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CFTC Proposes Rules on DCO Financial Resource Requirements, Conflicts of Interest

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In connection with its ongoing implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Commodity Futures Trading Commission last Friday voted to propose several rules for publication in the *Federal Register*. The CFTC proposals include rules relating to the financial resources requirements for derivatives clearing organizations (DCOs) and the mitigation of conflicts of interest by DCOs, designated contract markets (DCMs), and swap execution facilities (SEFs).

Under the proposed financial resources rules, DCOs would be required to maintain financial resources that, at a minimum, (i) exceed the total amount that would be required for a DCO to meet its financial obligations to its clearing members notwithstanding a default by the clearing member (or, in the case of DCOs designated as "systematically important" by the Financial Stability Oversight Council, the two clearing members) creating the largest financial exposure for the DCO in extreme but plausible market conditions, and (ii) enable the DCO to cover its operating costs for a period of one year, as calculated on a rolling basis. For purposes of meeting the first requirement above, DCOs would be permitted to include: (1) margin of a defaulting clearing member, (2) the DCO's own capital, (3) guaranty fund deposits, (4) default insurance, and (5) potential assessments (subject to certain haircuts and other restrictions) for additional guaranty fund contributions. For purposes of the second requirement, DCOs would be permitted to include the DCO's own capital and any other financial resource deemed acceptable by the CFTC, which would have to include unencumbered, liquid financial assets (which could include a committed line of credit or similar facility) equal to at least six months' operating costs.

The proposed rules regarding mitigation of conflicts of interest by DCOs, DCMs and SEFs impose specific structural governance requirements and limitations on the ownership of such entities. The governance requirements would, among other things, require that the boards of directors of such entities include a minimum number of "public directors" and certain specified committees and disciplinary panels (each subject to specific composition requirements). The ownership limitations set forth in the proposed rules would require the applicable DCO, DCM or SEF to cap the voting power of any of its members (taken together with the member's affiliates) at 20%. A DCO (but not a DCM or SEF) could choose one of two alternatives to come into compliance with this requirement (or petition the CFTC for a waiver of such requirements). One

alternative would cap at 5% the amount of voting power held or exercised by any DCO member or other "enumerated entity" (which generally includes certain large banks, swap dealers, major swap participants and their affiliates). The other alternative would cap at 20% the amount of voting equity or voting power held or exercised by any single DCO member, and would further impose a 40% cap on the aggregate voting equity or power held or exercised by all enumerated entities.

Both sets of rules are scheduled for publication in the *Federal Register* on October 8. The comment period for the conflicts of interest mitigation rules will expire 30 days from the date of publication; the comment period for the financial resources rules will expire 60 days from the date of their publication.

Additional information regarding the proposed rules, including the rule text and related Q&As, can be found here.

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