CFTC Proposed Rule Changes Affecting Domestic and Foreign Futures Exchanges

Futures & Derivatives 2011: Impact of New Legislative & Regulatory Reforms
New York City Bar
June 10, 2011

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Introduction

Although the Dodd-Frank Act ("DFA") [1] and the Commodity Futures Trading Commission's ("CFTC" or "the Commission") rules implementing the DFA are intended to provide a regulatory framework applicable for the over-the-counter derivatives markets, they also will have a major impact on the regulation of exchange-traded futures contracts. The Commission's proposed rules implementing the DFA will have a significant effect on both designated contract markets ("DCM") and foreign boards of trade ("FBOT"). The proposed rules will have a major impact on DCMs in two significant areas: (1) governance and (2) trade execution. In addition, as provided by the DFA, the Commission is proposing to replace the current no-action framework with a registration requirement for FBOTs wishing to provide U.S. customers with direct access to their electronic trading and order matching systems.[2]

1. Proposed Changes in DCM Governance

A major trend in the corporate organization of exchanges, which is largely now complete, has been their transformation from not-for-profit, mutual organizations to for-profit, publicly-traded companies.[3] This sea change in how exchanges are organized and governed occurred without large scale changes in the Commodity Exchange Act or in the Commission's rules. In implementing the mandates of the DFA, the Commission is now proposing to address in their rules several of the issues raised by exchange demutualization. Specifically, the Commission is proposing new rules regarding board composition, ownership limitations and enhanced self-regulatory ("SRO") requirements.[4]

a. The Board of Directors

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[1] On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Title VII of the Dodd-Frank Act amended the Commodity Exchange Act (CEA) to establish a comprehensive new regulatory framework for over-the-counter derivatives transactions and the entities which trade and clear these transactions. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) *available at* http://www.cftc.gov./LawRegulation/OTCDERIVATIVES/index.htm.

[2] *See* Registration of Foreign Boards of Trade, 75 Fed. Reg. 70972 (Nov. 19, 2010).

[3] *See* Architzel, Paul. Implications of Evolving Forms of Exchange Ownership for their Role as Self-Regulatory Organizations, *Futures & Derivatives Law Report*, June 2006.

[4] The CFTC's rule-making is consistent with the long-standing tradition of the federal government to support self-regulation. The federal government's commitment to self-regulation traces back to the Great Depression in the Securities Exchange Act of 1934 ("Exchange Act") and the Maloney Act of 1938 ("Maloney Act") and continues with the Exchange Act Amendments of 1975 ("1975 Amendments"). *See* Concept Release Concerning Self-Regulation, SEC Release No. 34-50700, File No. S7-40-04 (March 8, 2005). The federal government's commitment to self-regulation is still resilient today as evident in a 2005 Securities and Exchange Commission ("SEC") concept release focused on the issue of self-regulation, which noted several benefits of self-regulation over purely federal regulation, including the prohibitive cost that would be associated with federal regulators policing the securities industry and the complexity of securities trading practices. *Id.* In regard to the futures exchanges, the Commodity Futures Modernization Act of 2000 ("CFMA") amendment to the statement of purpose of the Commodity Exchange Act ("CEA") also reflects the commitment to self-regulation, noting in section 3(b): "It is the purpose of this Act to serve the public interests described in subsection (a) through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission." *See* 7 U.S.C § 3(b).

The Commission's strategy for mitigating conflicts of interest in the governance and operation of exchanges includes a required number of independent, or "public" members, on the board and on board committees.[5] The proposed rules increase the percentage of board members that are public directors[6] to 35% and require that, regardless of the size of the board, at least two members must be public directors.[7] To encourage the broadest range of participants, the Commission is proposing to require that each DCM attempt to make its board "broadly and culturally diverse"[8] as well as inclusive of market participants.[9]

The proposed rules also oblige DCMs to form committees to the board with required percentages of "public" members. The DCM is required to have a nominating committee, which is responsible for nominating individuals to the board and developing a process to select individuals for the board.[10] The rules propose that the chair of this committee be a public director and that public directors comprise 51% of the committee.[11] In order to prevent bias in membership decisions, the proposed rules also would mandate that the DCM have a Membership or Participation committee which is responsible for reviewing DCM membership decisions and policies.[12] According to the proposed rules, this committee would be required to be composed of at least 35% public directors and would review appeals of any staff denial of a membership.[13]

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[5] *See* Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732, 63738 (Oct. 18, 2010). (The Commission notes, "In the DCM Conflicts of Interest Release, the Commission stated that the 35 percent requirement [for public directors] struck an appropriate balance between (i) the need to minimize conflicts of interest in DCM decision-making processes with (ii) the need for expertise and efficiency in such processes.") . The same requirements also apply to entities that "operate" DCMs. § 40.9(b)(2)(ii)(A). The proposed rules would define "operates" as an entity that engages in "'the direct exercise of control (including through the exercise of veto power) over the day-to-day business operations." § 40.9(b)(2)(i).

[6] The definition of a public director is found in proposed rule § 1.3(ccc): "[A] a member of the board of Directors ...who has been found, by the board of Directors of the registered entity, on the record, to have no material relationship with such registered entity .... (1) For purposes of this definition, a "material relationship" is one that reasonably could affect the independent judgment or decision-making of the director .... Circumstances in which a director shall be considered to have a "material relationship" with the registered entity include, but are not limited to, the following: (i) Such director is an officer or an employee of the registered entity, or an officer or an employee of its affiliate...; (ii) Such director is a member of the registered entity, or a director, an officer, or an employee of a member ...; (iii) Such director is an officer of another entity, which entity has a compensation committee (or similar body) on which any officer of the registered entity serves; (iv) Such director, or an entity with which the director is a partner, an officer, an employee, or a director, receives more than $100,000 in combined annual payments for legal, accounting, or consulting services from the registered entity, any affiliate thereof... any member of the registered entity ... or any affiliate of such member; (v) ... in the case of a public director that is a member of the Regulatory Oversight Committee, the Risk Management Committee ..., Membership or Participation Committee ..., such director ... accepts, directly or indirectly, any consulting, advisory, or other compensatory fee from the registered entity, any affiliate thereof, etc."

[7] § 40.9(b)(1)(i). The Commission also requested comment, in the preamble to the proposed rules, on raising the percentage to 51%. Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732, 63739 (Oct. 18, 2010). The same requirements also apply to entities that "operate" DCMs. § 40.9(b)(2)(ii)(A). The proposed rules would define "operates" as an entity that engages in "'the direct exercise of control (including through the exercise of veto power) over the day-to-day business operations." § 40.9(b)(2)(i).

[8] § 38.1151.

[9] § 38.901(a) & (b).

[10] § 40.9(c)(1).

[11] § 40.9(c)(1)(iii).

[12] § 38.851(c).

[13] § 38.851(c)(1)(iii); § 38.851(c)(2)(i).

The rules also require that any "executive committee"[14] must be comprised of 35% public directors.[15]

The proposed rules also would require the formation of disciplinary panels which are responsible for "conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters."[16] The proposed rules would require that each disciplinary panel have at least one member who is a "public participant"[17] and a public participant must chair the disciplinary panel.[18] The proposed rules also would require that the panels have rules precluding any group or class of participants from dominating or exercising disproportionate influence on the disciplinary panel.[19] For instance, there must be rules preventing members from voting or deliberating on any matter in which they knowingly have a financial interest.[20]

To effectuate its composition requirements, the proposed rules would require that after a board election, DCMs submit to the Commission a list of the members of the board, and the members for each committee for which there is a composition requirement, and a description of the members' relationship to the DCM, including the grounds for considering them a "public director" or "public participant."[21] Further, to maintain their independence, the proposed rules would prohibit linking the compensation of public directors and other non-executive members of the board to the DCM's performance.[22]

The proposed rules also include requirements intended to promote impartiality and professionalism in DCM governance. For instance, the proposed rules would require that the board conduct an annual performance review of each individual member as well as the board as a whole. The Commission has suggested that this review periodically be carried out using external evaluators.[23] The proposed rules also would require the establishment of procedures to remove a board member "where the conduct of such member is likely to be prejudicial to the sound and prudent management" of the DCM.[24] Finally, the proposed rules also would require that a DCM provide impartial access to its markets and services to members and market participants, including equitably applied access criteria and fee structure.[25]

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[14] "Executive committee" is defined as "a committee of the Board of Directors that may exercise the authority delegated to it by the Board of Directors with respect to the management of the company or organization." §1.3 (bbb).
[15] § 40.9(c)(2).
[16] § 40.9(c)(3).
[17] A "public participant" is defined as someone who is not disqualified from serving as a public director under § 1.3 (ccc)(1)(i)-(iv) and (2). § 40.9(c)(3)(ii).
[18] § 40.9(c)(3)(ii).
[19] § 40.9(c)(3)(ii)(A).
[20] § 40.9(c)(3)(ii)(B).
[21] § 40.9(b)(1)(iii).
[22] § 40.9(b)(4).
[23] § 40.9(b)(5).
[24] § 40.9(b)(6).
[25] § 38.851(b)

b. Ownership and Voting Restrictions

The proposed rules also would restrict ownership and voting rights. As proposed, DCM members (and related persons or parent company if the DCM is a subsidiary) cannot beneficially own more than 20% of any class of voting equity or vote an interest exceeding 20% of the voting power of any class of equity interest in the registered entity.[26] By limiting the percentage of voting power that any individual entity possesses, the rules aim to lessen the likelihood that a few member organizations would be able to dominate the governance of the DCM.

The Commission explained that they viewed the voting limitations as a method to protect the independence of public directors, noting:

> Voting shareholders elect, directly or indirectly, members of the Board of Directors. Such members serve as fiduciaries to all shareholders under state law. Therefore, to ensure that ... DCM ... public directors maintain their independent perspective (rather than solely representing the competitive, commercial, or industry considerations of shareholders), the Commission believes that limits on ownership of voting equity and the exercise of voting rights are necessary.[27]

However, the Commission has not proposed to apply to DCMs the specific limitation on aggregate ownership by certain enumerated entities that it proposed with respect to ownership of Derivatives Clearing Organizations.[28]

c. Self-Regulatory Obligations

The Commission is also proposing rules to strengthen and formalize the DCM's self-regulatory programs. For instance, the rules mandate that the statutory, regulatory and self-regulatory responsibilities of the board must be clearly articulated.[29] Under the proposed rules, DCMs must also have a regulatory oversight committee ("ROC") which oversees regulatory policies and compliance personnel, including the chief regulatory officer. The ROC is also responsible for assessing the capacity of the regulatory system at the DCM.[30] The proposed rules require that this committee can only be composed of public directors.[31]

The proposed rules also would mandate that DCMs have the appropriate resources and arrangements effectively to enforce disciplinary rules on their membership.[32] As proposed, a DCM must have the capacity to collect information and documents, examine books and records, and analyze market data to detect potential violations.[33] DCMs also would be required to maintain a compliance staff that has sufficient resources and capacity to engage in its duties such

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[26] § 38.851(d)(2)(i) & (ii); § 38.851(d)(3)
[27] Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732, 63742 (Oct. 18, 2010).
[28] "Enumerated entities" include among others, bank holding companies and registered swap dealers. *Id.* at 63745.
[29] § 40.9(b)(1)(ii).
[30] § 38.851(b).
[31] § 38.851(b)(3).
[32] § 38.153
[33] *Id.*

as conducting audit trail reviews and market surveillance, and addressing unusual market events.[34]

The Commission is also proposing to require a report in the event that the DCM rejects a recommendation of the ROC or Membership/Participation Committees[35] and an annual report assessing the DCM's regulatory program in regard to issues such as investigations conducted, staffing, and expenses.[36]

The proposed rules also would require that DCMs actively monitor their membership as part of their self-regulatory duties. The rules noted that DCMs must monitor members for compliance with the DCM's minimum financial standards, minimum capital requirements for futures commission merchants, adherence to the Act's customer segregation requirements, and monitoring the positions of members and their customers.[37]

2. Proposed Changes in DCM Trade Execution

In addition to proposed rules relating to governance, the Commission also proposes major changes regarding trade execution. First, the proposed rules will require that DCMs provide for the financial integrity of transactions by clearing all such transactions (aside from security futures) through a Commission-registered Derivatives Clearing Organization ("DCO").[38]

The Commission is also proposing to set a minimum centralized market trading requirement; DCMs would not be permitted to list contracts for trading unless at least 85% of the total volume of the contract is traded on the DCM's centralized market.[39] To implement this rule, DCMs would have to monitor contracts annually for the percentage of trading done on and off the centralized market and, if a contract does not meet the 85% requirement, it must be de-listed.[40]

The proposed rules would also establish new requirements applicable to block trading. The proposed rules would require that if a DCM permits block trades, it must have rules to limit those trades to large transactions as defined in the proposed rule.[41] In furtherance of this requirement, each DCM would certify to the Commission or submit for Commission approval the block trade size for each contract.[42] The proposed rules also would restrict those eligible to

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[34] § 38.155.
[35] § 38.851(d).
[36] § 38.851(b)(5). The report must detail the recommendation, its rationale, the rationale for the DCM rejecting the recommendation, and the decided course of action.
[37] § 38.604.
[38] § 38.601.
[39] § 38.502(a).
[40] § 38.502(b) & (c). DCMs have the option of transferring the contracts to a swap execution facility ("SEF"), including one that the DCM operates, or liquidating the contract. § 38.502(c). DCMs are able to apply for exemptions for contracts that do not meet the trading requirement, but likely will do so within a twelve-month period. § 38.502(e).
[41] § 38.503(a).
[42] *Id.*

engage in block trading to Eligible Contract Participants ("ECPs")[43] or asset managers with over $25 M in total assets managed.[44] The proposed rules would prohibit the aggregation of orders for different accounts in order to satisfy the block trade requirement, with an exception for asset managers,[45] but would permit block trades between affiliated parties[46] if there are specific indications that the trades are arms length transactions.[47]

The Commission is also proposing specific requirements relating to a DCM's market surveillance program. Among these is the requirement to carefully monitor physical delivery contracts in order to promote price convergence and prevent price distortions or market disruptions.[48] Recent concerns about the lack of convergence in certain agricultural products led the CFTC to form the Subcommittee on Convergence in Agricultural Commodity Markets in March 2009.[49] This proposal is one outgrowth of the Committee's work.

3. Proposed Registration Requirements for FBOTs

Section 738 of the DFA permits the Commission to adopt rules requiring the registration of FBOTs that wish to provide direct access to their electronic trading and order matching systems to U.S. customers. The Commission has proposed a framework for registering such FBOTs under its section 738 authority. The proposed rules introduce both procedural and substantive changes to the current no-action process applicable to FBOTs seeking direct market access to the U.S.

a. Procedural Changes

Currently, in order to permit U.S. customers direct access to their electronic trading and order matching systems, FBOTs must apply for a no-action letter from the Commission's Division of Market Oversight ("DMO").[50] In considering no-action requests, the Division reviews several factors, including whether the FBOT "possess[es] the attributes of an established, organized exchange; adher[es] to appropriate rules prohibiting abusive trading practices; [has] been authorized by a regulatory process that examines customer and market protections; and [is] subject to continued oversight by a regulator that has power to intervene in the market and share

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[43] An "eligible contract participant" is defined in § 1a(18). The definition includes: "(i) a financial institution; (ii) an insurance company ...; (iii) an investment company ...; (iv) a commodity pool that has total assets exceeding $5,000,000 ....; (v) a corporation, partnership, proprietorship, organization, trust, or other entity that has total assets exceeding $10,000,000 ....; (vi) an employee benefit plan ...; (vii) a governmental entity ...; (viii) a broker or dealer ...; (ix) a futures commission merchant ...; (x) a floor broker or floor trader ...; (xi) an individual who has amounts invested on a discretionary basis, the aggregate of which is in excess of $10,000,000; or $5,000,000" [subject to certain conditions] ...."

[44] § 38.503(c).

[45] § 38.503(e).

[46] An "affiliated party" is defined as "a party that directly or indirectly through one or more persons, controls, is controlled by, or is under common control with another party." § 38.503(d)(2).

[47] § 38.503(d).

[48] § 38.252.

[49] *See* Report and Recommendations of the Subcommittee on Convergence in Agricultural Commodity Markets to the Agricultural Advisory Committee of the Commodity Futures Trading Commission on Convergence in Wheat with Implications for Other Commodity Markets, 2, *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/reportofthesubcommitteeonconve.pdf

[50] *See* Registration of Foreign Boards of Trade, 75 Fed. Reg. 70972, 70974 (Nov. 19, 2010).

information with the CFTC."[51] Over time, as the regulatory landscape has changed, the Commission has expanded the number of conditions required of FBOTs seeking no-action relief.[52]

The no-action process is a long-established practice, the conditions and standards for which have evolved over time.[53] The proposed rules codify the standards and conditions reflected in the most recent requests for no-action relief.[54] Because the earlier letters may not include all of the conditions of the later letters, the Commission has proposed not to permit grandfathering of no-action relief. Instead, the rules propose that all FBOTs will be required to file a registration application. However, those FBOTs operating under existing no-action relief would be able to use a "limited application" process. This "limited application" would include resubmitting information or documentation used in the original no-action application and mapping that information to the revised standards.[55] As proposed, these FBOTs with existing no-action relief would have 120 days to submit the limited application. FBOTs that had not previously received no-action relief, however, would have to file a complete application.

Because they would likely have satisfied most, if not all, of the requirements outlined in the newly proposed registration rules in their no-action requests, FBOTs that have been granted no-action relief more recently will likely find meeting the requirements of the limited application easier than those granted no-action relief earlier. However, as proposed, all FBOTs with existing no-action relief would be able to continue to provide direct access to U.S. customers while the application is pending.[56]

b. Substantive Changes

The proposed FBOT registration rules will have a significant impact in three substantive areas: recognition of FBOTs as an appropriate venue for swaps execution, required surveillance of linked contracts, and enhanced demonstration relating to clearing.

The Commission is proposing to recognize registered FBOTs as a venue on which swaps may be executed. In doing so, the Commission noted that section 733 of the DFA permits the Commission to exempt a swaps execution facility that is "subject to comparable, comprehensive supervision and regulation on a consolidated basis by . . . the appropriate governmental authorities in the home country of the facility" from the requirement to register with the Commission.[57] The Commission reasoned that this is similar to the section 737 requirement that applies to the registration provision governing FBOTs. Accordingly, the Commission proposed to permit a registered FBOT to offer and trade swaps through direct market access subject to the condition that the FBOT meet certain of the requirements that apply to swaps execution facilities.[58] These include providing data on swap transactions to the public on a real-time basis

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[51] Architzel, Paul & Castillo, Tara. New U.S. Registration Requirements for Foreign Boards of Trade Under Dodd-Frank Act, *BNA International World Securities Law Report*, September 2010.
[52] *See* Registration of Foreign Boards of Trade, 75 Fed. Reg. 70972, 70976 (Nov. 19, 2010).
[53] Architzel, Paul & Castillo, Tara. New U.S. Registration Requirements for Foreign Boards of Trade Under Dodd-Frank Act, *BNA International World Securities Law Report*, September 2010.
[54] *See* Registration of Foreign Boards of Trade, 75 Fed. Reg. 70972, 70976 (Nov. 19, 2010).
[55] § 48.6(b).
[56] § 48.6(c).
[57] *See* Registration of Foreign Boards of Trade, 75 Fed. Reg. 70972, 70978 (Nov. 19, 2010).
[58] *Id.*

and to a swap data repository that is either registered with the Commission or has an information sharing agreement with the Commission.[59] The FBOT would also be required to coordinate with the Commission regarding cross market oversight issues such as surveillance, emergency actions, and monitoring of trading.[60]

The Commission is also proposing enhanced market surveillance for FBOT contracts linked to those traded on a U.S. DCM. The proposed rules would require the FBOT to identify contracts that are linked to contracts listed for trading on a U.S. exchange, as well as contracts that share commonalities with contracts traded on a U.S. exchange.[61] In regard to the linked contracts, an FBOT would have to provide daily public information about these contracts and adopt position limits[62] that are comparable to that of the registered entity for the contract to which they are linked.[63] The FBOT or its regulator would also have to be empowered to direct market participants to alter or liquidate a position in order to avoid price manipulation or excessive speculation.[64] Also, the FBOT or its regulator would be required to provide the Commission with information regarding large and aggregate trader positions in the contracts[65] and with audit trail data, and to permit the Commission onsite access.[66]

Finally, the Commission is proposing to require an FBOT seeking registration to make an enhanced demonstration with regard to its clearing arrangements. As proposed, an FBOT applying for registration would be required to demonstrate that its clearing organization either is registered with the Commission as a Derivatives Clearing Organization or complies with the "Recommendations for Central Counterparties" that have been issued jointly by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions.[67]

Conclusion

The Commission has proposed broad revisions to the requirements governing the designation and operation of DCMs and the registration of FBOTs with direct market access to the U.S. The Commission's proposed rules on DCM governance will likely have a significant impact on their corporate organization and governance. Although the process of demutualization has resulted in significant changes to the organization and governance of futures exchanges, these rules, if adopted, will play a significant role in further shaping and guiding the evolution of exchanges from member-owned organizations to for-profit, publicly-owned companies that fulfill unique public interest functions. The rules will also likely have a profound impact on market structure through the proposed changes to the block trading requirements and the associated de-listing provision.

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[59] § 48.8(a)(8)(i)&(ii).
[60] § 48.8(a)(8)(iii).
[61] § 48.7(c)(2).
[62] The requirement is satisfied if the FBOT or its regulator is able to adopt position limits. § 48.8(c)(1)(ii).
[63] § 48.8(c)(1).
[64] § 48.8(c)(1)(ii)(a).
[65] § 48.8(c).
[66] § 48.8(c)(ii).
[67] The Recommendations for Central Counterparties, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Consultative Report (November 2004) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf. includes 15 recommendations in such areas as margin requirements, operational risk, governance, and financial resources.

Although the proposed rules establishing a framework for registration of FBOTs seeking direct market access largely codifies existing requirements, the proposal nevertheless will have a significant impact as FBOTs with existing relief are required to submit a registration application, even if limited in scope. This requirement will impose significant resource demands on both FBOTs and the Commission's staff.