



Commodity Futures Trading Commission

Office of Public Affairs

Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
www.cftc.gov

Proposed Rulemaking Q & A

What is the goal of the proposed rulemaking?

The notice of rulemaking proposes to implement new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) with respect to conflicts of interest. The proposed rules are designed to mitigate potential conflicts of interest in the operation of a derivatives clearing organization (“DCO”), designated contract market (“DCM”), and a swap execution facility (“SEF”) through (i) structural governance requirements and (ii) limits on ownership of voting equity and the exercise of voting power.

What potential conflicts of interest were identified by the Commission in proposing these rules?

- **DCO.** The Commission recognized that a DCO may confront potential conflicts of interest in, among other things, determining (i) whether a swap contract is capable of being cleared, (ii) the minimum criteria that an entity must meet in order to become a swap clearing member, and (iii) whether a particular entity satisfies such criteria.
- **DCM or SEF.** The Commission identified that a DCM or SEF may confront potential conflicts of interest in, among other things, balancing the advancement of commercial interests and the fulfillment of self-regulatory responsibilities, including with respect to determinations on access.

Why did the Commission decide to address conflicts of interest through the use of structural governance requirements and limits on ownership of voting equity and the exercise of voting power?

The Commission has concerns regarding the influence that certain shareholders may exert over the DCO, DCM, or SEF Board of Directors. This influence may affect, among other things, the independent perspective of public directors. The Commission believes limits on ownership of voting equity and the exercise of voting power enhance structural governance requirements by limiting such influence.

What structural requirements do the proposed rules impose on the composition of a DCO, DCM, or SEF’s Board of Directors?

The proposed rules require that DCO, DCM, or SEF Boards of Directors be composed of at least thirty-five (35) percent, but no less than two, public directors. The proposed rules request comment on whether such percentage is sufficient to mitigate the conflicts of interest that the Commission has identified.

What are the proposed modifications to the definition of “public director”?

The proposed rules include modifications to the definition of “public director” to allow for greater harmonization with the definition of “independent director” proposed by the Securities and Exchange Commission in 2004 and with currently accepted practices. The Commission seeks to modify the current definition of “public director” by:

- including a new bright-line test that prohibits any director that is an officer of another entity from being a public director, if such other entity has a compensation committee, on which any officer of the registered entity serves;
- precluding directors that are employees of members from being public directors;
- precluding a director, or an entity with which the director is an employee, from being a public director if certain payments are made to such director; and,

- expanding the definition of “immediate family” to include certain family members, whether by blood, marriage or adoption, and any person residing in the home of the director or his immediate family.

If the DCO, DCM or SEF is a subsidiary of a company, would the proposed board composition rules have an effect on the parent company?

Yes. The Commission proposes to prohibit a DCO, DCM, or SEF from permitting itself to be operated¹ by another entity, unless such entity agrees to comport with such requirements in the same manner as the DCO, DCM, or SEF.

Do the proposed board composition rules apply to DCO, DCM, or SEF board committees?

The proposed rules would apply to any committee of the Board of Directors that may exercise delegated authority with respect to the management of a DCO, DCM, or SEF.

What substantive requirements do the proposed rules impose on a DCO, DCM, or SEF Board of Directors?

The proposed rules impose the following substantive requirements on a DCO, DCM, or SEF Board of Directors:

- The roles and responsibilities of such Board of Directors must be clearly articulated, especially with respect to the manner in which such Board of Directors ensures that the DCO, DCM, or SEF complies with all statutory, regulatory, and self-regulatory responsibilities.
- Such Board of Directors shall review its performance and that of its individual members annually.
- A DCO, DCM, or SEF must have procedures to remove a member from the Board of Directors, where the conduct of such member is likely to be prejudicial to sound and prudent management.
- Each member of such Board of Directors must have sufficient expertise, where applicable, in financial services, risk management, and clearing services.
- A DCO, DCM or SEF would be prohibited from linking the compensation of public directors and other non-executive members of the Board of Directors to its business performance.

What board committees are required by the proposed rules for each DCO, DCM, and SEF?

The proposed rules require that each DCO have a Nominating Committee, one or more Disciplinary Panels, and a Risk Management Committee. For DCMs and SEFs, the proposed rules require the formation of a Nominating Committee, one or more Disciplinary Panels, a Regulatory Oversight Committee, and a Membership or Participation Committee.

What is the proposed role of the DCO, DCM, or SEF Nominating Committee? What is the proposed composition of the Nominating Committee?

The role of the Nominating Committee would be to: (i) identify individuals qualified to serve on the Board of Directors; and (ii) administer a process for the nomination of such individuals. The Commission proposes that (i) public directors comprise at least fifty-one (51) percent of the Nominating Committee, and (ii) a public director chair the Nominating Committee.

What is the proposed role of a DCO, DCM, or SEF Disciplinary Panel? What is the proposed composition of such Disciplinary Panel?

The role of each Disciplinary Panel would be to conduct hearings, render decisions, and impose sanctions with respect to disciplinary matters. The proposed rules require that each DCO, DCM or SEF Disciplinary Panel include at least one public participant, and that the chair of each Disciplinary Panel be a public participant.

What is a “Public Participant”?

¹ The proposed rule defines “operate” as “the direct exercise of control (including through the exercise of veto power) over the day-to-day business operations of” a DCO, DCM, or SEF “by the sole or majority shareholder of such registered entity, either through the ownership of voting equity, by contract, or otherwise. The term ‘operate’ shall not prohibit an entity, acting as the sole or majority shareholder of such registered entity, from exercising its rights as a shareholder under any contract, agreement, or other legal obligation.”

A “Public Participant” is an entity that meets the bright-line materiality tests in the definition of “Public Director.”

What are the proposed responsibilities of a DCM or SEF Membership or Participation Committee? What is the proposed composition of such committee?

The proposed responsibilities of a DCM or SEF Membership or Participation Committee are to (i) determine the standards and requirements for initial and continuing membership or participation eligibility; (ii) review appeals of staff denials of membership or participation applications; and (iii) approve rules that would result in different categories or classes of members or participants receiving disparate access. The proposed rules require that the Membership or Participation Committee be composed of thirty-five (35) percent public directors.

The proposed rules require each DCO to establish a Risk Management Committee. What is the proposed composition of this Committee?

The Commission proposes to require that the DCO Risk Management Committee be composed of (i) thirty-five (35) percent public directors with sufficient expertise in, among other things, clearing services, and (ii) ten (10) percent customers of clearing members. If the Risk Management Committee delegates certain responsibilities to a Risk Management Subcommittee, then it would not have to meet the composition requirements.

What is the DCO Risk Management Subcommittee? What are its proposed responsibilities?

The DCO Risk Management Subcommittee is a committee formed by the DCO Risk Management Committee to perform the following delegated responsibilities: (i) determining the standards and requirements for initial and continuing clearing membership eligibility; (ii) approving or denying (or reviewing approvals or denials of) clearing membership applications; and (iii) determining products eligible for clearing. The Subcommittee’s decisions are subject to review by the DCO Risk Management Committee. The decisions of the DCO Risk Management Committee are subject to review by the DCO Board of Directors.

Regulatory Oversight Committees are unique to DCMs and SEFs. What is the proposed role of the Regulatory Oversight Committee? What is the proposed composition of such Committee?

The Regulatory Oversight Committee represents the interests of vigorous, impartial and effective self-regulation. It also represents the interests and needs of regulatory officers and staff; the resource needs of regulatory functions; and the independence of regulatory decisions. The proposed rules require that the Regulatory Oversight Committee be composed of only public directors (100 percent).

What limits do the proposed rules place on the ownership of DCO, DCM, or SEF voting equity or the exercise of voting power?

The proposed rules do not place any restrictions on ownership of non-voting equity in a DCO, DCM, or SEF. However,

DCM or SEF: The proposed rules do limit DCM or SEF members from (i) beneficially owning more than twenty (20) percent of any class of voting equity in the registered entity or (ii) directly or indirectly voting (e.g., through proxy or shareholder agreement) an interest exceeding twenty (20) percent of the voting power of any class of equity interest in the registered entity.

DCO: Absent a Commission granted waiver, the proposed rules require a DCO to choose one of two alternative limits on the ownership of voting equity or the exercise of voting power:

- **First Alternative:** The Commission is proposing that certain individual and aggregate limits be met. Specifically, no individual DCO member (and its related persons) may (i) beneficially own more than twenty (20) percent of any class of voting equity in the DCO or (ii) directly or indirectly vote (e.g., through proxy or shareholder agreement) an interest exceeding twenty (20) percent of the voting power of any class of equity interest in the DCO. In addition, the

enumerated entities² (and their related persons), regardless of whether they are DCO members, may not collectively (i) own on a beneficial basis more than forty (40) percent of any class of voting equity in a DCO, or (ii) directly or indirectly vote (e.g., through proxy or shareholder agreement) an interest exceeding forty (40) percent of the voting power of any class of equity interest in the DCO.

- **Second Alternative:** The Commission proposes a five (5) percent limitation on the voting equity that any DCO member or enumerated entity (whether or not such entity is a DCO member), and their related persons, may own, and an identical five (5) percent limitation on voting rights.

Can a DCO request a waiver of the limitations on ownership of voting equity or the exercise of voting power?

Yes. The Commission believes that circumstances may exist where neither the First Alternative nor the Second Alternative would be appropriate for a DCO. Therefore, the Commission proposes permitting a DCO to request a waiver of the limitations in the First and Second Alternatives.

Under what circumstances may the Commission grant the waiver?

The Commission may grant such a waiver if, upon reviewing the DCO request, the Commission determines that, with respect to the DCO, the limitations in the First and Second Alternatives are not necessary or appropriate to:

- improve the governance of the DCO;
- mitigate systemic risk;
- promote competition;
- mitigate conflicts of interest in connection with a swap dealer's or major swap participant's conduct of business with the DCO with respect to fair and open access and participation and product eligibility; or
- otherwise accomplish the purposes of the Commodity Exchange Act.

Are there any limitations on the waiver? Is it revocable?

The Commission may grant the waiver for any period of time that it deems reasonable. In addition, it may revoke the waiver, upon its own motion, at any time. Upon the expiration or revocation of such waiver, the DCO would need to cause its equity holders to comply with, through divestiture or other means, either the First or Second Alternative.

What is the proposed effective date for the final rules on mitigation of conflicts of interest? What is the proposed transition period associated with the final rules?

The Commission must adopt final rules on the mitigation of conflicts of interest by January 14, 2011. The Commission is proposing a staggered effective date for the final rules. Any portion of the final rules implicating entities subject to further definition would not become effective until sixty (60) days after July 15, 2011, the statutory deadline for certain other rulemakings under the Dodd-Frank Act. Portions of the final rules not involving such entities would become effective sixty (60) days after the Federal Register publication of the final rules.

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

² The "enumerated entities" include: (i) bank holding companies with over \$50,000,000,000 in total consolidated assets; (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; (iii) an affiliate of (i) or (ii); (iv) a swap dealer; (v) a major swap participant; or (vi) an associated person of (iv) or (v).