options markets and designated contract markets in the futures markets in that they will provide a centralized trading facility for the trading of security-based swaps. To the extent that SB SEFs would organize and form in a similar manner to these structures, the Commission preliminarily anticipates that SB SEFs and SBS exchanges would be significantly more competitive than security-based swap clearing agencies. In particular, barriers to entry in terms of capital are likely to be lower, and many existing dealers, national securities exchanges and other entities of various sizes currently have electronic trading capabilities that could allow them to enter this market readily.

1. Costs and Benefits Related to Ownership Requirements of SB SEFs and SBS Exchanges

The 20% ownership and voting limits contained in proposed Rule 702(b) under Regulation MC would prohibit any SB SEF participant or SBS exchange member or small group thereof from owning or otherwise controlling any class of voting securities or other interests of a SB SEF, SBS exchange or SBS exchange facility, as applicable. The intent of this requirement, as with security-based swap clearing agencies, is to limit the influence of any single dealer or a small group of dealers in a single SB SEF, SBS exchange or SBS exchange facility and thus reduce the likelihood that smaller non-owner dealers would be unfavorably treated and the ability of dealer-owners to influence market prices of security-based swaps. It is hard to predict, however, what entities will be SB SEFs or SBS exchanges or whether there will be any market power from owning or controlling a SB SEF or SBS exchange as discussed above. If the concern, as with central clearing, is that a single SB SEF or SBS exchange emerges as the dominant trading platform, then ownership and voting restrictions may be an important consideration. For example, the NYSE was the dominant exchange for trading equity securities for a long period, and even today U.S. futures markets are characterized by a dominant exchange connected to a single clearing agency.

However, evidence from the current cash equity and options markets shows that several trading platforms with different business models and clienteles often emerge.[217] Hence, SB SEFs, SBS exchanges, and SBS exchange facilities that are controlled by a single dealer may not necessarily result in unfair trading practices if market participants have alternative comparable venues to execute the same security-based swaps and those venues are able to compete effectively with single dealer platforms. Allowing SB SEFs, SBS exchanges and SBS exchange facilities that are controlled by a single dealer may in fact increase the level of competition, which would benefit investors. A 20% restriction on ownership of voting securities could require a dealer to partner with either other dealers or a non-dealer majority owner, or to hold a non-voting ownership interest, which could reduce incentives to start up a new venue, potentially limiting innovative alternatives to security-based swap execution and security-based swap products.[218]

The Commission anticipates that the proposed ownership and voting limitations may impose costs on SB SEFs, SBS exchanges and SBS exchange facilities. Entities planning to register as SB SEFs and SBS exchanges would have to ensure that they are in compliance with the proposed ownership and voting limitations and thus would need to spend time and incur costs to design or modify their ownership structure and internal processes, as well as take the necessary steps to draft or amend their governing documents and rules to comply with such ownership and voting limitations. Designing or modifying internal processes and drafting or revising governing documents and rules would impose costs on SB SEFs, SBS exchanges and SBS exchange facilities. The Commission estimates that it would take a compliance attorney approximately 15 hours to revise the relevant governing documents and to file them with the appropriate authorities. Assuming an hourly cost of $291 for a compliance attorney,[219] these requirements would result in an overall annual cost per SB SEF, SBS exchange or SBS exchange facility of $4,365, or $152,775 in the aggregate for all SB SEFs, SBS exchanges, and SBS exchange facilities.[220]

As previously discussed in the PRA section, proposed Rule 702(c) would require SB SEFs, SBS exchanges, or SBS exchange facilities, as applicable, to have an effective mechanism to obtain information relating to ownership and voting interest in the SB SEF, SBS exchange, or SBS exchange facility, by any participant or member of the SB SEF, SBS exchange or SBS exchange facility.[221] It was estimated that these obligations would result in a total annual burden for all SB SEFs, SBS exchanges, and SBS exchange facilities of 1,960 hours. It was also estimated that there would be a total annual reporting and recordkeeping burden for all participants or members of 2,800 hours. Assuming an hourly cost of $291 for a compliance attorney [222] to meet these requirements, this would result in an overall annual cost of $1,385,160 for participants or members and SB SEFs, SBS exchanges, and SBS exchange facilities collectively.[223] To the extent that certain participants or members may be required to file ownership or voting information with a domestic or international government authority pursuant to securities laws, and such information is made available to the SB SEF, SBS exchange, or SBS exchange facility, this cost would be reduced.

Proposed Rule 702(c) under Regulation MC also would require a SB SEF, SBS exchange or SBS exchange facility to have rules to divest a participant or member of an ownership interest that violates the proposed ownership limits, and to not give effect to a voting interest of a participant or member that violates the proposed voting limits. As previously discussed in the PRA section, this requirement is estimated to result in an initial paperwork burden for all SB SEFs, SBS exchanges, or SBS exchange facilities of 525 hours. Assuming an hourly cost of $291 for a compliance attorney [224] to meet these requirements, this would

Act. *See* Section 763(c) of the Dodd-Frank Act, Public Law 111–203, Section 763(c).

[217] For example, there are currently 15 registered national securities exchanges with varying platforms and business models that compete for clients and order flow in the equities and/or options markets.

[218] As noted above, Section 763(c) of the Dodd-Frank Act sets forth 14 core principles that SB SEFs must satisfy, including one relating to conflicts of interest, and provides the Commission with rulemaking authority with respect to implementation of these core principles. The Commission may determine that it is appropriate to propose additional rules to mitigate conflicts of interest with respect to SB SEFs, including incorporating ownership and/or voting limits and other requirements with respect to ownership of a SB SEF by persons other than SB SEF participants. The Commission also may consider proposals such as providing for the fair representation of SB SEF participants in the selection of the SB SEF's directors and the administration of its affairs as part of its broader rulemaking relating to SB SEFs.

[219] *See supra* note 210.

[220] Overall annual cost per SB SEF, SBS exchange, or SBS exchange facility = 15 hours × $291 = $4,365; aggregate annual cost for all SB SEFs, SBS exchanges, and SBS exchange facilities = $4,365 × 35 = $152,775.

[221] *See supra* Section IX.

[222] *See supra* note 210.

[223] Overall annual cost for participants or members and SB SEFs, SBS exchanges and SBS exchange facilities = (1,960 hours + 2,800 hours) × $291 = $1,385,160.

[224] *See supra* note 210.

result in an initial cost of $152,775 for all SB SEFs, SBS exchanges, and SBS exchange facilities.[225]

This proposed rule also would impose costs on SB SEFs, SBS exchanges, or SBS exchange facilities to initiate the divestiture or not give effect to the voting rights that surpass the stated threshold. For example, a SB SEF, SBS exchange, or SBS exchange facility could incur costs involved with redeeming shares held in excess of the proposed limits if such entity chooses to provide in its rules that any such excess shares would be purchased by the entity. A SB SEF, SBS exchange, or SBS exchange facility also could adopt rules to limit voting by any participant or member that owns more than 20% of outstanding interests. Thus, a SB SEF, SBS exchange, or SBS exchange facility also could incur costs associated with monitoring votes cast at any shareholder meeting to determine that no SB SEF participant or SBS exchange member and its related persons subject to the voting limits exceeds those limits.

The Commission recognizes that entities that are currently in existence and plan to become SB SEFs, SBS exchanges or SBS exchange facilities could incur costs if they do not meet the proposed ownership and voting limitations. For example, if a single or small group of market participants that would be direct participant(s) in a SB SEF plans to register a platform as a SB SEF, it or they potentially would need to secure additional owners to meet the 20% limitation on ownership of voting securities of a SB SEF. This could impose costs on an entity that has a single owner-participant or a small number of owner-participants and that plans to register a platform as a SB SEF, from the costs of finding other owners or the sharing of potential profits with a larger group of owners. As noted above, currently there are no trading venues that are registered with the Commission as SB SEFs. Based on initial discussions with market participants that have indicated an interest in registering as a SB SEF, the Commission preliminarily believes that few entities that may register as a SB SEF currently have ownership structures that would conflict with the proposed ownership and voting limitations for SB SEFs. In addition, as discussed above, national securities exchanges that may potentially register as SBS exchanges or create a facility that will be a SBS exchange facility should already be in compliance with the proposed ownership and voting limitations. Based on these factors, the Commission preliminarily believes that the aggregate costs imposed by the ownership and voting limitations on entities initially seeking to register as SB SEFs, SBS exchanges or SBS exchange facilities would not be significant.

2. Costs and Benefits Related to Independence Requirements in SB SEFs and SBS Exchanges

Proposed Rule 702(d) under Regulation MC would require the Boards of SB SEFs and SBS exchanges or SBS exchange facilities to be composed of at least a majority of independent directors to mitigate conflicts of interest and help ensure that the entity does not advance the interests of its owners, some of which may be dealer-participants or their affiliates. By mandating a structure that would require a majority of Board members to be independent, the governance of SB SEFs, SBS exchanges and SBS exchange facilities should be less susceptible to promoting the self-interests of such participants. The majority independent directors should help foster a greater degree of independent decision-making consistent with the objectives of the Dodd-Frank Act and the Exchange Act. Further, a Board whose independent directors constitute at least a majority of the Board should help ensure that the views of independent directors are taken into account and should help strengthen the hand of independent directors when dealing with management. In the Commission's preliminary view, requiring the Boards of SB SEFs, SBS exchanges and SBS exchange facilities to have a majority of independent directors should help reduce the possibility of damaging conflicts of interest that otherwise might arise when persons who do not meet the definition of independent director at the SB SEF, SBS exchange or SBS exchange facility are involved in key decisions, such as which products will be made available for trading and the access levels of potential market participants. To the extent that independent directors would reduce the likelihood that one group of participants could coordinate decision-making in such a way that would be detrimental to the SB SEF, SBS exchange or SBS exchange facility as a whole, this would be a benefit.

In addition, proposed Rule 702(f) under Regulation MC would require that the nominating committee of a SB SEF, SBS exchange or SBS exchange facility be composed solely of independent directors. This proposed requirement should foster a process for nominating independent directors that would help to assure that such directors are independent and not likely to be unduly influenced by an owner of the SB SEF, SBS exchange or SBS exchange facility who is possibly a SB SEF participant-dealer or SBS exchange member or affiliate thereof. In addition, the requirement in proposed Rule 702(g) under Regulation MC that any committee that would have the authority to act on behalf of the Board be composed of a majority of independent directors is designed to prevent important decisions from escaping the view of a majority of independent directors. Many Board decisions come from committees and conflicts may be similarly prevalent or even more pronounced in these situations.

Proposed Rule 702(e) under Regulation MC also would require the Board of any SB SEF and SBS exchange to establish a ROC consisting solely of independent directors to oversee the entity's regulatory obligations.[226] The Commission preliminarily believes that this requirement should be effective in managing the conflicts of interest inherent in the Board's oversight of whether a SB SEF or SBS exchange satisfies its regulatory obligations. The proposed provision relating to the establishment of an independent ROC should help promote greater accountability on the part of SB SEFs and SBS exchanges with respect to the obligations placed on them by the Exchange Act, including as amended by the Dodd-Frank Act, and strengthen their ability to meet those obligations. A ROC composed solely of independent directors should result in a greater degree of objective decision-making with respect to the SB SEF's or SBS exchange's regulatory obligations. Vigilant and informed oversight by a strong, effective and independent ROC may increase investor confidence in the operation of SB SEFs and SBS exchanges, and the security-based swaps market generally. National securities exchanges that currently have a ROC composed of independent directors have noted the benefits of such a governance mechanism.[227] In

[225] This initial cost is estimated as follows: 15 hours × 35 respondents × $291 per hour = $152,775.

[226] Proposed Rule 702(e) under Regulation MC does not explicitly include SBS exchange facilities because the exchange whose facility posts or makes available for trading a security-based swap must itself establish the requisite ROC. *See supra* note 173.

[227] *See* CBOE Comment Letter, *supra* note 165 ("CBOE also implemented other changes that are similar to the proposals contained in the Release, for example establishing a Regulatory Oversight Committee, composed solely of public directors * * *. As a result, CBOE believes that its existing governance structure and practices serve not only to protect investors and the public interest and

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addition, requiring the Board to report promptly to the Commission any recommendation of the ROC that the Board does not implement should provide the Commission with information on a timely basis regarding the Board's decision not to take certain actions.

The governance proposals for SB SEFs, SBS exchanges and SBS exchange facilities would complement the proposed ownership and voting limits for these entities. Five or more dealer-participants or members could still own 100% of the voting securities of a SB SEF, SBS exchange or SBS exchange facility, as applicable, under the proposed voting and ownership limits. In addition, even when the influence of any single dealer is limited through ownership and voting restrictions, economic incentives can align several dealer participants in a way that may be costly to investors. As a result, there are potential incentives for SB SEF participant-dealers and SBS exchange member-dealers to coordinate in ways that ownership and voting restrictions could not address. Requiring independence on the Board and certain key Board committees should further reduce the ability of the participant-owners of the SB SEF or member-owners of the SBS exchange or SBS exchange facility to unduly influence decision-making at the Board level in a way that advances their interests. Representation by independent directors would provide views and influence that by design are not subject to these conflicts.

As noted in the discussion relating to security-based swap clearing agencies, while director independence is widely believed to be a catalyst for improved governance and the Commission recognizes that the industry widely accepts a majority of independent directors as "best practices," [228] there is no conclusive empirical evidence to support the view that a majority of independent directors benefits shareholder profits. However, the Model Business Corporation Act recognizes the important role of independent directors.[229]

The proposed governance requirements could impose costs on SB SEFs, SBS exchanges and SBS exchange facilities. Entities planning to register as SB SEFs and SBS exchanges may need to draft or amend their governing documents and design or modify their governance processes to comply with the proposed governance requirements, which would impose costs on SB SEFs, SBS exchanges and SBS exchange facilities. The Commission estimates that it would take a compliance attorney approximately 15 hours to revise the relevant governing documents and to file them with the appropriate authorities, for a total estimated cost per SB SEF, SBS exchange or SBS exchange facility of $4,365, or $152,775 in the aggregate for all SB SEFs or SBS exchanges, and SBS exchange facilities.[230]

An entity that plans to register as a SB SEF or a SBS exchange may need to revise the composition of its Board (or that of its SBS exchange facility, in the case of an exchange that posts or makes available for trading security-based swaps through a facility with a separate governance structure), if the Board currently is not composed of a majority of independent directors. SB SEFs and SBS exchanges or SBS exchange facilities also would need to establish wholly independent nominating committees, and SB SEFs and SBS exchanges would need to establish wholly independent ROCs. In this regard, SB SEFs, SBS exchanges and SBS exchange facilities could face difficulties in locating qualified individuals to serve as independent directors, particularly because security-based swaps trading is complex and some potential candidates may decline to serve as a director if they believe that they lack sufficient expertise.

The Commission preliminarily believes that the cost of securing independent directors to serve on the Board of the SB SEF, SBS exchange or SBS exchange facility could range from a relatively low cost for those entities that have the contacts and resources to be able to search for one or more independent directors on their own; to a moderate cost for those entities that can undertake the search on their own but would incur some expenditures, such as placing advertisements in national media; to a higher cost for those entities that must secure the services of a recruitment firm that specializes in the placement of independent directors. The Commission preliminarily estimates that those SB SEFs, SBS exchanges or SBS exchange facilities that must rely on a recruitment specialist to secure an independent director could incur a cost of approximately $68,000 per director.[231] The Commission preliminarily estimates that 10–20 entities could seek to register as SB SEFs and notes that there are 15 national securities exchanges; however, the number of Board members could vary widely among SB SEFs, SBS exchanges and SBS exchange facilities. Therefore, the Commission provides an estimate of a maximum recruitment cost of $68,000 per independent director.[232]

The imposition of a Board structure that precludes the likely participants in SB SEFs, SBS exchanges or SBS exchange facilities—dealers—from gaining a majority or having representation on certain Board committees may have a negative effect on the operations of the SB SEF, SBS exchange or SBS exchange facility if independent directors do not have commensurate qualifications or skills as affiliated directors or do not engage actively in their Board or committee duties. There could be costs in educating independent directors to become familiar with the manner in which security-based swaps are traded and in the new regulatory structure that would govern them, which could slow Board or committee processes at least initially. In addition, independent directors may yield to industry directors who have more knowledge and experience, thereby undermining the benefits of requiring independence. In the context of wholly independent committees, such as a nominating

assure the integrity of CBOE's regulatory activities, but also to enhance the ability of CBOE to develop and implement sound business strategies"); NYSE Comment Letter, *supra* note 165 ("As an important part of the reform process of 2003, the NYSE formalized the effective functional separation of regulatory programs from the competitive business functions, under a Chief Regulatory Officer ("CRO") reporting to a Regulatory Oversight Committee ("ROC") of the Board of Directors consisting of all independent directors * * *. We agree with the Commission that this structure, with a separate regulatory executive reporting to an empowered, qualified and independent board, amply funded and professionally staffed, assures the integrity of the regulatory process.")

[228] *See supra* note 122.

[229] MODEL BUS. CORP. ACT § 8.01(c) (4th ed. 2008).

[230] Assuming an hourly cost of $291 for a compliance attorney, the overall annual cost per SB SEF, SBS exchange or SBS exchange facility and aggregate cost for all SB SEFs, SBS exchanges, and SBS exchange facilities was calculated as follows: per entity annual cost = 15 hours × $291 = $4,365; aggregate annual cost = $4,365 × 35 = $152,775. *See supra* note 210.

[231] The Commission is basing this estimate on a recent study noting that the retainer fee for outside directors is on average $67,624. *See http://www.hewittassociates.com/_MetaBasicCMAssetCache_/Assets/Articles/2010/2010_Outside_Director_Compensation.pdf*. The Commission believes that this amount could serve as a proxy for the amount of any fee to be charged by a recruitment firm that would conduct a national search for an independent director.

[232] As discussed above, since 2004 when the Commission proposed rules to promote the fair administration and governance of, and to impose ownership and voting limitations on, national securities exchanges, a number of exchanges have adopted governance structures which meet many of the requirements of proposed Rule 702. Thus, the costs for complying with the proposed governance rules would be decreased for some SBS exchanges.

committee or ROC, the independent directors may become reliant on executive officers and other employees of the SB SEF or SBS exchange to inform their decision-making due to their lack of expertise in the industry. If management fails to keep the directors on wholly independent committees fully-informed, if the independent directors on such committees fail to seek sufficient information from management to make informed decisions or if management fails to give independent directors adequate resources to make effective decisions, there could be costs to the SB SEF, SBS exchange or SBS exchange facility. On the other hand, if management fully apprises the directors on wholly independent committees of necessary information and the independent directors have sufficient resources and are fully engaged with respect to their duties, there would be benefits to the SB SEF, SBS exchange or SBS exchange facility.

In addition, the effectiveness of majority independent Boards can depend on the personalities and personal traits, as well as the qualifications, of the persons serving on the Board. Independent directors that take the time to understand the operations and programs of a SB SEF, SBS exchange or SBS exchange facility and to ask probing questions of management are more likely to be effective independent directors. However, because independent directors would not be employed by the SB SEF, SBS exchange, or SBS exchange facility or be participants or members of such entity, they often may need to rely on management or other directors to keep them fully informed. There could be costs to the SB SEF, SBS exchange, or SBS exchange facility if one or more independent directors is ineffectual because he or she did not fully understand the operations of the SB SEF or SBS exchange, either because the independent directors did not take the necessary initiative or management failed to keep the independent directors fully apprised of information that would lead to their effective decision-making. Thus, imperfect decisions by independent directors could result in costs to the SB SEF, SBS exchange, or SBS exchange facility. On the other hand, independent directors who have expertise in areas that could be helpful to the SB SEF, SBS exchange or SBS exchange facility, who are engaged in carrying out their director duties, and who grasp the issues confronting the SB SEF, SBS exchange or SBS exchange facility could be very beneficial to the SB SEF, SBS exchange or SBS exchange facility because they could bring fresh insights and ideas to these entities.

Finally, under the proposed Rule 702(e)(2) under Regulation MC, SB SEFs and SBS exchanges would need to report promptly to the Commission any recommendation of the ROC that the Board does not adopt or implement, which would result in costs to SB SEFs and SBS exchanges. As discussed above, the Commission preliminarily estimates that the annual information collection burden for each SB SEF or SBS exchange under this provision of the proposed rules would be 12 hours.[233] Accordingly, the Commission's staff estimates that it would cost each SB SEF or SBS exchange $3,492 annually to comply with this provision of the proposed rules.[234]

D. Request for Comments

The Commission requests that commenters provide views and supporting information regarding the costs and benefits associated with the proposals. The Commission seeks estimates of these costs and benefits, as well as any costs and benefits not already identified. The Commission also requests comment regarding the relative costs and benefits of pursuing alternative regulatory approaches that are consistent with Section 765 of the Dodd-Frank Act. In addition, the Commission requests comment on whether other provisions of the Dodd-Frank Act for which Commission rulemaking is required are likely to have an effect on the costs and benefits of the proposed rules.

XI. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act[235] requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act[236] requires the Commission, when adopting rules under the Exchange Act, to consider the effect such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Security-based swaps are currently executed and traded in the OTC market, with five large commercial banks representing 97% of the total U.S. banking industry national amounts outstanding of derivatives.[237] The gross notional amount of CDS as of the end of 2009 was approximately $30 trillion.[238]

As discussed above, the Commission has granted exemptions to five entities to act as security-based swap clearing agencies for CDS.[239] Four of the exemptions are currently active. SB SEFs and SBS exchanges are expected to register to trade security-based swaps in connection with the implementation of rules under Title VII of the Dodd-Frank Act.

As discussed above, the intent of the ownership and voting limitations and governance proposed rules is to mitigate potential conflicts of interests of market participants in the clearing and trading of security-based swaps. These proposed rules may have a significant effect on the level of competition within the marketplace.

The voting restrictions on security-based swap clearing agencies that limit the influence of any single participant or group of participants could increase the level of competition at the participant level if they preserve access to central clearing and trading by other participants. Without these voting restrictions, it may be possible for a dominant participant owner to use its voting interest to set rules, fees, or capital requirements that engender an uncompetitive environment. For instance, a heightened capital threshold for participation might prevent some firms from qualifying as participants and thus deny them access to clearing. However, the proposed voting limitations among participants may also impede competition at the security-based swap clearing agency level, since

[233] *See supra* Section IX.D.

[234] 12 hours (estimated annual information collection burden for each SB SEF and SBS exchange) × $291 (hourly cost for a compliance attorney) = $3,492. The hourly rate for the compliance attorney is from SIFMA's *Management & Professional Earnings in the Securities Industry 2009,* modified by the Commission's staff to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[235] 15 U.S.C. 78c(f).

[236] 15 U.S.C. 78w(a)(2).

[237] *See* Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2010.

[238] Data available at *http://www.isda.org/statistics/pdf/ISDA-Market-Survey-results1987-present.xls.*

[239] *See* CDS Clearing Exemption Orders, *supra* note 17.

there are likely a limited number of firms with the expertise, resources and desire to have an ownership interest in a security-based swap clearing agency.[240]

As previously noted, evidence from the securities markets suggests that clearing agencies over the long-run tend to converge to a small number of entities or even a single entity. Clearing activities are characterized by high start-up costs and low marginal costs such that there are large economies of scale. For example, all trades executed on the eight U.S. based options exchanges are cleared at the Options Clearing Corporation, and trades executed on the U.S. equity markets, composed of exchanges, alternative trading platforms, and OTC trading, are cleared at the National Securities Clearing Corporation, a wholly-owned subsidiary of the Depository Trust and Clearing Corporation.[241] A single security-based swap clearing agency may also be more efficient in that it would facilitate the fungibility of contracts across multiple execution facilities and exchanges.

Whether the differences in the Voting Interest Focus Alternative and the Governance Focus Alternative would result in substantially different effects on efficiency, capital formation, and competition remains uncertain. Preliminarily, the Commission believes that the aggregate cap on participant voting interests may limit the formation of new clearing agencies and, consequently, limit the opportunity for competition among security-based swap clearing agencies. However, the aggregate cap under the Voting Interest Focus Alternative may also be more effective at mitigating conflicts of interest than the rules proposed under the Governance Focus Alternative, and could result in greater access to central clearing and a higher volume of security-based swap products made eligible for clearing. As discussed previously, central clearing would facilitate improved transparency, risk management, and competition in the security-based swaps market. This in turn should have a positive effect on efficiency, capital formation, and competition.

The Commission preliminarily believes that the start-up costs for a SB SEF, SBS exchange or SBS exchange facility, or for an existing national securities exchange to post or make available for trading security-based swaps, will be low. If a SB SEF, SBS exchange or SBS exchange facility would not provide the desired level of access to a market participant, and the start-up costs of setting up a competing SB SEF, SBS exchange or SBS exchange facility are low, then this would encourage the entrance of alternate trading venues for market participants and allow competition to discipline harmful practices by any single SB SEF, SBS exchange, or SBS exchange facility. However, if ownership restrictions are such that dealers must coordinate ownership among a group, then there may be fewer potential owners available, and thus there could be less incentive to form competing SB SEFs, SBS exchanges, or SBS exchange facilities. In this case, ownership limitations would impede competition.[242]

The proposed rules under Regulation MC relating to Board and committee independence may also increase the level of participant competition by making it more difficult for a small group of dealer-owners to influence a security-based swap clearing agency, SB SEF or SBS exchange even in light of the proposed ownership and voting restrictions. This is necessary because economic incentives could align the interests of participants against the interest of the security-based swap clearing agency, SB SEF or SBS exchange as a whole irrespective of whether those participants are owners. For example, if the Board of a dealer-controlled security-based swap clearing agency determines to refuse to clear a proposed security-based swap product, then such a product would not be required to be traded on a SB SEF or SBS exchange and would likely trade OTC, reducing price transparency and likely resulting in higher revenue for the dealers in the OTC market than if the product was available through a SB SEF, SBS exchange or SBS exchange facility. Majority independence requirements for the Board and committees that have the authority to act on behalf of the Board are an additional tool to address this potential conflict of interest. Given the size of the security-based swaps market and its non-competitive tendencies, the benefits with respect to efficiency and competition that ownership, voting, and director representation requirements would provide are likely to be substantial.

The Commission requests comment on the possible effects of the proposed rules under Regulation MC on efficiency, competition, and capital formation. The Commission requests that commenters provide views and supporting information regarding any such effects. The Commission notes that such effects are difficult to quantify. The Commission seeks comment on possible anti-competitive effects of the proposed rules under Regulation MC not already identified. The Commission also requests comment regarding the competitive effects of pursuing alternative regulatory approaches that are consistent with Section 765 of the Dodd-Frank Act. In addition, the Commission requests comment on how the other provisions of the Dodd-Frank Act for which Commission rulemaking is required will interact with and influence the competitive effects of the proposed rules under Regulation MC.

XII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[243] the Commission must advise the OMB as to whether proposed Regulation MC and the rules proposed thereunder constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation.

The Commission requests comment on the potential impact of proposed Regulation MC and the rules proposed thereunder on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

XIII. Regulatory Flexibility Act Certification

Section 603(a) of the Regulatory Flexibility Act[244] ("RFA") requires the Commission to undertake an initial regulatory flexibility analysis of the proposed rules under Regulation MC on small entities, unless the Commission certifies that the proposed rules, if adopted, would not have a significant economic impact on a substantial number of small entities.[245]

[240] The Commission pursuant to Section 36 of the Exchange Act may grant an exemption from any rule or any provision of any rule under Regulation MC. *See supra* Section VI.

[241] The central clearing of security-based swaps is still developing and the Commission has not made any determinations about the number of security-based swap clearing agencies that may be used by market participants.

[242] *See supra* note 240.

[243] Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[244] 5 U.S.C. 603(a).

[245] 5 U.S.C. 605(b).

A. Security-Based Swap Clearing Agencies

Proposed Rule 701 under Regulation MC would apply to all security-based swap clearing agencies. Four entities are currently exempt from registration as a clearing agency under section 17A of the Exchange Act to provide central clearing services for CDS, a class of security-based swaps.[246] The Commission believes, based on its understanding of the market, that likely no more than six security-based swap clearing agencies could be subject to the requirements of proposed Rule 701.

For purposes of Commission rulemaking in connection with the RFA, an issuer or person, other than an investment company, is a small business if its total assets on the last day of its most recent fiscal year were $5 million or less.[247] The Commission believes that the entities likely to register as security-based swap clearing agencies will not be small entities, but rather part of large business entities that have assets in excess of $5 million and total capital in excess of $500,000.[248]

B. SB SEFs

Proposed Rule 702 under Regulation MC would apply to all SB SEFs. In the Dodd-Frank Act, Congress defined for the first time what activity would constitute a SB SEF and mandated the registration of these new facilities. The Commission preliminarily believes that approximately 10 to 20 SB SEFs could be subject to the requirements of proposed Rule 702.

For purposes of Commission rulemaking in connection with the RFA, an issuer or person, other than an investment company, is a small business if its total assets on the last day of its most recent fiscal year were $5 million or less.[249] The Commission preliminarily believes that the entities likely to register as SB SEFs will not be considered small entities because most, if not all, of the SB SEFs will be part of large business entities, and that all SB SEFs will have assets in excess of $5 million.[250]

C. SBS Exchanges

Proposed Rule 702 under Regulation MC would apply to all SBS exchanges. All of the 15 currently registered national securities exchanges could become SBS exchanges, and therefore, subject to the requirements of Rule 702.[251]

For purposes of Commission rulemaking in connection with the RFA, a national securities exchange is a small business if it has been exempted from the reporting requirements of Rule 601 of Regulation NMS [252] (Dissemination of Transaction Reports and Last Sale Data with Respect to Transactions in NMS Stocks) and is not affiliated with any person (other than a natural person) that is not a "small business." [253] None of the currently registered national securities exchanges is a small entity. Therefore, the Commission preliminarily believes that none of the SBS exchanges will be considered small entities.

D. Certification

For the reasons stated above, the Commission certifies that the proposed rules under Regulation MC would not have a significant economic impact on a substantial number of small entities. The Commission requests comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities, including national securities exchanges, clearing agencies or other small businesses or small organizations that may register as SB SEFs, SBS exchanges or security-based swap clearing agencies, and provide empirical data to support the extent of the impact.

XIV. Statutory Basis and Rule Text

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.,* and particularly, Sections 3, 3D, 6, 11A, 17A, 19, and 23(a) thereof, and Section 765 of the Dodd-Frank Act, the Commission is proposing to adopt Regulation MC under the Exchange Act.

List of Subjects in 17 CFR Part 242

Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule Amendments

For the reasons stated in the preamble, the Commission is proposing to amend Title 17, Chapter II of the Code of the Federal Regulations as follows:

PART 242—REGULATIONS M, SHO, ATS, AC, NMS, AND MC AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. The authority citation for part 242 is amended by adding authorities for Sections 242.700, 242.701 and 242.702 to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78f, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78*l,* 78m, 78n, 78o(b), 78o(c), 78o(g), 78q–1, 78q(a), 78q(h), 78w(a), 78dd–1, 78mm, 80a–23, 80a–29, and 80a–37.

* * * * *

Section 242.700 is also issued under sec. 943, Public Law 111–203, Section 765.

Section 242.701 is also issued under sec. 943, Public Law 111–203, Section 765.

Section 242.702 is also issued under sec. 943, Public Law 111–203, Sections 763 and 765.

2. The part heading for part 242 is revised to read as set forth above.

3. Sections 242.700, 242.701 and 242.702 are added to read as follows:

§ 242.700 Definitions.

(a) The term *affiliate* means any person that, directly or indirectly, controls, is controlled by, or is under common control with, the person.

(b) The terms *beneficial ownership, beneficially owns* or any derivative thereof shall have the same meaning, with respect to any security or other ownership interest, as set forth in § 240.13d–3, as if (and whether or not) such security or other ownership interest were a voting equity security registered under section 12 of the Exchange Act (15 U.S.C. 78*l*); *provided that* to the extent any person beneficially owns any security or other ownership interest solely because such person is a member of a group within the meaning of section 13(d)(3) of the Exchange Act (15 U.S.C. 78m(d)(3)), such person shall not be deemed to beneficially own such security or other ownership interest for purposes of this section, unless such person has the power to direct the vote of such security or other ownership interest.

(c) The term *Board* means the Board of Directors or Board of Governors of the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any equivalent body.

(d) The term *clearing agency* has the same meaning as set forth in section 3(a)(23) of the Exchange Act (15 U.S.C. 78c(a)(23)).

(e) The term *control* means the possession, direct or indirect, of the

[246] *See* CDS Clearing Exemptions, *supra* note 17.

[247] 17 CFR 230.157. *See also* 17 CFR 240.0–10(a).

[248] Commission staff based this determination on its review of various public sources of financial information about the current registered clearing agencies and entities currently exempt from clearing agency registration under Section 17A of the Exchange Act.

[249] 17 CFR 230.157. *See also* 17 CFR 240.0–10(a).

[250] Commission staff based this determination on its review of various public sources of financial information about the entities likely to register as SB SEFs.

[251] *See supra* note 194.

[252] 17 CFR 242.601.

[253] 17 CFR 240.0–10(e).

power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. A person is presumed to control another person if the person:

(1) Is a director, general partner or officer exercising executive responsibility (or having similar status or functions);

(2) Directly or indirectly has the right to vote 25 percent or more of a class of voting securities or has the power to sell or direct the sale of 25 percent or more of a class of voting securities; or

(3) In the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25 percent or more of the capital.

(f) The term *director* means any member of the Board.

(g) The term *Exchange Act* means the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*).

(h) The term *facility* has the same meaning as set forth in section 3(a)(2) of the Exchange Act (15 U.S.C. 78c(a)(2)).

(i) The term *immediate family member* means a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home.

(j) The term *independent director* means:

(1) A director who has no material relationship with:

(i) The security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable;

(ii) Any affiliate of the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable;

(iii) A security-based swap execution facility participant, a member of a national securities exchange that posts or makes available for trading security-based swaps, or a participant in the security-based swap clearing agency, as applicable; or

(iv) Any affiliate of a security-based swap execution facility participant, a member of a national securities exchange that posts or makes available for trading security-based swaps, or a participant in the security-based swap clearing agency, as applicable.

(2) A director is not an independent director if any of the following circumstances exists:

(i) The director, or an immediate family member, is employed by or otherwise has a material relationship with the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof, or within the past three years was employed by or otherwise had a material relationship with the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof;

(ii) (A) The director is a security-based swap execution facility participant, a member of a national securities exchange that posts or makes available for trading security-based swaps, or a participant in the security-based swap clearing agency, as applicable, or within the past three years was employed by or affiliated with such participant or member or any affiliate thereof; or

(B) The director has an immediate family member that is, or within the past three years was, an executive officer of a security-based swap execution facility participant, a member of a national securities exchange that posts or makes available for trading security-based swaps, or a participant in the security-based swap clearing agency, as applicable, or any affiliate thereof;

(iii) The director, or an immediate family member, has received during any twelve month period within the past three years payments that reasonably could affect the independent judgment or decision-making of the director from the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof or from a security-based swap execution facility participant, a member of a national securities exchange that posts or makes available for trading security-based swaps, or a participant in the security-based swap clearing agency, as applicable, or any affiliate thereof, other than the following:

(A) Compensation for Board or Board committee services;

(B) Compensation to an immediate family member who is not an executive officer of the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof or of a security-based swap execution facility participant, a member of a national securities exchange that posts or makes available for trading security-based swaps, or a participant in the security-based swap clearing agency, as applicable, or any affiliate thereof; or

(C) Pension and other forms of deferred compensation for prior services, not contingent on continued service.

(iv) The director, or an immediate family member, is a partner in, or controlling shareholder or executive officer of, any organization to or from which the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof made or received payments for property or services in the current or any of the past three full fiscal years that exceed two percent of the recipient's consolidated gross revenues for that year, other than the following:

(A) Payments arising solely from investments in the securities of the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or affiliate thereof; or

(B) Payments under non-discretionary charitable contribution matching programs.

(v) The director, or an immediate family member, is, or within the past three years was, employed as an executive officer of another entity where any executive officers of the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, serve on that entity's compensation committee;

(vi) The director, or an immediate family member, is a current partner of the outside auditor of the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof, or was a partner or employee of the outside auditor of security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof who worked on the audit of the security-based swap execution facility or national securities exchange or facility thereof that posts or makes

available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof, at any time within the past three years; or

(vii) In the case of a director that is a member of the audit committee, such director (other than in his or her capacity as a member of the audit committee, the Board, or any other Board committee), accepts, directly or indirectly, any consulting, advisory, or other compensatory fee from the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or security-based swap clearing agency, as applicable, or any affiliate thereof or a security-based swap execution facility participant, a member of a national securities exchange that posts or makes available for trading security-based swaps, or a participant in the security-based swap clearing agency, as applicable, or any affiliate thereof, other than fixed amounts of pension and other forms of deferred compensation for prior service, provided such compensation is not contingent in any way on continued service.

(k) The term *major security-based swap participant* has the same meaning as set forth in section 3(a)(65) of the Exchange Act (15 U.S.C. 78c(a)(65)) or any rules or regulations thereunder.

(l) The term *material relationship* means a relationship, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the director.

(m) The term *member* has the same meaning as set forth in section 3(a)(3) of the Exchange Act (15 U.S.C. 78c(a)(30)).

(n) The term *national securities exchange* means any exchange registered pursuant to section 6 of the Exchange Act (15 U.S.C. 78f).

(o) The term *participant* when used with respect to a clearing agency has the same meaning set forth in section 3(a)(24) of the Exchange Act (15 U.S.C 78c(a)).

(p) The term *person* has the same meaning as set forth in section 3(a)(9) of the Exchange Act (15 U.S.C. 78c(a)(9)).

(q) The term *person associated with a member* has the same meaning as set forth in section 3(a)(21) of the Exchange Act (15 U.S.C. 78c(a)(21)).

(r) The term *person associated with a participant in a security-based swap clearing agency* means:

(1) Any partner, officer, director, or branch manager of such security-based swap dealer or major security-based swap participant (or any person occupying a similar status or performing similar functions);

(2) Any person directly or indirectly controlling, controlled by, or under common control with such security-based swap dealer or major security-based swap participant; or

(3) Any employee of such security-based swap dealer or major security-based swap participant. This term does not include any person associated with a participant in a security-based swap clearing agency whose functions are solely clerical or ministerial.

(s) The term *person associated with a security-based swap dealer or major security-based swap participant* has the same meaning as set forth in section 3(a)(70) of the Exchange Act (15 U.S.C. 78c(a)(70)) or any rules or regulations thereunder.

(t) The term *person associated with a security-based swap execution facility participant* means any partner, officer, director, or branch manager of such security-based swap execution facility participant (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such security-based swap execution facility participant, or any employee of such security-based swap execution facility participant.

(u) The term *related person* means:

(1) When used with respect to a security-based swap clearing agency:

(i) Any affiliate of a security-based swap clearing agency participant;

(ii) Any person associated with a security-based swap clearing participant;

(iii) Any immediate family member of a security-based swap clearing agency participant that is a natural person or any immediate family member of the spouse of such person, who, in each case, has the same home as the security-based swap clearing agency participant or who is a director or officer of the security-based swap clearing agency or any of its parents or subsidiaries; or

(iv) Any immediate family member of a person associated with a security-based swap clearing agency participant that is a natural person or any immediate family member of the spouse of such person, who, in each case, has the same home as the person associated with the security-based swap clearing agency participant or who is a director or officer of the security-based swap clearing agency or any of its parents or subsidiaries;

(2) When used with respect to a security-based swap execution facility:

(i) Any affiliate of a security-based swap execution facility participant;

(ii) Any person associated with a security-based swap execution facility participant;

(iii) Any immediate family member of a security-based swap execution facility participant or any immediate family member of the spouse of such person, who, in each case, has the same home as the security-based swap execution facility participant or who is a director or officer of the security-based swap execution facility or any of its parents or subsidiaries; or

(iv) Any immediate family member of a person associated with a security-based swap execution facility participant or any immediate family member of the spouse of such person, who, in each case, has the same home as the person associated with the security-based swap execution facility participant or who is a director or officer of the security-based swap execution facility or any of its parents or subsidiaries; and

(3) When used with respect to a national securities exchange or facility thereof that posts or makes available for trading security-based swaps:

(i) Any affiliate of a member of the national securities exchange that posts or makes available for trading security-based swaps;

(ii) Any person associated with a member of the national securities exchange that posts or makes available for trading security-based swaps;

(iii) Any immediate family member of a member of the national securities exchange that posts or makes available for trading security-based swaps or any immediate family member of the spouse of such person, who, in each case, has the same home as the member of the national securities exchange that posts or makes available for trading security-based swaps or who is a director or officer of the national securities exchange or facility thereof that posts or makes available for trading security-based swaps, or any of its parents or subsidiaries; or

(iv) Any immediate family member of a person associated a member of the national securities exchange that posts or makes available for trading security-based swaps or any immediate family member of the spouse of such person, who, in each case, has the same home as the person associated with the national securities exchange that posts or makes available for trading security-based swaps or who is a director or officer of the national securities exchange or facility thereof that posts or makes available for trading security-based swaps or any of its parents or subsidiaries.

(v) The term *security-based swap* has the same meaning as set forth in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68)) or any rules or regulations thereunder.

(w) The term *security-based swap dealer* has the same meaning as set forth in section 3(a)(71) of the Exchange Act (15 U.S.C. 78c(a)(71)) or any rules or regulations thereunder.

(x) The term *security-based swap clearing agency* means a clearing agency that clears security-based swaps.

(y) The term *security-based swap execution facility* has the same meaning as set forth in section 3(a)(77) of the Exchange Act (15 U.S.C. 78c(a)(77)) or any rules or regulations thereunder.

(z) The term *security-based swap execution facility participant* means a person permitted to directly effect transactions on the security-based swap execution facility.

§ 242.701 Mitigation of conflicts of interest of security-based swap clearing agencies.

Each security-based swap clearing agency must comply with the provisions of either paragraphs (a) or (b) this section, and must have the capacity to carry out the purposes of paragraphs (a) or (b) of this section, respectively.

(a)(1) *Limits on voting interest.* A security-based swap clearing agency shall not permit any security-based swap clearing agency participant, either alone or together with its related persons, to:

(i) Beneficially own, directly or indirectly, any interest in the security-based swap clearing agency that exceeds 20 percent of any class of securities, or other ownership interest, entitled to vote of such security-based swap clearing agency;

(ii) Directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the security-based swap clearing agency that exceeds 20 percent of the voting power of any class of securities or other ownership interest of such security-based swap clearing agency;

(iii) In the aggregate with any other security-based swap clearing agency participants and their related persons, beneficially own, directly or indirectly, any interest in the security-based swap clearing agency that exceeds 40 percent of any class of securities, or other ownership interest, entitled to vote of such security-based swap clearing agency; or

(iv) In the aggregate with any other security-based swap clearing agency participants and their related persons, directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the security-based swap clearing agency that exceeds 40 percent of the voting power of any class of securities or other ownership interest of such security-based swap clearing agency.

(2) *Divestiture.* (i) The rules of the security-based swap clearing agency must provide an effective mechanism to divest any participant of any voting interest owned in excess of the limitation in paragraph (a)(1) of this section.

(ii) The rules of the security-based swap clearing agency must be reasonably designed not to give effect to the portion of any voting interest held by one or more participants in excess of the limitations in paragraph (a)(1) of this section.

(iii) The rules of the security-based swap clearing agency must provide an effective mechanism for it to obtain information relating to voting interests in the security-based swap clearing agency by any participant in the security-based swap clearing agency and its related persons.

(3) *Board.* (i) The Board of each security-based swap clearing agency must be composed of at least 35 percent independent directors.

(ii) No director may qualify as an independent director unless the Board affirmatively determines that the director does not have a material relationship with the security-based swap clearing agency or any affiliate of the security-based swap clearing agency, or a participant in the security-based swap clearing agency, or any affiliate of a participant in the security-based swap clearing agency.

(iii) The security-based swap clearing agency must establish policies and procedures to require each director, on his or her own initiative or upon request of the security-based swap clearing agency, to inform the security-based swap clearing agency of the existence of any relationship or interest that may reasonably be considered to bear on whether such director is an independent director.

(4) *Nominating committee.* (i) A Board of any security-based swap clearing agency shall establish a nominating committee composed of a majority of independent directors.

(ii) The nominating committee of any security-based swap clearing agency must identify individuals qualified to become Board members through a consultative process with the participants of the security-based swap clearing agency consistent with criteria approved by the Board and consistent with the provisions of this section, and administer a process for the nomination of individuals to the Board.

(5) *Other committees of the Board.* A security-based swap clearing agency may establish such other committees of the Board, including a risk committee, as it deems appropriate. However, if such committee has the authority to act on behalf of the Board, the committee must be composed of at least 35 percent independent directors.

(6) *Disciplinary panels.* The disciplinary processes of a security-based swap clearing agency shall preclude any group or class of persons that is a participant from dominating or exercising disproportionate influence on the disciplinary process. Any disciplinary panel of a security-based swap clearing agency shall also include at least one person who would qualify as an independent director. If the security-based swap clearing agency provides for a process of an appeal to the Board, or to a committee of the Board, then that appellate body also shall include at least one person who would qualify as an independent director.

(b)(1) *Limits on voting interests.* A security-based swap clearing agency shall not permit any security-based swap clearing agency participant, either alone or together with its related persons, to:

(i) Beneficially own, directly or indirectly, any interest in the security-based swap execution facility that exceeds 5 percent of any class of securities, or other ownership interest, entitled to vote of such security-based swap clearing agency; or

(ii) Directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the security-based swap clearing agency that exceeds 5 percent of the voting power of any class of securities or other ownership interest of such security-based swap clearing agency.

(2) *Divestiture.* (i) The rules of the security-based swap clearing agency must provide an effective mechanism to divest any participant of any voting interest owned in excess of the limitation in paragraph (b)(1) of this section.

(ii) The rules of the security-based swap clearing agency must be reasonably designed not to give effect to the portion of any voting interest held by one or more participants in excess of the limitations in paragraph (b)(1) of this section.

(iii) The rules of the security-based swap clearing agency must provide an effective mechanism for it to obtain information relating to voting interests

in the security-based swap clearing agency or its holding company by any participant in the security-based swap clearing agency.

(3) *Board.* (i) The Board of each security-based swap clearing agency must be composed of a majority of independent directors.

(ii) No director may qualify as an independent director unless the Board affirmatively determines that the director does not have a material relationship with the security-based swap clearing agency or any affiliate of the security-based swap clearing agency, or a participant in the security-based swap clearing agency, or any affiliate of a participant in the security-based swap clearing agency.

(iii) The security-based swap clearing agency must establish policies and procedures to require each director, on his or her own initiative or upon request of the security-based swap clearing agency, to inform the security-based swap clearing agency of the existence of any relationship or interest that may reasonably be considered to bear on whether such director is an independent director.

(4) *Nominating committee.* (i) A Board of any security-based swap clearing agency shall establish a nominating committee composed solely of independent directors.

(ii) The nominating committee of any security-based swap clearing agency must identify individuals qualified to become Board members through a consultative process with the participants of the security-based swap clearing agency consistent with criteria approved by the Board and consistent with the provisions of this section, and administer a process for the nomination of individuals to the Board.

(5) *Other committees of the Board.* A security-based swap clearing agency may establish such other committees of the Board, including a risk committee, as it deems appropriate. However, if such committee has the authority to act on behalf of the Board, the committee must be composed of a majority of independent directors.

(6) *Disciplinary panels.* The disciplinary processes of a security-based swap clearing agency shall preclude any group or class of persons that is a participant from dominating or exercising disproportionate influence on the disciplinary process. Any disciplinary panel of a security-based swap clearing agency shall also include at least one person who would qualify as an independent director. If the security-based swap clearing agency provides for a process of an appeal to the Board, or to a committee of the Board, then that appellate body also shall include at least one person who would qualify as an independent director.

§ 242.702 Mitigation of conflicts of interest of security-based swap execution facilities and national securities exchanges that post or make available for trading security-based swaps.

(a) *General.* Each security-based swap execution facility and national securities exchange or facility thereof that posts or makes available for trading security-based swaps must comply with the provisions of this section and must have the capacity to carry out the purposes of this section.

(b) *Limits on ownership and voting.* (1) A security-based swap execution facility shall not permit any security-based swap execution facility participant, either alone or together with its related persons, to:

(i) Beneficially own, directly or indirectly, any interest in the security-based swap execution facility that exceeds 20 percent of any class of securities, or other ownership interest, entitled to vote of such security-based swap execution facility; or

(ii) Directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the security-based swap execution facility that exceeds 20 percent of the voting power of any class of securities or other ownership interest of such security-based swap execution facility.

(2) A national securities exchange or facility thereof that posts or makes available for trading security-based swaps shall not permit any member, either alone or together with its related persons, to:

(i) Beneficially own, directly or indirectly, any interest in the national securities exchange or facility thereof that posts or makes available for trading security-based swaps that exceeds 20 percent of any class of securities, or other ownership interest, entitled to vote of such national securities exchange or facility thereof that posts or makes available for trading security-based swaps; or

(ii) Directly or indirectly vote, cause the voting of, or give any consent or proxy with respect to the voting of, any interest in the national securities exchange or facility thereof that posts or makes available for trading security-based swaps that exceeds 20 percent of the voting power of any class of securities or other ownership interest of such national securities exchange or facility thereof that posts or makes available for trading security-based swaps.

(c) *Divestiture.* (1) The rules of a security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps must provide an effective mechanism to divest any security-based swap execution facility participant or member, as applicable, of any interest owned in excess of the ownership limitations in paragraphs (b)(1)(i) and (2)(i) of this section.

(2) The rules of a security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps must be reasonably designed not to give effect to the portion of any voting interest held by one or more security-based swap execution facility participant or member, as applicable, in excess of the limitations in paragraphs (b)(1)(ii) and (b)(2)(ii) of this section.

(3) The rules of a security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps must provide an effective mechanism for it to obtain information relating to ownership and voting interests in the security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps by any security-based swap execution facility participant or member, as applicable.

(d) *Board.* (1) The Board of any security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps must be composed of a majority of independent directors.

(2) No director may qualify as an independent director of a security-based swap execution facility unless the Board affirmatively determines that the director does not have a material relationship with the security-based swap execution facility, any affiliate of the security-based swap execution facility, a security-based swap execution facility participant, or any affiliate of a security-based swap execution facility participant.

(3) No director may qualify as an independent director of a national securities exchange or facility thereof that posts or makes available for trading security-based swaps unless the Board affirmatively determines that the director does not have a material relationship with the national securities exchange or facility thereof, any affiliate of the national securities exchange or

facility thereof, a member of the national securities exchange, or any affiliate of such member.

(e) *Regulatory oversight committee.* (1) A Board of any security-based swap execution facility or national securities exchange that posts or makes available for trading security-based swaps shall establish a regulatory oversight committee, composed solely of independent directors, to assist it in minimizing actual and potential conflicts of interest. The regulatory oversight committee shall oversee the security-based swap execution facility's obligations under section 3D of the Exchange Act or the national securities exchange's obligation under section 6 of the Exchange Act (15 U.S.C. 78f), as applicable, on behalf of the Board. The Board shall delegate sufficient authority, dedicate sufficient resources, and allow sufficient time for the regulatory oversight committee to fulfill its mandate.

(2) The Board shall promptly report to the Commission any recommendations of the Regulatory Oversight Committee that the Board does not adopt or implement.

(f) *Nominating committee.* (1) The nominating committee of a security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps must be composed solely of independent directors.

(2) The nominating committee of a security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps must identify individuals qualified to become directors, consistent with criteria approved by the Board and consistent with the provisions of this section, and administer a process for the nomination of individuals to the Board.

(g) *Other committees of the Board.* A security-based swap execution facility or national securities exchange or facility thereof that posts or makes available for trading security-based swaps may establish such other committees of the Board, including an executive committee, as it deems appropriate. However, if such committee has the authority to act on behalf of the Board, the committee must be composed of a majority of independent directors.

(h) *Disciplinary panels.* The disciplinary processes of a security-based swap execution facility or national securities exchange that posts or makes available for trading security-based swaps shall preclude any group or class of security-based swap execution facility participants or group or class of members of the national securities exchange that posts or makes available for trading security-based swaps, as applicable, from dominating or exercising disproportionate influence on the disciplinary process. Any disciplinary panel of a security-based swap execution facility or national securities exchange that posts or makes available for trading security-based swaps shall also include at least one person who would qualify as an independent director. If the security-based swap execution facility or national securities exchange that posts or makes available for trading security-based swaps provides for a process of an appeal to the Board, or to a committee of the Board, then that appellate body also shall include at least one person who would qualify as an independent director.

Dated: October 14, 2010.

By the Commission.

Elizabeth M. Murphy,

Secretary.

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