



Commodity Futures Trading Commission

Office of Public Affairs

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Proposal to Mitigate Potential Conflicts of Interest in the Operation of Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities

The Commodity Futures Trading Commission (Commission) is proposing to mitigate potential conflicts of interest in the operation of a derivatives clearing organization (DCO), designated contract market (DCM), or a swap execution facility (SEF) through (i) structural governance requirements and (ii) limits on ownership of voting equity and exercise of voting power.

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The proposed rules implement Section 726 of the Dodd-Frank Act, which requires the Commission to mitigate conflicts of interest in the operation of certain DCOs, DCMs, and SEFs. Specifically:

- **Section 726(a)** of the Dodd-Frank Act expressly empowers the Commission to adopt “numerical limits...on control” or “voting rights” that enumerated entities¹ may hold with respect to such DCOs, DCMs, and SEFs.
- **Section 726(b)** of the Dodd-Frank Act directs the Commission to determine the manner in which its rules may be deemed necessary or appropriate to improve the governance of certain DCOs, DCMs, or SEFs or to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with the interaction between swap dealers and major swap participants, on the one hand, and such DCOs, DCMs, and SEFs.
- **Section 726(c)** of the Dodd-Frank Act directs the Commission to consider the manner in which its rules address conflicts of interest in the abovementioned interaction arising from equity ownership, voting structure, or other governance arrangements of the relevant DCOs, DCMs, and SEFs.

Potential Conflicts of Interest in the Operation of DCOs, DCMs, or SEFs.

In carrying out Section 726 of the Dodd-Frank Act, the Commission identified potential conflicts of interest that DCOs, DCMs, or SEFs may face. With respect to a DCO, the Commission recognized that a DCO may confront 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. For a DCM or SEF, the Commission identified the conflicts of interest that these entities may confront in, among other things, balancing the advancement of commercial interests and the fulfillment of self-regulatory responsibilities, including with respect to determinations on access.

¹ 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 (i) or (v).

To mitigate such potential conflicts of interest in the operation of DCOs, DCMs, and SEFs, the Commission is proposing (i) structural governance requirements and (ii) limits on the ownership of voting equity and the exercise of voting power. The Commission views the latter as a method of enhancing the former, in that the latter limits the influence that certain shareholders may exert over the DCO, DCM, or SEF Board of Directors. The Commission believes that such influence may affect, among other things, the independent perspective of public directors.

Structural Requirements.

The proposed rules impose specific composition requirements on DCO, DCM, or SEF Boards of Directors. Also, the proposed rules require that each DCO, DCM, or SEF have a nominating committee and one or more disciplinary panels. Further, the proposed rules require that (i) each DCO have a risk management committee and (ii) each DCM or SEF have a regulatory oversight committee and a membership or participation committee. In each case, the proposed rules impose specific composition requirements on such committees or panels.

In addition to the composition requirements, the Commission is proposing certain substantive requirements on DCO, DCM, or SEF Board of Directors to enhance accountability to the Commission regarding the discharge of statutory, regulatory, or self-regulatory responsibilities. Such substantive requirements include annual self-review of the Board of Directors; board member expertise in financial services, risk management, and clearing; and procedures for board member removal.

Limits on Ownership or Voting Power.

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

With respect to a DCO only, the proposed rules require a DCO to choose one of two alternative limits on the ownership of voting equity or the exercise of voting power:

- **First Alternative.** The Commission is proposing that certain individual and aggregate limits be met.
 - a. **Individual Limit.** 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.
 - b. **Aggregate Limit.** The enumerated entities (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 is proposing an individual limit only for this alternative. Specifically, no DCO member or enumerated entity (whether or not such entity is a DCO member), and their related persons, may (i) beneficially own more than five (5) 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 five (5) percent of the voting power of any class of equity interest in the DCO.

The Commission recognizes that circumstances may exist where neither the first nor second alternative would be appropriate for a DCO. Consequently, the Commission is proposing a procedure for the DCO to apply for, and the Commission to grant, a waiver of the limits specified in the first and second alternatives.

Definition of Public Director.

The Commission is proposing 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 modifications include expanding the definition of “immediate family” and adding new bright-line tests that would prohibit certain directors from being deemed “public directors.”