

MEMO# 24640

October 21, 2010

CFTC and SEC Propose Rules to Mitigate Conflicts of Interest at Swap Clearing Organizations and Trading Venues

[24640]

October 21, 2010

TO:

CLOSED-END INVESTMENT COMPANY MEMBERS No. 54-10
ETF ADVISORY COMMITTEE No. 48-10
EQUITY MARKETS ADVISORY COMMITTEE No. 40-10
FIXED-INCOME ADVISORY COMMITTEE No. 22-10
SEC RULES MEMBERS No. 106-10

RE:

CFTC AND SEC PROPOSE RULES TO MITIGATE CONFLICTS OF INTEREST AT SWAP CLEARING ORGANIZATIONS AND TRADING VENUES

The Commodity Futures Trading Commission and the Securities and Exchange Commission have proposed rules for the mitigation of conflicts of interest at swap^[1] clearing organizations and entities where swaps may be traded, including designated contract markets (“DCMs”), swap execution facilities (“SEFs”) and national securities exchanges.^[2] The proposed rules would implement Sections 726 and 765 of the Dodd-Frank Wall Street Reform and Consumer Protection Act by imposing limits on the ownership, voting and governance of these swap-related entities. In developing the rules, both of the Commissions identified perceived conflicts of interest and the need to address such

conflicts by balancing the policy objective of promoting competition in the swap industry with the objective of minimizing systemic risk.

I. CFTC Proposal

A. Ownership and Voting Restrictions

The CFTC proposal would not place any restrictions on the ownership of non-voting equity in

a derivatives clearing organization (“DCO”), DCM or SEF. It would, however, limit DCM or SEF members^[3] (and their related persons^[4]) from (1) beneficially owning more than 20 percent of any class of voting equity in the entity or (2) directly or indirectly voting an interest exceeding 20 percent of the voting power of any class of equity interest in the entity. The CFTC proposal would require a DCO to choose one of two alternatives for the ownership of voting equity or the exercise of voting power:

- First Alternative. No individual DCO member (and its related persons) may (1) beneficially own more than 20 percent of any class of voting equity in the DCO or (2) directly or indirectly vote an interest exceeding 20 percent of the voting power of any class of equity interest in the DCO. In addition, “enumerated entities”^[5] (and their related persons), regardless of whether they are DCO members, may not collectively (1) beneficially own more than 40 percent of any class of voting equity in a DCO or (2) directly or indirectly vote an interest exceeding 40 percent of the voting power of any class of equity interest in the DCO.
- Second Alternative. No DCO member or enumerated entity, regardless of whether it is a DCO member, may (1) beneficially own more than 5 percent of any class of voting equity in the DCO or (2) directly or indirectly vote an interest exceeding 5 percent of the voting power of any class of equity interest in the DCO.^[6]

B. Governance Restrictions

The CFTC proposal would impose structural governance requirements on the boards of directors and board committees of DCOs, DCMs and SEFs, including a requirement that the boards be comprised of at least 35 percent, but no less than two, public directors.^[7] This compositional requirement would extend to any committee of the board that may exercise delegated authority with respect to the management of a DCO, DCM or SEF. In addition, the proposal would prohibit a DCO, DCM or SEF from being operated by another entity unless such entity agrees to comport with the same compositional requirements.

The CFTC proposal would require boards to conduct annual self-reviews and adopt procedures for board member removal and board member expertise (where applicable) in financial services, risk management and clearing services. DCOs, DCMs and SEFs would be required to have a nominating committee, comprised of at least 51 percent public directors, and one or more disciplinary panels, constructed to ensure fair representation. Further, the proposal would require that (1) each DCO have a risk management committee made up of 35 percent public directors and 10 percent representatives of customers of clearing

members and (2) each DCM or SEF have a regulatory oversight committee composed of public directors and a membership or participation committee composed of 35 percent public directors.

II. SEC Proposal

A. Ownership and Voting Restrictions

The SEC proposal, entitled Regulation MC, would impose similar ownership and voting restrictions on security-based swap clearing agencies (“SBCAs”), security-based SEFs (“SB SEFs”) and national stock exchanges that facilitate trading in security-based swaps (“SB exchanges”)[8] as proposed in the CFTC proposal for DCOs, DCMs and SEFs.[9] Specifically, participants[10] and members of SB SEFs and SB exchanges (and their related persons)[11] could not (1) beneficially own more than 20 percent of any class of voting securities, or other ownership interest, in the entity entitled to vote or (2) directly or indirectly vote an interest exceeding 20 percent of the voting power of any class of securities or other ownership interest in the entity.[12]

SBCAs would elect between two alternatives regarding voting and governance limitations:

- First Alternative. No individual SBCA participant (and its related persons) may (1) beneficially own more than 20 percent of any class of securities, or other ownership interest, entitled to vote in the SBCA or (2) directly or indirectly vote an interest exceeding 20 percent of the voting power of any class of securities, or other ownership interest, in the SBCA. In addition, SBCA participants (and their related persons) may not collectively (1) beneficially own more than 40 percent of the voting power of any class of securities, or other ownership interest, in the SBCA or (2) directly or indirectly vote an interest exceeding 40 percent of the voting power of any class of securities, or other ownership interest, in the SBCA.
- Second Alternative. No SBCA participant (and its related persons) may (1) beneficially own more than 5 percent of any class of securities, or other ownership interest, entitled to vote in the SBCA or (2) directly or indirectly vote any interest exceeding 5 percent of the voting power of any class of securities, or other ownership interest, in the SBCA.

To enforce these limitations, the proposal would require that SB SEFs, SB exchanges and SBCAs have rules that: provide an effective mechanism to divest a participant’s or member’s ownership interest that exceeds the 20 percent threshold; are reasonably designed to prevent use of ownership interest in excess of 20 or 40 percent, respectively; and provide a mechanism to obtain information related to their ownership and voting interests.

B. Governance Restrictions

1. SB SEFs and SB Exchanges

The SEC proposal would require that the board of directors of a SB SEF and SB exchange be composed of a majority of independent directors. In contrast to the CFTC proposal, the SEC proposal would neither impose a 35 percent independence requirement on these entities nor require their parent companies to satisfy the compositional requirement of a majority independent board. The SEC proposal would require that a SB SEF and SB exchange establish a regulatory oversight committee composed solely of independent directors,[\[13\]](#) and compose the nominating committee solely of independent directors. Disciplinary panels would have to be balanced, include industry member representation, and include at least one independent director. Further, any committee of the board with delegated authority to act on the board's behalf would need to be comprised of a majority of independent directors.

2. SBCAs

The governance requirements for SBCAs would be determined based on which ownership and voting alternative the entity elected. SBCAs opting for the First Alternative (20/40 percent alternative) would be required to have a board composed of at least 35 percent independent directors. The SEC proposal would require a SBCA to create and maintain a nominating committee composed of a majority of independent directors. It also would require that other board committees with delegated authority to act on behalf of the board consist of at least 35 percent independent directors. Disciplinary panels would have to be balanced and include at least one independent director.

SBCAs opting for the Second Alternative (5 percent alternative) would be required to have a board and nominating committee composed of a majority of independent directors. Similarly, other board committees with delegated authority to act on behalf of the board would need to consist of a majority of independent directors. Disciplinary panels would have to be balanced and include at least one independent director.

Heather L. Traeger
Associate Counsel

endnotes

[1] In this memorandum, the term “swap” includes security-based swaps.

[2] See CFTC Release – Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 FR 63732 (October 18, 2010), available at <http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2010-26220.html> and SEC Release No. 34-63107 (October 14, 2010), available at <http://www.sec.gov/rules/proposed/2010/34-63107.pdf>. Comments on the CFTC proposal must be filed by November 17; comments on the SEC proposal must be filed 30 days after the proposal is published in the Federal Register.

[3] Under the CFTC proposal, a “member” would include persons who hold membership in the entity, have membership privileges or, in non-membership organizations, are participants in such organizations.

[4] Under the CFTC proposal, a “related person” would include: (1) an affiliate; (2) any partner, director, officer, or other employee; (3) any immediate family member, or any immediate family member of such person’s spouse, who, in each case, has the same home as such person; or (4) any immediate family member of the persons enumerated in (2), or any immediate family member of such person’s spouse, who, in each case, has the same home as such person.

[5] Under the CFTC proposal, an “enumerated entity” would include: (1) bank holding companies with over \$50 billion in total consolidated assets; (2) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; (3) an affiliate of (1) or (2); (4) a swap dealer; (5) a major swap participant; or (6) an associated person of (4) or (5).

[6] The proposal would permit a DCO to apply to the CFTC for a waiver of the limits specified in either of the alternatives.

[7] The proposal would narrow the definition of “public director” to harmonize it with the SEC definition of “independent director.”

[8] In this memorandum, the term “SB exchange” includes the exchange and facilities of the exchange.

[\[9\]](#) The SEC would have the authority to grant an exemption to Regulation MC.

[\[10\]](#) Under the SEC proposal, a “participant” would include any person who uses the clearing agency to clear or settle securities transactions or to transfer, pledge, lend or hypothecate securities.

[\[11\]](#) Under the SEC proposal, a “related person” would include: (1) any affiliate; (2) any associated person; (3) any immediate family member, or any immediate family member of the spouse of such person, who, in each case, has the same home as the participant or member or who is a director or officer of the entity or any of its parents or subsidiaries; and (4) any immediate family member of an associated 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 or member or who is a director or officer of the entity or any of its parents or subsidiaries.

[\[12\]](#) An SB SEF or SB exchange member would not be prohibited from owning any percentage of a nonvoting interest in a SB SEF or SB exchange even though national securities exchanges generally limit their members from owning more than 20 percent of any interest in the exchange.

[\[13\]](#) The board would be required to report to the SEC any recommendations of the regulatory oversight committee that it did not adopt or implement.