COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 38

RIN 3038-AC28

Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations ("SROs")

AGENCY: Commodity Futures Trading Commission ("Commission").

ACTION: Final acceptable practices for Section 5(d)(15) ("Core Principle 15")[1] of the Commodity Exchange Act ("CEA" or "Act").[2]

SUMMARY: The Commission hereby adopts final acceptable practices for minimizing conflicts of interest in decision making by designated contract markets ("DCMs" or "exchanges").[3] The final acceptable practices are the first issued for Core Principle 15 and are applicable to all DCMs.[4] They focus upon structural conflicts of interest within modern self-regulation, and offer DCMs a "safe harbor" by which they may minimize such conflicts and comply with Core Principle 15. To receive safe harbor treatment, DCMs must implement the final acceptable practices in their entirety, including instituting boards of directors that are at least 35% public and establishing oversight of all regulatory functions through Regulatory Oversight Committees ("ROCs") consisting exclusively of public directors.

The final acceptable practices recognize DCMs' unique public-interest responsibilities as self-regulatory organizations ("SROs") in the U.S. futures industry. They address conflicts of interest that exist within DCMs as they operate in an increasingly competitive environment and

[1] Core Principle 15 states: "CONFLICTS OF INTEREST—The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest." CEA § 5(d)(15), 7 U.S.C. § 7(d)(15).

[2] The Act is codified at 7 U.S.C. § 1 *et seq*. (2000).

[3] The acceptable practices for core principles reside in Appendix B to Part 38 of the Commission's Regulations, 17 CFR Part 38, App. B.

[4] Any board of trade that is registered with the Securities and Exchange Commission ("SEC") as a national securities exchange, is a national securities association registered pursuant to section 15(A)(a) of the Securities Exchange Act of 1934, or is an alternative trading system, and that operates as a designated contract market in security futures products under Section 5f of the Act and Commission Regulation 41.31, is exempt from the core principles enumerated in Section 5 of the Act, and the acceptable practices thereunder, including those adopted herein.

transform from member-owned, not-for-profit entities into diverse enterprises with a variety business models and ownership structures. While continuing to meet their regulatory responsibilities, DCMs must now compete effectively to generate profits, advance their commercial interests, maximize the value of their stock, and/or serve multiple membership, ownership, customer, and other constituencies. The presence of these potentially conflicting demands within a single entity—regulatory authority coupled with commercial incentives to misuse such authority—constitute the new structural conflict of interest addressed by the acceptable practices adopted herein.

The Commission has determined that the structural conflicts outlined above are appropriately addressed through reforms within DCMs themselves, including reforms of DCMs' governing bodies. Accordingly, the Commission offers the new acceptable practices for Core Principle 15 as an appropriate method for minimizing such conflicts. The Commission believes that additional public directors on governing bodies, greater independence at key levels of decision making, and careful insulation of regulatory functions and personnel from commercial pressures, are important elements in ensuring vigorous, effective, and impartial self-regulation now and in the future. The new acceptable practices incorporate and emphasize each of these elements, and offer all DCMs clear instruction as to how they may comply with Core Principle 15.

Although DCMs are free to comply with Core Principle 15 by other means, the Commission stresses that they all must address structural conflicts of interest and adopt substantive measures to protect their regulatory decision making from improper commercial considerations. DCMs must ensure that regulatory decisions are made on their own merits, and that they are not compromised by the commercial interests of the DCMs or the interests of their

numerous constituencies. Likewise, DCMs' regulatory operations and personnel must be insulated from improper influence and commercial considerations to ensure appropriate regulatory outcomes.

The new acceptable practices are set forth in four component parts, and DCMs must meet all four to receive safe harbor treatment under Core Principle 15. Each component part is summarized as follows:

First, the *Board Composition Acceptable Practice* calls upon all DCMs to minimize conflicts of interest in self-regulation by establishing boards of directors that contain at least 35% "public directors" (as defined by a separate *Public Director Acceptable Practice* discussed below). The Board Composition Acceptable Practice further requires that DCMs ensure that any executive committees (or similarly empowered bodies) also meet the 35% public director standard. This 35% standard in the new acceptable practices represents a modification from the 50% public director standard in the proposed acceptable practice.[5]

Second, the *Regulatory Oversight Committee Acceptable Practice* mandates that all DCMs establish Regulatory Oversight Committees, composed only of public directors, to oversee core regulatory functions and ensure that they remain free of improper influence. The Commission notes that ROCs are intended to insulate self-regulatory functions and personnel from improper influence. In fulfilling this role, however, ROCs are not expected to assume managerial responsibilities, or to isolate self-regulatory functions and personnel from others within the DCM. ROCs' oversight and insulation should be aided by their DCMs' chief regulatory officers ("CROs"). A full description of the responsibilities and authority of ROCs may be found in the text of the final acceptable practices.

[5] Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations ("Proposed Rule"), 71 FR 38740 (July 7, 2006).

Third, the *Disciplinary Panel Acceptable Practice* states that DCM disciplinary panels should not be dominated by any group or class of DCM members or participants, and must include at least one "public person" on every panel. Under the Disciplinary Panel Acceptable Practice, disciplinary panels must keep thorough minutes of their meetings, including a full articulation of the rationale supporting their disciplinary decisions.

Finally, the *Public Director Acceptable Practice* establishes specific definitions of "public" for DCM directors and for members of disciplinary panels. Public directors are persons who have no "material relationship" with their DCM, *i.e.*, any relationship which could reasonably affect their independent judgment or decision making. In addition, public directors must meet a series of "bright-line tests" which identify specific circumstances and relationships which the Commission believes are clearly material. For members of disciplinary panels, the definition of "public" includes the bright-line tests, but not the materiality criterion.

The final acceptable practices also include clarifications to the acceptable practices originally proposed by the Commission on July 7, 2006. For example, the final acceptable practices clarify that a DCM's public directors may also serve as public directors of its holding company under certain circumstances. These clarifications were made in response to public comments on the proposed acceptable practices.

In addition, although the final acceptable practices are effective 30 days after publication in the *Federal Register*, the Commission will permit currently established DCMs to implement responsive measures over a phase-in period of two years or two regularly-scheduled board elections, whichever occurs sooner.[6] Responsive measures include implementing the final acceptable practices or otherwise fully complying with the requirements of Core Principle 15,

[6] "Currently established" DCMs are those that are already designated at the time this release is published in the *Federal Register*.

including requirements to minimize the structural conflicts of interest discussed herein. The phase-in period and the modified public director requirements for boards and executive committees are the only significant changes between the proposed acceptable practices and those adopted today.

EFFECTIVE DATE: [Insert date 30 days after publication in the *Federal Register*.]

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I. Introduction

U.S. futures markets are a critical component of the U.S. and world economies, providing significant economic benefits to market participants and the public at large. They provide an important hedging vehicle to individuals and firms in myriad industries, resulting in more efficient production, lower costs for consumers, and other economic benefits. By offering a competitive marketplace and focal point where traders can freely interact based on their assessments of supply and demand, futures markets also provide a vital forum for discovering prices that are generally considered to be superior to administered prices or prices determined privately. For this reason, futures markets are widely utilized throughout the global economy. Participants in the markets include virtually all economic actors, and the prices discovered on a daily basis materially affect a wide range of businesses in the agricultural, energy, financial, and other sectors.

For the reasons outlined above, DCMs are not just typical commercial enterprises, but are commercial enterprises affected with a significant national public interest. Actions that distort prices or otherwise undermine the integrity of the futures markets have broad, detrimental implications for the economy as a whole and the public in general. Congress recognized the importance of futures trading in the Act, when it explicitly stated that futures transactions "are entered into regularly in interstate and international commerce and are affected with a national public interest…."[7] It defined the public interest to include "liquid, fair, and financially secure

[7] CEA § 3(a), 7 U.S.C. § 5(a).

trading facilities."[8] Congress also identified the purposes of the Act: "to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this Act and the avoidance of systemic risk; and to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets."[9] To accomplish these purposes, Congress established a statutory system of DCM self-regulation, combined with Commission oversight, to promote "responsible innovation and fair competition among boards of trade, other markets and market participants."[10] Meeting these statutory obligations and purposes requires DCM self-regulation that is as vigorous, impartial, and effective as possible.

All DCMs face unique and potentially conflicting regulatory obligations and commercial demands as they work to meet the statutory requirements outlined above. On the commercial side, they must attract trading to their markets, maximize the value of their stock, generate profits, satisfy the financial needs of their numerous stakeholders and constituencies, and/or meet the diverse business needs of their market participants. At the same time, as self-regulatory organizations, DCMs must exercise their authority judiciously, impartially, and in the public interest. As essential forums for the execution of futures transactions and for price discovery, DCMs must ensure fair and financially secure trading facilities. DCMs must also help to "serve" and "foster" the national public interest through self-regulatory responsibilities that include ensuring market integrity, financial integrity, and the strict protection of market participants.[11]

When DCMs were first entrusted with these extensive regulatory responsibilities, they were almost exclusively member-owned, not-for-profit exchanges facing little competition for customers or in their prominent contracts. Although conflicts of interest in self-regulation were a

[8] *Id.*
[9] CEA § 3(b), 7 U.S.C. § 5(b).
[10] *Id.*
[11] *Id.*

concern even then, such conflicts typically centered on individual exchange members policing one another. Today's DCMs, however, are vibrant commercial enterprises competing globally in an industry whose ownership structures, business models, trading practices, and products are evolving rapidly. As a result, DCMs now face potential conflicts of interest between their critical self-regulatory responsibilities and their powerful commercial imperatives. Specifically, DCMs must: defend and expand their markets against others offering similar products or services; generate returns for their owners; and provide liquid markets where their members and customers may profit. At the same time, they must continue to meet fundamental public interest responsibilities through vigorous and impartial self-regulation. To reconcile these obligations, DCMs must acknowledge and guard against conflicts between their regulatory responsibilities and their commercial interests, and take measures to prevent improper influence upon self-regulation by their numerous constituencies, including members, owners, customers, and others.

As explained in the proposing release, rapid and ongoing changes in the futures industry have raised concerns as to whether existing self-regulatory structures are equipped to manage evolving conflicts of interest. Self-regulation's traditional conflict—that members will fail to police their peers with sufficient zeal—has been joined by the possibility that competing DCMs could abuse their regulatory authority to gain competitive advantage or satisfy commercial imperatives. Such conflicts of interest must be addressed promptly and proactively to prevent them from becoming real abuses, and to ensure continued public confidence in the integrity of the U.S. futures markets.

After three-and-a-half years of careful study, the Commission has determined that the conflicts of interest identified above are inherent in any system of self-regulation conducted by competing DCMs, many of which operate under new ownership structures and business models,

and all of which are possessed of strong commercial imperatives. The Commission has further determined that successfully addressing such conflicts, and complying with Core Principle 15, requires appropriate responses within DCMs. Only by reconciling the inherent tension between their self-regulatory responsibilities and their commercial interests, whether via the new acceptable practices or otherwise, can DCMs successfully minimize conflicts of interest in their decision-making processes and thereby ensure the integrity of self-regulation in the U.S. futures industry.

The new acceptable practices for Core Principle 15 are a direct response to the industry changes outlined above. As required by the Act, they "promote responsible innovation and fair competition" among U.S. DCMs, and ensure that self-regulation remains compatible with the modern business practices of today's DCMs.[12] The new acceptable practices embody the Commission's firm belief that effective self-regulation in an increasingly competitive, publicly traded, for-profit environment requires independent decision making at key levels of DCMs' regulatory governance structures. The Commission further believes that the new acceptable practices constitute an ideal solution to emerging structural conflicts of interest in self-regulation. Both proactive and carefully targeted, the new acceptable practices for Core Principle 15 advance the public interest and ensure the continued strength and integrity of self-regulation in a rapidly evolving industry.

The conflicts of interest described above require careful responses by all DCMs. The Commission believes that DCMs can comply with Core Principle 15 by minimizing conflicts of interest between their regulatory responsibilities and their commercial interests or those of their membership, ownership, management, customer, and other constituencies. However, whether

[12] *Id.*

DCMs choose to comply with Core Principle 15 via the acceptable practices adopted herein or by other means, the Commission recognizes that necessary measures may take time to implement. Accordingly, and at the request of public commenters, the Commission is adopting a phase-in period for full compliance with Core Principle 15. Within two years of this document's effective date, or two regularly-scheduled board elections, whichever occurs first, all DCMs must be in full compliance with Core Principle 15, either by availing themselves of the new acceptable practices or undertaking other effective measures to address the structural conflicts of interest identified herein. Commission staff will contact all DCMs in six months of the effective date of these final acceptable practices to learn of their plans for full compliance. Established DCMs must demonstrate substantial compliance with Core Principle 15, and plans for full compliance, well before the phase-in period's expiration. New candidates for designation as contract markets should be prepared to demonstrate compliance with Core Principle 15, or a plan for compliance, upon application.

II. Procedural History

The four acceptable practices for Core Principle 15 adopted today are the culmination of a comprehensive review of self-regulation in the U.S. futures industry ("SRO Review" or "Review") launched by the Commission in May of 2003. Phase I of the Review explored the roles, responsibilities, and capabilities of SROs in the context of industry changes. Staff examined the designated self-regulatory organization system of financial surveillance, the treatment of confidential information, the composition of DCM disciplinary committees and panels, and other aspects of the self-regulatory process. Phase I of the Review also included staff interviews with over 100 persons including representatives of DCMs, clearing houses, futures

commission merchants ("FCMs"), industry associations, and securities-industry entities, as well as current and retired industry executives, academics, and consultants.

In June of 2004, the Commission initiated Phase II of the SRO Review and broadened its inquiry to explicitly address SRO governance and the interplay between DCMs' self-regulatory responsibilities and their commercial interests. In June of 2004, the Commission issued a *Federal Register* Request for Comments ("Request") on the governance of futures industry SROs.[13] The Request sought input on the proper composition of DCM boards, optimal regulatory structures, the impact of different business and ownership models on self-regulation, the proper composition of DCM disciplinary committees and panels, and other issues.

In November of 2005, the Commission updated its previous findings through a second *Federal Register* Request for Comments ("Second Request") that focused on the most recent industry developments.[14] The Second Request examined the board-level ROCs recently established at some SROs in the futures and securities industries. It also asked commenters to consider the impact of New York Stock Exchange ("NYSE") listing standards on publicly traded futures exchanges; whether the standards were relevant to self-regulation; and how the standards might inform the Commission's own regulations.[15]

Phase II of the SRO Review concluded with a public Commission hearing on "Self-

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[13] Governance of Self-Regulatory Organizations, 69 FR 32326 (June 9, 2004). Comment letters received are available at: <<http://www.cftc.gov/foia/comment04/foi04--005_1.htm>>.

[14] Self-Regulation and Self-Regulatory Organizations in the Futures Industry, 70 FR 71090 (Nov. 25, 2005). Comment letters received are available at <<http://www.cftc.gov/foia/comments05/foi05--007_1.htm>>.

[15] The NYSE's corporate governance listing standards require listed companies to: have a majority of independent directors; meet materiality and bright-line tests for independence; convene regularly scheduled executive sessions of the board without management present; institute nominating/governance, compensation, and audit committees consisting exclusively of public directors; *etc.* *See* NYSE Listed Company Manual, §§ 303A:00-14, available at: << http://www.nyse.com/regulation/listed/1101074746736.html>>. The NASDAQ Stock Market has adopted corporate governance listing standards similar to the NYSE's. *See* the NASDAQ Stock Market Listing Standards and Fees, available at: <<http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf>>. DCMs whose parent companies are listed on the NYSE include the CBOT, CME, NYBOT, and NYMEX. Although these DCMs themselves are not required to comply with the listing standards, they may be in *de facto* compliance if they have chosen to name identical boards of directors for both the listed parent and the DCM.

Regulation and Self-Regulatory Organizations in the U.S. Futures Industry" ("Hearing"). The day-long Hearing, held on February 15, 2006, included senior executives and compliance officials from a wide range of U.S. futures exchanges, representatives of small and large FCMs, academics and other outside experts, and an industry trade group. The Hearing afforded the Commission an opportunity to question panelists on four broad subject areas: (1) board composition; (2) alternative regulatory structures, including ROCs and third-party regulatory service providers; (3) transparency and disclosure; and (4) disciplinary committees.[16]

Finally, in July of 2006, the Commission published the Proposed Rule and sought public comment on new acceptable practices for Core Principle 15.[17] The Commission proposed that at least 50% of the directors on DCM boards and executive committees (or similarly empowered bodies) be public directors. It also proposed that day-to-day regulatory operations be overseen and insulated through a CRO reporting directly to a board-level ROC consisting exclusively of public directors. The proposed acceptable practices also defined "public director" for persons serving on boards and ROCs, and defined "public person" for disciplinary panel members. To qualify as a public director under the proposal, the director in question would require an affirmative determination that he or she had no material relationship with the DCM. In addition, public directors and public persons would both have been required to meet a series of "bright-line" tests. The inability to satisfy both the material relationship and bright-line test requirements would automatically preclude them from serving as public directors or public disciplinary panel members. Finally, the proposed acceptable practices called for DCM disciplinary panels that were not dominated by any group or class of SRO participants, and that included at least one public person.

[16] The Hearing Transcript is available at <<http://www.cftc.gov/files/opa/opapublichearing021506.final.pdf>>.
[17] *See supra* note 5.

The proposal's original 30-day comment period, scheduled to close on August 7, 2006, was extended by an additional 30 days, to September 7, 2006. The Commission received a total of 34 comment letters in response to the proposed acceptable practices for Core Principle 15, significant aspects of which are discussed below.[18]

III. Public Comments Received and the Commission's Response

The 34 comment letters received in response to the proposed acceptable practices included responses from 10 industry associations and trade groups, nine individuals (including directors of exchanges writing separately), eight DCMs, six futures commission merchants ("FCMs"), one group of DCM public directors, one U.S. Senator, and one U.S. Congressman.[19]

The Commission thoroughly reviewed and considered all comments received. In response to persuasive arguments by various commenters, the final acceptable practices include two significant modifications from those originally proposed. Specifically, the final acceptable practices include: (1) a reduction in the required number of public directors on boards and executive committees, from at least 50% public to at least 35% public; and (2) a phase-in period to implement the acceptable practices, or otherwise come into full compliance with Core Principle 15, of two years or two regularly scheduled board elections, whichever occurs sooner.

In addition, in response to comments received, the Commission has made several clarifications and non-substantive revisions to the final acceptable practices. The Commission

[18] Comment letters in response to the Proposed Rules are available at: <<http://www.cftc.gov/foia/comment06/foi06--004_1.htm>>.

[19] The commenters were: Bear Stearns; Citigroup; Morgan Stanley; the Chicago Mercantile Exchange ("CME"); the New York Mercantile Exchange ("NYMEX"); U.S. Sen. Pat Roberts and Congressman Jerry Moran; the National Grain Trade Council; Daniel L. Gibson; the National Grain and Feed Association; the New York Board of Trade ("NYBOT"); Public Members of the NYBOT; the Chicago Board of Trade ("CBOT"); Philip McBride Johnson; the CBOE Futures Exchange ("CFE"); Dennis M. Erwin; HedgeStreet; Colby Moss; Horizon Milling, LLC; John Legg; the National Futures Association; Robert J. Rixey; Michael Braude; Lehman Brothers; the Kansas City Board of Trade ("KCBT"); the Futures Industry Association ("FIA"); the Florida Citrus Producers Association; the National Cotton Council of America; Cargill Juice North America; Nickolas Neubauer; the American Cotton Shippers Association; Barry Bell; Fimat; J.P. Morgan Futures Inc.; and the Minneapolis Grain Exchange ("MGEX").

has also provided further discussion or elaboration in this preamble in order to provide further clarification on specific aspects of the acceptable practices, consistent with the Commission's original intent.

Specifically, in the text of the final acceptable practices, the Commission has clarified: that a public director may serve on the boards of both a DCM and of its parent company; that public directors are allowed deferred compensation in excess of $100,000 under certain circumstances; and that public persons serving on disciplinary panels are subject only to the bright-line tests used to define public directors. The Commission has also clarified that the acceptable practices do not address the manner in which DCMs select their public directors, whether by election, appointment, or other means.

Some commenters called for greater requirements than in the proposed acceptable practices, and others called for less requirements. The Commission carefully considered those comments, but decided not to make any changes other than those outlined above. As stated previously, the Commission believes that adopting the new acceptable practices strikes a careful balance between an appropriate approach to minimizing conflicts of interest in self-regulation, as required by Core Principle 15, and the overall flexibility offered by the core principle regime. Moreover, the Commission believes that the acceptable practices adopted herein are necessary and appropriate to fulfill the purposes of the Act and advance the public interest.

The substantive comments received, and the Commission's responses thereto, are presented below. They are organized as follows:

Legal Comments: comments questioning the Commission's authority to issue the proposed acceptable practices, including comments with respect to the meaning of Core Principle 15 and its interaction with other core principles;

Policy Comments: comments requesting more or stricter guidance than that proposed by the Commission; comments requesting that the Commission issue no acceptable practices, or

fewer or less detailed acceptable practices; and comments questioning the rationale behind the proposed acceptable practices, including:

- general comments;
- comments with respect to board composition;
- comments with respect to the definition of public director;
- comments with respect to Regulatory Oversight Committees;
- comments with respect to disciplinary committees;

Comments Requesting Modifications and Clarifications, including:

- phase-in period for the new acceptable practices;
- selection of public directors;
- compensation of public directors;
- overlapping public directors;
- jurisdiction of disciplinary panels and definition of "public" for persons serving on disciplinary panels;
- "no material relationship" test for public directors;
- elimination of ROCs' periodic reporting requirements.

A. Legal Comments: Public Comments Received and the Commission's Response.

1. Overview of the Commission's Authority to Issue the Acceptable Practices.

The Commission's issuance of the acceptable practices for Core Principle 15 respects the letter and spirit of the Act. The Commission's authority to do so is firmly rooted in Core Principle 15's mandate to DCMs to minimize conflicts of interest in decision making. Core Principle 15 requires DCMs to maintain systems to minimize structural conflicts of interest inherent in self-regulation, as well as individual conflicts of interest faced by particular persons.[20] The acceptable practices are rationally related to the purposes of Core Principle 15.

The Board Composition Acceptable Practice recognizes that the governing board of a DCM is its ultimate decision maker and therefore the logical place to begin to address conflicts. Participation by public directors in board decision making is a widely accepted and effective means to reduce conflicts of interest.[21] By providing for significant public participation on the

[20] 71 FR 38740, 38743.
[21] *See, e.g.*, NYSE Listed Company Manual, § 303A (commentary).

board, the seat of DCM governance and policymaking, the acceptable practice ensures that conflicts of interest are minimized at the highest level of decision making.

The ROC Acceptable Practice recognizes the importance of insulating core regulatory functions from improper influences and pressures stemming from a DCM's commercial affairs. It operates to minimize conflicts of interest in decisions made in the ordinary course of business. Finally, the Disciplinary Panel Acceptable Practice, by mandating participation on most disciplinary panels of at least one person who meets the bright-line tests for public director, minimizes conflicts of interest that may undermine the fundamental fairness required of DCM disciplinary proceedings. In sum, these acceptable practices represent an effective means to implement Core Principle 15 and are fully consistent with its mandate that DCMs minimize conflicts of interest in all decision making. They therefore lie well within the Commission's authority.

Congress has determined that there is a national public interest in risk management and price discovery.[22] The individual provisions of the Act operate in furtherance of those interests by instituting and enforcing a system of "effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission."[23] Core Principle 15 must be read in light of those public interests and purposes.

The safe harbor created by the new acceptable practices removes the guesswork from compliance with Core Principle 15. Congress intentionally wrote the core principles to be broad and flexible, and to help DCMs and the Commission to adjust to changing circumstances. Flexibility, however, may give rise to uncertainty. In order to provide DCMs with greater certainty in the context of flexible core principles, Congress, in adopting the Commodity Futures

[22] CEA Section 3(a), 7 U.S.C. § 5(a).
[23] CEA Section 3(b), 7 U.S.C. § 5(a).

Modernization Act ("CFMA"),[24] added Section 5c(a)(1) to the CEA, which specifically authorizes the Commission, consistent with the purposes of the CEA, to "issue interpretations, or approve interpretations submitted to the Commission . . . to describe what would constitute an acceptable business practice for Core Principles."[25] As a general rule, the Commission believes that issuing acceptable practices and other guidance under the core principles is beneficial, given the CFMA's lack of legislative history that might otherwise have been a source of guidance. Safe harbors, such as those created by the acceptable practices being issued today, remove uncertainty while setting high standards consistent with the purposes of the CEA and the authority granted by Congress to the Commission to issue such acceptable practices. Nothing in these acceptable practices, as safe harbors, infringes upon the Congressional directive in Section 5c(a)(2) of the CEA that acceptable practices not be the "exclusive means for complying" with core principles, as DCMs remain free to demonstrate core principle compliance by other means.[26]

Pursuant to its duty under the CEA to consider the costs and benefits of its action in issuing the acceptable practices, as discussed separately below, the Commission believes that the acceptable practices will minimize conflicts of interest in DCM decision making and promote public confidence in the futures markets. These are significant benefits to the futures industry, market participants, and the public. While commenters alleged that compliance would be costly, none of them provided an estimate of those costs in response to the Commission's specific request for quantitative data. The Commission has no basis to conclude that compliance would not be a reasonable cost of doing business in an industry subject to federal oversight—a cost that may be phased in gradually over two years or two election cycles.

[24] The CFMA is published at Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).
[25] 7 U.S.C. § 7a-2(a)(1).
[26] 7 U.S.C. § 7a-2(a)(2).

Finally, the Board Composition Acceptable Practice operates without impeding the duties owed to shareholders by the directors of a public corporation. Demutualized DCMs typically have reorganized themselves as subsidiaries of parent holding companies. The acceptable practice applies to the board of a DCM itself—not to the parent. Accordingly, the Board Composition Acceptable Practice is unquestionably within the Commission's authority to issue acceptable practices under the core principles applicable to DCMs. The composition of a DCM governing board may be identical to that of its parent—that decision is a matter for the business judgment of the persons involved. Nevertheless, the boards are separate bodies, even if their memberships overlap. DCM directors have a fiduciary duty to stockholders, to be sure, but stockholders of a DCM own an entity that, as a matter of federal law, is required to minimize conflicts of interest under Core Principle 15 and that serves a public interest through its business activity. Stockholders are well served when the DCMs that they own comply with applicable laws and regulations.

We now turn to the legal issues raised by the commenters with respect to the Commission's authority to issue the acceptable practices.

2. Specific Legal Issues Raised by Commenters.

FIA, five major FCMs, and one exchange, CFE, filed comments generally in favor of the proposed acceptable practices and endorsed the Commission's analysis of its authority to issue them. CME, CBOT, NYMEX, and other commenters, in opposition, challenged the Commission's interpretation of Core Principle 15 and the statutory authority under which the proposals were issued.

As stated above, Core Principle 15 requires DCMs to establish and maintain systems that address conflicts of interest inherent in the structure of self-regulation, as well as personal

conflicts faced by individuals. FIA endorsed this analysis, stating that the proposed acceptable practices are "well-grounded" in the Commission's statutory authority and "rationally related" to the purposes of Core Principle 15.[27]

Commenters challenging the Commission's authority to promulgate the acceptable practices for Core Principle 15 contend that they: (1) conflict with Core Principle 16; (2) are contrary to the text of the statute; (3) are contrary to Congressional intent in enacting the CFMA; (4) lack factual support; (5) conflict with guidance for Core Principle 14; and (6) impermissibly shift the burden to DCMs to demonstrate compliance with Core Principle 15. As discussed below, none of these contentions is persuasive.

a. THE ACCEPTABLE PRACTICES FOR CORE PRINCIPLE 15 DO NOT CONFLICT WITH CORE PRINCIPLE 16.

CME challenged Core Principle 15's applicability to the acceptable practices, contending that because Core Principle 16 is the only core principle that mentions board composition, it is the only source of authority the Commission may use for this purpose, and that it is limited to mutually-owned DCMs.[28] Similarly, NYBOT and KCBT contended that as member-owned DCMs, they are subject to Core Principle 16's requirement to maintain governing boards that "reflect[] market participants," and should not face any other board composition provision.[29]

Core Principle 16 requires a mutually owned board of trade to ensure that the composition of its governing board reflects market participants. Based on its plain language, Core Principle 16 is limited to that goal,[30] and has no bearing on the entirely separate goal of Core Principle 15 to "minimize conflicts of interest in the decision-making process of the

[27] FIA Comment Letter ("CL") 7 at 3-4.
[28] CME CL 29 at 4-5. Core Principle 16 states: "COMPOSITION OF BOARDS OF MUTUALLY OWNED CONTRACT MARKETS.—In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants." CEA § 5(d)(16), 7 U.S.C. § 7(d)(16).
[29] NYBOT CL 21 at 4; KCBT CL 8 at 3.
[30] There is no legislative history concerning Core Principle 16 other than the statutory language itself.

contract market," whether or not it is mutually owned. Core Principle 16 applies only to mutually owned contract markets and directs that their governing boards must fairly represent market participants. Core Principle 15 applies to all contract markets, no matter how organized, and directs them to minimize conflicts of interest. Conflicts may be structural as well as personal. Core Principle 15 embraces both and supports the public director membership requirement for boards of DCMs. Accordingly, Core Principle 16 does not limit the Commission's authority to issue acceptable practices to increase public director representation on DCM boards in order to minimize conflicts of interest under Core Principle 15.

b. THE ACCEPTABLE PRACTICES FOR CORE PRINCIPLE 15 ARE NOT CONTRARY TO THE CEA'S TEXT.

Other opposing comments based on the text of Core Principle 15 substitute the Commission's straightforward reading of the statute with targeted interpretations of individual words and phrases. The Commission believes that these comments do not rise to the stature of significant questions of statutory interpretation. For instance, various commenters contended that Core Principle 15 says "minimize" conflicts of interest, not "eliminate" them, as they argue the Commission seeks to do with the Board Composition Acceptable Practice.[31] However, if the Commission had sought to "eliminate" conflicts of interest, the Commission could have imposed a 100% public director requirement. Certainly any less-than-100% public director requirement may not eliminate all conflicts of interest.

Another such comment stated that Core Principle 15 applies to "rules" and "process," but board composition is contained in DCM "bylaws" (not rules), and a change to board composition is not a "process."[32] Contrary to this commenter's restrictive interpretation of the term, "rule" is

[31] *See, e.g.*, KCBT CL 8 at 2 and Roberts & Moran CL 27 at 1-2.
[32] NYMEX CL 28 at 6.

defined broadly in Commission regulations to include by-laws.[33] Thus, the mere mention of "rules" in Core Principle 15 has no bearing on the Commission's authority. In addition, Core Principle 15 provides that a DCM shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest. The two requirements are not mutually exclusive.

Another commenter stated that Core Principle 15 provides that a DCM shall "enforce" rules, and thereby contemplates action against individuals rather than the DCM itself.[34] In fact, Core Principle 15 states "establish and enforce" rules. Use of the conjunctive belies any contention that Core Principle 15 was intended to be directed solely to individuals.

Numerous comments of this type were received, none of which constitutes a serious challenge to the Commission's legal authority and reasonable interpretation of Core Principle 15.

c. THE ACCEPTABLE PRACTICES FOR CORE PRINCIPLE 15 ARE NOT CONTRARY TO CONGRESSIONAL INTENT IN ENACTING THE CFMA.

Several commenters, including NYMEX and CBOT, contended that the Board Composition Acceptable Practice is contrary to Congress' intent in enacting Core Principle 15 and the CFMA.

Specifically, CBOT stated that prior to the CFMA's enactment, the CEA treated board composition and conflicts of interest in two distinct provisions of the statute. In passing the CFMA, Congress omitted the board composition provision and kept the conflicts of interest provision. CBOT interpreted this as evidence that Congress did not view board composition as a mechanism to minimize conflict of interests.[35] We believe that the legal import of silence as a statutory canon of construction in these circumstances is a weak indicator of Congressional

[33] *See* Commission Reg. 40.1(h), 17 C.F.R. § 40.1(h).
[34] NYMEX CL 28 at 6.
[35] CBOT CL at 5-6.

intent.[36] Moreover, inclusion of public directors on company boards is a widely accepted means to reduce conflicts of interest.[37] Congress has in other contexts recognized the utility of public directors in controlling conflicts of interest.[38] Interpreting the CFMA as the CBOT advocates would require the Commission to infer that Congress was unaware of its own enactments, as well as the aforementioned wide acceptance of public directors for reducing conflicts, which the Commission is not prepared to do.

Similarly, NYMEX commented that when the CFMA was enacted there was a general understanding among DCMs, Commission staff, and legislators that Congress did not intend the Commission to establish board composition requirements for demutualized DCMs, which would instead be subject to corporate governance and NYSE listing standards.[39] A congressional comment letter stated that it does not "appear" that Congress intended the Commission to address board composition in the instance of small mutually-owned DCMs like KCBT.[40]

No commenter, however, cited any legislative history supporting these views, and no rule of statutory or legal interpretation compels the Commission to adopt them. The Commission may interpret the CEA according to its reasoned discretion and agency expertise given the absence of any contrary indication of Congressional intent at the time the CFMA was enacted.

Various commenters also asserted that the proposed acceptable practices in general are counter to the spirit of the CFMA, which transformed the Commission into an oversight agency.[41] They contended also that the 50% public board member requirement in the proposed Board Composition Acceptable Practice is stricter than the former statutory requirement that

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[36] *See, e.g., U.S. v. Vonn*, 535 U.S. 55, 65 (2002); *Pauley v. Bethenergy Mines, Inc.*, 501 U.S. 680, 703 (1991) (internal citation omitted).
[37] *See, e.g.*, NYSE Corporate Governance Rule 303A (commentary).
[38] *See* Section 10(a) of the Investment Company Act of 1940, 7 U.S.C. § 80a-10(a); *Burks v. Lasker*, 441 U.S. 471, 484 (1979).
[39] NYMEX CL 28 at 5-6.
[40] Roberts & Moran CL 27 at 1-2.
[41] *See, e.g.*, NYMEX CL 28 at 9-10.

DCM boards have 20% independent directors.[42] This comment would apply equally to the minimum 35% requirement contained in the final acceptable practice. These commenters, however, overlook the essential fact that the acceptable practices—unlike the pre-CFMA 20% rule—are safe harbors, not statutory mandates. Persons taking this view appear to want the Commission to do nothing at all—neither issue rules nor announce nonbinding acceptable practices that embody high standards.

One commenter argued that the Commission did not subject DCMs to Commission Rule 1.64 (containing the board composition requirement for non-member representation)[43] when it adopted Commission Rule 38.2[44] shortly after the enactment of the CFMA, thus suggesting that the Commission's interpretation was that Core Principle 15 did not impose a board composition requirement.[45]

The Commission did not adopt acceptable practices for all of the core principles when it promulgated Commission Rule 38.2. Nor did the Commission permanently reserve from exemption all regulations that are reflected in core principles. Indeed, in January 2006, the Commission added Commission Rule 1.60 to the enumerated list of regulations to which DCMs are subject pursuant to Commission Rule 38.2.[46] Accordingly, the fact that Commission Rule 1.64 was not specifically exempted when Commission Rule 38.2 was promulgated is not a reliable indicator of the Commission's interpretation of Core Principle 15. Moreover, not long after Commission Rule 38.2 was issued, the Commission began the SRO Review to examine governance issues in order to determine whether action was warranted. Thus, even if the omission of Commission Rule 1.64 from the enumerated regulations in Commission Rule 38.2

[42] *See, e.g.*, CME CL 29 at 12.
[43] 17 C.F.R. 1.64.
[44] Commission Rule 38.2 contains an exemption for DCMs from all Commission regulations except those specifically enumerated. 17 C.F.R. 38.2.
[45] NYMEX CL 28 at 15.
[46] *See* 71 FR 1953 (Jan. 12, 2006).

were somehow indicative of a contemporaneous interpretation by the Commission of Core Principle 15, a matter that the Commission does not concede, the Commission's evolving views – based on the extensive record developed during the course of the SRO Review – support its current interpretation that Core Principle 15 authorizes it to adopt the Board Composition Acceptable Practice.

d. ACCEPTABLE PRACTICES ARE JUSTIFIED AS A PROPHYLACTIC MEASURE.

Several commenters contended that the acceptable practices lack factual support demonstrating a need for their issuance. They argued that the Commission did not point to any specific event or documented self-regulatory failure or allegation of such failure in support of the acceptable practices.[47] Several commenters contended that the studies cited by the Commission in the proposing release applied only to the securities industry, and thus were inapposite to conditions in the futures industry.[48]

These comments are misplaced. Although the Commission did not specifically identify futures industry self-regulatory lapses in support of the acceptable practices, it identified significant trends in the futures industry, including increased competition and changing ownership structures, that justify the acceptable practices as a prophylactic measure to minimize conflicts in decision making and to promote public confidence in the futures markets in the altered, demutualized, and more competitive landscape. Commenters pointed to nothing in the CEA, nor has the Commission found anything, to suggest that Congress intended to restrict the authority of the Commission to make "precautionary or prophylactic responses to perceived risks," that would render the Commission's action a violation of the CEA.[49]

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[47] *See* CME CL 29 at 9; NYMEX CL 28 at 11-12; NYBOT CL 22 at 4; CBOT CL 21 at 3.
[48] *See, e.g.*, NYMEX CL 28 at 11-13; CME CL 29 at 9; NYBOT CL 22 at 2; Comment of Donald L. Gibson, CL 25 at 1.
[49] *Chamber of Commerce v. SEC*, 412 F.3d 133, 141 (D.C. Cir. 2005).

e. ACCEPTABLE PRACTICES FOR CORE PRINCIPLE 15 DO NOT CONFLICT WITH GUIDANCE TO CORE PRINCIPLE 14.

Another issue raised is whether the new acceptable practices for Core Principle 15 conflict with guidance issued for Core Principle 14.[50] One commenter asserted that guidance to Core Principle 14 suggests that directors of DCMs should, at a minimum, be market participants, contrary to the proposed "public director" definition.[51] This contention misreads the guidance for Core Principle 14. Minimum standards for directors provided in the guidance are derived from the bases for refusal to register persons under CEA Section 8a(2),[52] and from the types of serious disciplinary offenses that would disqualify persons from board and committee service under Commission Rule 1.63.[53] Nothing in the Application Guidance for Core Principle 14 requires directors to be market participants. Moreover, a significant number of DCMs currently have directors on their boards who are not market participants.

f. ACCEPTABLE PRACTICES FOR CORE PRINCIPLE 15 DO NOT IMPERMISSIBLY SHIFT THE BURDEN TO DCMS FOR DEMONSTRATING COMPLIANCE.

Finally, CME, CBOT, and NYMEX contended that the Board Composition Acceptable Practice impermissibly shifts the burden of demonstrating a DCM's compliance with Core Principle 15 from the Commission to the DCM if a DCM elects not to comply with the acceptable practices.

There is no burden shifting here. All DCMs are required to demonstrate to the Commission how they are complying with the core principles. Without such a factual demonstration, the Commission could not determine whether a contract market is in compliance

[50] Core Principle 14 provides that a "Board of Trade shall establish and enforce appropriate fitness standards for directors [and others]." CEA § 5(d)(14), 7 U.S.C. § 7(d)(14).
[51] CME CL 29 at 9.
[52] 7 U.S.C. § 12a(2).
[53] 17 C.F.R. § 1.63. *See* 17 C.F.R. Part 38, Appendix B, Core Principle 14 ("Application Guidance").

with the core principles, and thus the Commission could not meet its obligations under the CEA.[54] Compliance with these acceptable practices merely eliminates the need for a DCM to demonstrate to the Commission that it is complying with certain aspects of Core Principle 15. It follows that a contract market that does not comply with the acceptable practices must demonstrate to the Commission that it is complying with Core Principle 15 by other means, as stated in the release.

B. Policy Comments: Public Comments Received and the Commission's Response.

1. General Comments.

The Commission received a series of general comments, as discussed more fully below, both in support of and in opposition to the overall direction and findings of the proposed acceptable practices.

a. THE PROPOSED ACCEPTABLE PRACTICES ARE INFLEXIBLE; DCMS SHOULD BE FREE TO DETERMINE THEIR OWN METHODS OF CORE PRINCIPLE COMPLIANCE.

Several commenters stated that, consistent with the CFMA, DCMs, and not the Commission, should determine the composition of their boards and committees, and should have the discretion to establish their own definition of "public director." One commenter noted that the concept of membership has evolved as markets have become increasingly electronic and global, and now encompasses a growing number of new types of market participants (which consequently reduces the population of potential public directors). Commenters argued that DCMs should be permitted to tap these new types of members for service as directors, bringing market knowledge and differing perspectives to their boards, rather than adding public directors, who, as defined by the Commission, will lack experience and expertise. It was further argued that DCMs should be permitted to decide for themselves how to constitute their boards in order

[54] *See* CEA § 5c(d), 7 U.S.C. § 7a-2(d).

to obtain the necessary knowledge, experience, and expertise that will permit them to serve their economic functions and the public interest.

With respect to the other committees and panels addressed in the proposal, commenters stated that each DCM should be permitted to determine the appropriate size and composition of its executive committee, and likewise should be permitted: to determine whether to establish an ROC; to determine the extent of an ROC's responsibilities; and to determine the most appropriate composition for such committee. Commenters also stated that each DCM should be permitted to determine the composition and the structure of its disciplinary committees in order to ensure that decisions are informed by knowledge and experience.

Numerous commenters opined that the proposals are inflexible, arbitrary, or overly prescriptive. Among other things, commenters stated that the regulatory proposals: could stifle vital day-to-day market functions; could swing the balance too far towards rigid, arbitrary requirements when there is no demonstrable need for such action; are contrary to the spirit and intent of the CFMA and the market-oriented, principle-based structure authorized by that legislation; unnecessarily micromanage the operations of DCMs; fail to recognize the changing definition and increasing breadth of the concept of DCM membership; inflexibly impose uniform requirements upon all DCMs without regard to the nature of a particular DCM or the products traded on that DCM; and should be presented not as a model for DCMs to adopt, but rather as examples of ways for DCMs to meet core principle requirements.

Commenters also expressed concern that a bright-line test regarding the proper number of public directors will become the de facto requirement for all DCMs and will severely limit the ability of DCMs to undertake other approaches to achieving the general performance standard set by the core principles. Some commenters also contended that requiring a DCM that does not

meet the proposed acceptable practices to demonstrate compliance with Core Principle 15 through other means impermissibly shifts the burden of proof to DCMs to justify departures from the acceptable practices, when the Act gives DCMs reasonable discretion in how they comply with the core principles. Another commenter noted that since the Commission has proposed absolute numerical standards as a means of avoiding conflicts of interest, there is no legitimate way to prove compliance by other means.

b. SAFEGUARDS ARE ALREADY IN PLACE TO PROTECT AGAINST CONFLICTS OF INTEREST AT PUBLICLY TRADED, MUTUALLY-OWNED, AND OTHER DCMS.

Numerous commenters opined that the proposals are not necessary because there are sufficient safeguards already in place to ensure that potential conflicts of interest are adequately identified and controlled and that self-regulation remains effective. Several commenters argued that small DCMs already have in place adequate controls to address potential conflicts of interest, and that the Commission conducts an independent review of each DCM's compliance department through its rule enforcement review ("RER") program.[55] Several commenters noted that their board composition standards already require public directors (albeit at a level lower than the proposed 50% requirement). Those commenters opined that their existing procedures for avoiding conflicts and including public participation are sufficient and more effective than the proposed 50% public member requirement.

Commenters also argued that fear of a possible conflict of interest between a demutualized DCM's regulatory responsibilities and the demands of a for-profit company is without foundation. These comments asserted that demutualization actually encourages rather than discourages effective self-regulation because market integrity is key to attracting and

[55] The Commission's Division of Market Oversight conducts periodic RERs at all DCMs to assess their compliance with particular core principles over a one-year target period. Staff's analyses, conclusions, and recommendations regarding any identified deficiency are included in a publicly available written report.

retaining business. Commenters stated that large, publicly traded DCMs already have numerous safeguards in place to ensure that they act in the best interest of their shareholders and do not act to the detriment of a particular group of shareholders. In addition, some commenters opined that corporate governance requirements currently applicable to publicly traded DCMs, combined with the reasonable exercise of discretion by DCMs pursuant to Core Principle 1,[56] provide sufficient assurance that conflicts of interest will be kept to a minimum in the decision-making process. One DCM commented that the proposed acceptable practices are unnecessary given, *inter alia*, the NYSE and NASDAQ listing standards to which some DCM parent companies are subject. In addition, it was observed that when a potential conflict does arise, DCMs have developed specific board governance procedures to ensure proper disclosure and to remove the potential conflict from the decision-making process. One commenter stated that the proposals are unnecessary because, if the Commission's general concern is that a DCM will adopt rules that will disadvantage members who are their competitors, it may address that concern through its review of self-certified rules to ensure that such rules comply with the Act and regulations.

Several commenters argued that the proposals should not be applied to mutually-owned DCMs, as none of the factors cited by the Commission as justification for the proposed acceptable practices apply to them. These commenters further argued that applying the acceptable practices to mutually-owned DCMs to the same degree as large publicly traded DCMs would be burdensome in terms of cost, administration, and efficiency.

1a. The Commission's response to the General Comments.

i. Proactive measures are justified to protect the integrity of self-regulation in the U.S. futures industry.

[56] Core Principle 1 states: "IN GENERAL—To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles." CEA § 5(d)(1), 7 U.S.C. § 7(d)(1).

The Commission's response to the comments summarized above is three-fold. First, the Commission believes that the argument that there are no specific regulatory failures justifying new acceptable practices for Core Principle 15 is misplaced. As discussed more fully in the cost-benefit analyses in Section V-A, the Commission did identify industry changes that it believes create new structural conflicts of interest within self-regulation, increase the risk of customer harm, could lead to an abuse of self-regulatory authority, and threaten the integrity of, and public confidence in, self-regulation in the U.S. futures industry. Increased competition, demutualization and other new ownership structures, for-profit business models, and other factors are highly relevant to the impartiality, vigor, and effectiveness with which DCMs exercise their self-regulatory responsibilities. The Commission strongly believes that credible threats to effective self-regulation must be dealt with promptly and proactively, and is confident that precautionary and prophylactic methods are fully justified and well within its authority.

Second, the Commission firmly rejects commenters' implicit argument that its oversight authority may be exercised only in response to crises or failures in self-regulation. To the contrary, the Commission's mandate, given by the Congress, is affirmative and forward-looking, including promoting "responsible innovation" and "fair competition" in the U.S. futures industry.[57] As catalogued throughout the SRO Review, rapid innovation and increasing competition are powerful new realities for all DCMs. The Commission's statutory obligation is to ensure that these realities evolve as fairly and responsibly as possible, and always in a manner that serves the public interest. The Commission believes that the new acceptable practices for Core Principle 15 serve exactly those purposes by ensuring a strong public voice at key levels of SRO decision making, particularly as it effects self-regulation.

[57] CEA § 3(b), 7 U.S.C. § 5(b) .

Finally, prior to adopting these acceptable practices, the Commission initiated an exhaustive, three-and-one-half year research program that resulted in a uniquely informed regulatory process. The Commission determined, as have many other regulatory and self-regulatory bodies, that "independent" directors can be of great benefit to the deliberations and decisions of corporate boards and their committees. The Commission further determined, as have others, that DCMs charged with self-regulatory responsibilities are distinct from typical corporations, and thereby require careful attention to how their independent directors are defined. Finally, the Commission determined, as have others, that DCMs' independent directors should be of a special type—"public" directors—and should meet higher standards, including non-membership in the DCM. All three decisions have ample precedent in exchange governance and self-regulation, both in the futures and the securities industries, are based on the extensive record amassed during the SRO Review and on the Commission's expertise and unique knowledge of the futures industry, and are well-grounded in the Commission's statutory authority to issue acceptable practices for core principle compliance.

ii. Some comments do not stand up to factual scrutiny.

Some general comments in opposition to the proposed acceptable practices do not stand up to factual scrutiny. For example, DCMs whose parent companies are publicly traded and subject to NYSE listing standards (50% "independent" board of directors and key committees that are 100% independent) argued that those standards are sufficient to ensure effective self-regulation. The argument fails on two grounds.

First, by their very terms, the NYSE's listing standards are designed for shareholder protection, not the effective self-regulation of futures exchanges in the public interest. Second, DCM holding companies have determined that DCM members are independent under the

NYSE's listing standards.[58] By doing so, they have demonstrated the inappropriateness of relying on the listing standards as a means of identifying public directors for effective self-regulation. Notably, the NYSE itself recognized this same point when reforming its own governance and self-regulatory structure, which is substantially more demanding than what it requires of its listed companies, or than what the Commission's new acceptable practices will require of DCMs.[59]

The related argument that the proposed acceptable practices should not be applied to mutually-owned DCMs is also without merit. It ignores the futures industry's rapid and continuing evolution. When the SRO Review began in 2003, three of the four largest DCMs were member-owned. Now, all four are subsidiaries of public companies.[60] Only two member-owned futures exchanges remain in the United States, and one is actually structured as a Delaware for-profit stock corporation that has paid dividends for nine consecutive years, including $11,000 per share in 2006 and $7,000 per share in 2005.[61] More importantly, all DCMs, regardless of ownership structure, operate in an increasingly competitive environment

[58] *See, e.g.*, CME's Categorical Independence Standards: "…the Board of Directors has determined that a director who acts as a floor broker, floor trader, employee or officer of a futures commission merchant, CME clearing member firm, or other similarly situation person that intermediates transactions in or otherwise uses CME products and services shall be presumed to be "independent," if he or she otherwise satisfies all of the above categorical standards and the independence standards of the [NYSE] and The Nasdaq Stock Market, Inc…." CME Holdings Inc., Definitive Proxy Statement (Form DEF 14A), App. A, (March 10 2006). *Accord* CBOT Holdings Inc., Definite Proxy Statement (Form DEF 14A), App. A, (March 29, 2006). Both holding companies are listed on the NYSE and subject to its listing standards.

[59] NYSE Group's board of directors consists exclusively of directors who are independent both of member organizations and listed companies. In addition, NYSE Group and NASD recently announced plans to consolidate their member firm regulation into a single new SRO for all securities broker/dealers. Market regulation and listed company compliance will remain with NYSE Regulation, a not-for-profit subsidiary of NYSE Group. A majority of NYSE Regulation's directors must be independent of member organizations and listed companies, and unaffiliated with any other NYSE Group board. *See* << http://www.nyse.com/regulation/1089235621148.html>>.

[60] CME, CBOT, and NYMEX are wholly-owned subsidiaries of CME Holdings Inc., CBOT Holdings Inc., and NYMEX Holdings Inc., respectively. NYBOT is a wholly owned subsidiary of IntercontinentalExchange Inc. In each case, the DCMs are now subsidiaries of for-profit, publicly traded stock corporations listed on the NYSE.

[61] The two mutually-owned exchanges are the Kansas City Board of Trade and the Minneapolis Grain Exchange. However, as noted above, KCBT is structured as a for-profit, dividend-paying, stock corporation. *See* <<http://www.kcbt.com/news_2.asp?id=457>> (KCBT press release announcing ninth consecutive annual dividend, including $11,000 per share in 2006) and << http://www.kcbt.com/news_2.asp?id=347>> (KCBT press release announcing eighth consecutive annual dividend, including $7,000 per share in 2005).

where improper influence may be brought to bear upon regulatory functions, personnel, and decisions.

Another misplaced series of comments argued that existing Commission processes, such as RERs, provide sufficient safeguards to ensure the future integrity of self-regulation. RERs are in fact central to the Commission's oversight regime for DCMs, and constitute the primary method by which the Commission verifies core principle compliance. However, RERs are retrospective in nature (focusing on a target period in the past) and cannot guarantee future performance. When self-regulatory failures are discovered, they are typically corrected via recommendations made by the Commission's Division of Market Oversight and implemented by the relevant DCM on a forward-looking basis. In contrast, the objective of effective self-regulation and Commission oversight is to prevent such failures from ever occurring. The Commission does not believe that RERs should be a substitute for issuing acceptable practices for compliance with a particular core principle. The Commission has found that acceptable practices improve core principle compliance by providing all DCMs with greater clarity regarding the Commission's expectations, and a safe-harbor upon which they may fully rely. Neither RERs nor any other existing Commission process, such as the review of self-certified rules, is an adequate substitute for carefully tailored acceptable practices.[62] This is particularly true when the new acceptable practices concern a core principle that has no previous acceptable practices or respond to a rapidly changing area of the futures industry.

iii. The Commission may implement detailed acceptable practices as safe-harbors for core principle compliance.

[62] The argument that RERs make acceptable practices unnecessary is further misplaced as it ignores the beneficial interaction between the two oversight tools. For example, acceptable practices facilitate core principle compliance and advance the RER process by providing both DCMs and Commission staff with information as to the areas of concern which must be addressed under a particular core principle. The final acceptable practices for Core Principle 15 are no exception, as they highlight the type of structural conflicts of interest which all DCMs must address.

Notwithstanding those comments generally opposed to the proposed acceptable practices for Core Principle 15, the Commission continues to strongly believe that the recent structural changes in the U.S. futures industry require an appropriate response within DCMs to ensure that self-regulation remains compatible with competitive, for-profit DCMs. Accordingly, the new acceptable practices for Core Principle 15 establish appropriate governance and self-regulatory structures, while preserving DCMs' flexibility to adopt alternate measures if necessary.

Those commenters that opposed the new acceptable practices for their "inflexibility" misunderstand the nature of the core principle regime and the interaction between core principles and acceptable practices. The 18 core principles for DCMs establish standards of performance and grant DCMs discretion in how to meet those standards. However, compliance with the core principles is not static and does not exist in a vacuum; instead, core principles are broad precepts whose specific application is subject to change as DCMs and the futures industry evolve. Furthermore, as discussed in Section III, core principle compliance is an affirmative and continuing obligation for all DCMs, and it is incumbent upon them to demonstrate compliance to the Commission's satisfaction.[63]

The flexibility inherent in the core principles permits each DCM to comply in the manner most appropriate to it. At the same time, such flexibility provides both the Commission and the futures industry with the latitude to grow in their understanding of self-regulation and its requirements. One common example is the Commission's approach to the safe storage of trade

[63] *See* 17 CFR Part 38, App. B, ¶ 1 ("This appendix provides guidance on complying with the core principles, both initially *and on an ongoing basis* to maintain designation under Section 5(d) of the Act and this part" (emphasis added)).

data under Core Principle 10,[64] which evolved following the events of September 11, 2001.[65] Similarly, the Commission's expectations for the management of conflicts of interest under Core Principle 15 now include an understanding that in a highly competitive futures industry, where almost all DCMs are for-profit and many are subsidiaries of publicly traded companies, the conflicts that may arise are not purely personal or individual. Simply stated, whether or not DCMs choose to implement the new acceptable practices, the conflicts of interest which they must address to comply with Core Principle 15 now include structural conflicts between their self-regulatory responsibilities and their commercial interests.

All acceptable practices, including those for Core Principle 15, are designed to assist DCMs by offering "pre-approved" roadmaps or safe-harbors for core principle compliance. Although it may be a preferred method of compliance, no acceptable practice is mandatory. Instead, as safe-harbors, acceptable practices provide all DCMs with valuable regulatory certainty upon which they may rely, should they choose to do so, when seeking initial designation, when subject to periodic RERs by the Division of Market Oversight, or at any other time in which the Commission requires a DCM to demonstrate core principle compliance.[66]

Because they offer such broad and beneficial safe-harbors, acceptable practices are sometimes detailed and exact in their requirements. If the Commission effectively "pre-approves" a specific self-regulatory structure for minimizing conflicts of interests under Core Principle 15, as it is doing here, then it must be sufficiently specific in describing that structure

[64] Core Principle 10 states: "TRADE INFORMATION—The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market." CEA § 5(d)(10), 7 U.S.C. § 7(d)(10).
[65] On September 11, 2001, the physical location of three DCMs was destroyed, and both the Commission and the industry recognized the importance of redundancy capabilities, including safe storage of trade information, that are sufficiently distant from primary locations.
[66] The Commission has explained that "boards of trade that follow the specific practices outlined under [the acceptable practices]…will meet the applicable core principle." 17 CFR § 38, App. B, ¶ 2.

and all of its components. In the alternative, the Commission would be offering not a safe-harbor upon which DCMs may fully rely, but only additional guidance, subject to varying interpretations, raising many questions, and providing few answers and even less certainty. That is not the intent of these acceptable practices.

In addition, the Commission notes that the presence of "must," "shall," and similar words in the new acceptable practices indicates only that these things must be done to receive the benefits of the safe-harbor, not that the acceptable practices themselves are required. What is now required of all DCMs under Core Principle 15 is to demonstrate that they have effectively insulated their self-regulatory functions, personnel, and decisions from improper influence and commercial considerations, including those stemming from their numerous member, customer, owner, and other constituencies. If a DCM chooses not to implement the new acceptable practices for Core Principle 15, then the Commission will evaluate the DCM's alternative plan, either through RERs, the rule submission process, or other means. During any such review, the DCM will be required to present and demonstrate what procedures, arrangements, and methods it has adopted or will adopt to minimize structural conflicts of interest in self-regulation. The DCM will further be required to demonstrate that its approach is capable of responding effectively to conflicts that may arise in the future.

2. Comments With Respect to the Board Composition Acceptable Practice.

The proposed Board Composition Acceptable Practice calling for at least 50% public director representation on DCM boards and executive committees drew substantial comment, both for and against. In their comment letters, the FIA and five large FCMs strongly supported the 50% public director benchmark for DCM boards. The FIA particularly noted that the proposal provides DCMs with flexibility as to how they want to address the diversity of interest

groups in that the proposal does not specify any fixed number of board members. The FIA also recommended that a subgroup of public directors should serve as a nominating committee to select new or re-nominate existing public directors. One exchange also generally supported the proposals, commenting that the proposed governance standards and ROCs will enhance DCM governance and serve to protect market participants and the public interest.

Many commenters, however, opposed the proposed 50% public director composition requirement. Several commenters were concerned that the proposal would dilute the voices of trade, commodity, and farmer interests in DCM governance, as well as the voices of market users, members, shareholders, and other stakeholders in the DCM. Commenters were also concerned about the need for experience and expertise on DCM boards.[67]

Several commenters stated that, in order to meet the proposed 50% board composition requirement, either the board would have to be made unreasonably large, or a DCM would have to reduce the number of directors drawn from its commercial interest and other memberships. Commenters also contended that it would be difficult to attract a sufficient number of qualified public directors.[68]

Many of the comments regarding executive committee composition raised the same points as comments regarding the board composition requirement. Such comments included the need for a diversity of representation on executive committees, the need for experience and expertise, and the difficulty of attracting qualified public directors. In addition, several

[67] One commenter stated that filling governance positions with those totally devoid of any connection to the marketplace would necessarily lead to major decisions regarding the operation of futures markets being made by those with no expertise in such decision making and no vested interest in the long-term best interests of those markets. It was suggested that this will result in either grossly mismanaged DCMs or the appearance of conflicts of interest as public directors defer to the less diverse non-public directors and officers.

[68] One mutually-owned DCM commented that payment of a stipend to directors will create additional financial burdens on smaller, non-profit DCMs and create the possibility of less qualified directors serving on the board. Another commenter noted that public directors with no industry experience might be less inclined to invest in the self-regulatory functions of the DCM.

commenters argued that members of an executive committee have a special need for expertise due to its unique involvement in day-to-day operational and managerial issues.

2a. The Commission's Response to Comments on the Board Composition Acceptable Practice.

After carefully reviewing the comments above, the Commission has decided to modify the proposed Board Composition Acceptable Practice, and reduce the required ratio of public directors on boards and executive committees from at least 50% to at least 35%. The Commission is confident that the new Board Composition Acceptable Practice, together with the other acceptable practices adopted herein, effectively accomplishes what Core Principle 15 requires—"minimiz[ing] conflicts of interest in the decision-making process of the contract market"—while simultaneously respecting the legitimate needs of efficiency and expertise in that process.

Both the proposed and final Board Composition Acceptable Practices recognize the importance of DCM boards of directors in effective self-regulation. Boards of directors bear ultimate responsibility for all regulatory decisions, and must ensure that DCMs' unique statutory obligations are duly considered in their decision making. While exchange boards do have fiduciary obligations to their owners, they are also required by the Act to ensure effective self-regulation, to protect market participants from fraud and abuse, and to compete and innovate in a fair and responsible manner. To meet these obligations, boards of directors, and any committees to which they delegate authority, including executive committees, must make certain that DCMs' regulatory responsibilities are not displaced by their commercial interests or those of their numerous constituencies.

The Commission strongly believes that DCMs are best able to meet their statutory obligations if their boards and executive committees include a sufficient number of public

directors.[69] While determining a "sufficient" level of public representation is not an exact process, the Commission has concluded that the public interest will be furthered if the boards and executive committees of all DCMs are at least 35% public. Such boards and committees will gain an independent perspective that is best provided by directors with no current industry ties or other relationships which may pose a conflict of interest. These public directors, representing over one-third of their boards, will approach their responsibilities without the conflicting demands faced by industry insiders. They will be free to consider both the needs of the DCM and of its regulatory mission, and may best appreciate the manner in which vigorous, impartial, and effective self-regulation will serve the interests of the DCM and the public at large. Furthermore, boards of directors that are at least 35% public will help to promote widespread confidence in the integrity of U.S. futures markets and self-regulation. Public participation on such boards will enhance the independence and accountability of all self-regulatory actions. As regulatory authority flows from the board of directors to all decision-makers within a DCM, such independence should permeate every level of self-regulation and successfully minimize conflicts of interest as required by Core Principle 15.

As stated above, the Commission is confident that boards of directors and executive committees that are at least 35% public will effectively protect the public interest; at the same time, the Commission believes that they are appropriately responsive to the comments. Under

[69] As noted previously, some commenters made similar arguments with respect to executive committee composition and board composition. Those arguments are addressed jointly in this Section. Some commenters also argued that executive committees require a special degree of expertise due to their unique role in day-to-day operational and managerial issues. The Commission notes that this argument runs counter to commenters' opposition to the ROC Acceptable Practice on the grounds that directors and board committees should not take part in day-to-day operational and managerial issues. The Commission believes that executive committees' unique role stems from their authority to act in place of the full board of directors. Regardless of the decision being made, if a DCM decides that such decision is best made by a small group of directors to whom full board authority has been delegated, then the ratio of public directors in that group should be no less than the ratio on the full board. Anything less would deprive a key level of DCM decision making from the benefits attendant to sufficient public representation and independence, and diminish the effectiveness of the Board Composition Acceptable Practice.

the new 35% standard, DCMs will have more latitude to include a broader diversity of non-public directors, such as commercial representatives and other highly experienced industry professionals, and to appoint more member directors and other emerging classes of trading privilege holders. There will also be sufficient room for stockholders and other outside investors, DCM officers, and persons representing affiliated entities or business partners.

The Commission believes that a public director level of at least 35% will not require DCMs to increase the size of their boards or executive committees, nor will they lose the ability to convene boards and committees on short notice. Furthermore, at the 35% level, DCMs should find it easier to attract a sufficient number of qualified public directors to serve on their boards and executive committees, thereby substantially reducing any disproportionate burden on smaller or start-up DCMs. Finally, while this modification makes ROCs with 100% public representation all the more necessary, it also provides ROC directors with access to a larger pool of industry expertise from among their fellow board members, with whom they may freely consult whenever needed.

At the same time, the Commission has determined that the 35% standard adopted in the final Board Composition Acceptable Practice is sufficient to ensure strong representation of the public interest in DCM decision making. While a DCM may determine that a 50% public director standard is more appropriate for its circumstances,[70] the Commission believes that the 35% standard for safe harbor purposes under Core Principle 15 will be effective while also responsive to reasonable concerns voiced in the public comments.

The Commission has concluded that the most effective way to address DCM conflicts of interest, while still maintaining the self-regulatory model, is to place a sufficient number of

[70] Certain DCMs, such as large exchange subsidiaries of publicly traded companies, may be better served by a higher ratio of public directors, and may be better able to attract them. Although the Commissions believes that the 35% standard adopted herein is an appropriate minimum standard for all DCMs, the core principle regime grants DCMs the flexibility to adopt higher ratios of public directors should they wish.

public persons on DCM boards of directors, executive committees, and other decision-making bodies. Ultimately, however, the Commission's objective is not to engineer specific board-level decisions, but rather to encourage a process that ensures that every decision will be both well-informed by inside expertise and well-balanced by the public interest. Following implementation of the Board Composition and companion acceptable practices, the Commission will carefully monitor DCM decision making, and reserves the right to modify the required ratio of public directors as necessary.

3. Comments with respect to the Public Director Acceptable Practice.

Many commenters addressed the proposed acceptable practices' definition of "public" for DCM directors and members of disciplinary panels. With respect to the definition generally, the FIA supported the Commission's definition but noted that it had proposed a more stringent public director standard of no involvement with the futures or derivatives business. Several commenters expressed the general concern that the Commission's definition of public would lead to a lack of experience and expertise among DCM directors and members of disciplinary panels. One commenter contended that the definition was not needed for NYSE-listed DCMs as the definition of independence contained in the NYSE listing requirements was sufficient to ensure the appropriate level of independence in a DCM's decision-making processes.

With respect to the proposed definition's exclusion of persons having a material relationship with the contract market, one commenter asked that the Commission clarify that DCM boards may make material relationship determinations without any independent nominating committee involvement. That commenter also asked that the Commission clarify whether it would represent a material relationship with the futures exchange for an individual, who otherwise satisfied the proposed qualification criteria, to be a lessor member of a DCM

affiliate with a de minimus equity percentage interest in the DCM affiliate. Another commenter questioned whether the material relationship test would prevent an otherwise qualified individual from becoming a public director if its family farming operation used the DCM's contracts as risk management tools.[71]

The proposed definition stated that a director will not be considered "public" if the director is a member of the contract market or a person employed by or affiliated with a member. In response, one commenter stated that such a restriction would be a mistake because it would exclude from the board people with both industry knowledge and substantial shareholdings, including persons who hold membership but who are retired or lease their membership to others, members that are marginally involved in trading, persons who are members at other DCMs, and holders of corporate memberships whose firms likely conduct business at multiple DCMs. One commenter stated that the proposal's definition of member does not take into account the various types of membership, some of which may raise greater potential for conflicts of interest, while others may raise very little potential.

The proposed definition also stated that a director will not be considered "public" if the director is an officer or employee of the DCM or a director, officer, or employee of its affiliate. In response, one commenter argued against the disqualification of an otherwise public DCM because he or she is also serving as a director at an affiliate of the DCM. Another commenter

[71] The use of a DCM's contracts to hedge risks in commercial activities otherwise unrelated to futures trading does not automatically constitute a material relationship. However, a board of directors should consider all relevant factors carefully when making its materiality determination. For example, if the farm operator cited above conducted its hedging activities as an exchange member, as broadly defined herein, such membership would disqualify it and persons affiliated with it from serving as public directors. Likewise, if futures trading is a central economic activity for an individual or firm, rather than incidental to other commercial activity, then the board should consider whether such futures trading rises to the level of a material relationship that could affect a director's decision making. For example, a director voting on a proposed exchange rule that would facilitate or deter a particular trading strategy will have a material conflict if their personal or firm trading is likely to benefit or be harmed by such new rule.

requested that the Commission clarify that a director of a DCM would not be considered non-public because he or she was also a director of the DCM's holding company.

Several comments addressed the proposed definition's determination that a director will not be considered "public" if the director receives more than $100,000 in payments, not including compensation for services as a director, from the DCM, any affiliate of the DCM or from a member or anyone affiliated with a member. The FIA argued that the Commission should adopt a "no-payment-from-contract-market" standard, noting that payment of up to $100,000 would result in at least some allegiance to DCM management. Additionally, the FIA commented that if the $100,000 compensation limit is retained, the Commission should clarify that it is an overall cap of permissible compensation from contract markets and their members. The FIA also opined that receipt of more than $100,000 by a potential director's firm (rather than by the director) from a DCM member constitutes indirect payment or compensation and should not prevent an otherwise qualified director from being considered public.

By contrast, one DCM stated that the public director definition should be modified to eliminate the $100,000 compensation provision because it is an arbitrary level and may amount to de minimis compensation in the context of the person's total compensation.[72] Another exchange requested that the Commission clarify that pensions and other forms of deferred compensation for prior services that are not contingent on continued service would not automatically disqualify a person from serving as a public director.

One commenter addressed the proposed definition's determination that a person will be precluded from serving as a public director if any of the relationships identified in the definition apply to a member of the director's immediate family. That commenter stated that an individual

[72] This commenter stated that each DCM board should consider compensation from the DCM or its members as one factor in determining whether the person has a material relationship with the DCM.

should not be prohibited from serving as a public director based on the affiliation of an immediate family member with a member firm unless the family member is an executive officer of the member firm. The same commenter further noted that the exclusion should not apply to family members who do not live in the same household as the director.

The proposed definition also included a one-year look back provision with respect to the identified disqualifying circumstances. With respect to this provision, the FIA commented that a two-year look back would be more realistic and effective. In contrast, an exchange commented that the proposed one-year look back is more than sufficient and noted that that the longer the look back period, the less likely that individuals will plan to return to the industry.

3a. The Commission's Response to Comments on the Public Director Acceptable Practice.

The Commission carefully considered all of the comments with respect to the Public Director Acceptable Practice, and generally found that many of the discrete requests for clarification regarding the definition of "public" were reasonable. Accordingly, the Commission made appropriate responsive modifications to the final Public Director Acceptable Practice, as discussed in Section IV below.

The Commission has determined, however, that a less stringent definition of public director, as requested by some, is contrary to the acceptable practices' stated objectives: minimizing conflicts of interest through independent decision making, encouraging a strong regard for the public interest, and insulating regulatory functions via public directors and persons who are not conflicted by industry ties. Furthermore, the Commission believes that a strict definition of public director is especially necessary now that it will apply to 35% of a DCM's directors, rather than the 50% originally proposed. More importantly, the Commission strongly believes that, rather than being a drawback, the most significant contribution made by public

directors to the DCM decision-making process is precisely their outside, non-industry perspective. The Commission is confident that a board consisting of at least 35% public directors, as defined in the Public Director Acceptable Practice, is more than capable of reaching intelligent collective decisions, even on technical matters requiring detailed knowledge of futures trading, while at the same time exercising its regulatory authority in a manner consistent with the public interest.

The Commission rejects the contention that it will be impossible to find a sufficient number of qualified public directors to serve on DCM boards. Similarly, it rejects the argument that the materiality and bright-line tests may result in inexperienced directors with limited knowledge of the futures industry. To the contrary, the Commission believes that DCMs are fully capable of finding a sufficient number of qualified directors to constitute at least 35% public boards. DCMs may draw from a large pool of talented candidates with relevant or related experience, including retired futures industry insiders; scholars whose research focuses on the futures markets and related disciplines; officers and executives of many sophisticated corporate entities; persons with expertise in the securities industry, which may translate well into futures; and other members of the legal, business, and regulatory communities.

The Commission notes that a wide variety of DCMs—large and small, mutually-owned and publicly traded, for-profit and not-for-profit—already have boards of directors that are at least 20% non-member, as once required by Commission Regulation 1.64. One securities exchange that is the parent company of a DCM has a board that is at least 50% non-member,[73] and the NYSE's board of directors is 100% non-member. Accordingly, many exchanges have

[73] The board of directors of the Chicago Board Options Exchange, which owns CFE, is 50% public (independent non-member).

already demonstrated an ability to successfully recruit, retain, and thrive with significant numbers of public directors.

It is noteworthy that the three largest-volume DCMs, all of which are subsidiaries of publicly traded companies, are already required to have boards that are at least 50% "independent," as defined by the NYSE. In certain respects, the Commission's definition of "public director" overlaps with the NYSE's "independent directors" definition. Thus, these DCMs could potentially select at least some of their public directors from among their independent directors who do not have current ties to the futures industry. At the same time, the argument that the NYSE listing standards render the proposed Public Director Acceptable Practices unnecessary is misplaced. Despite the similarities between the acceptable practices and the NYSE's definition of independent, one overarching difference remains-- the listing standards are designed to protect shareholders, through boards of directors that are sufficiently independent from management.[74] In contrast, the new acceptable practices for Core Principle 15, while recognizing that DCMs are commercial enterprises, serve the national public interest in vigorous, impartial, and effective self-regulation.

The Commission agrees with many of the commenters that effective self-regulation is in the long-term interest of DCM owners, including shareholders. However, it is crucial for all DCMs and their owners to understand that DCMs have two responsibilities: a responsibility to their ownership and a responsibility to the public interest as defined in the Act.[75] Whereas the NYSE listing standards serve those with a direct fiduciary claim upon a company (shareholders (owners)), the new acceptable practices serve the public, whose claim upon DCMs is entirely independent of ownership, membership, or any other DCM affiliation. In short, through the new

[74] The NYSE's commentary to its listing standards emphasizes that "*as the concern is independence from management*, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding." NYSE Listed Company Manual, § 303A.02 (commentary) (emphasis added).
[75] CEA § 3(b), 7 U.S.C. § 5(b).

acceptable practices for Core Principle 15, the Commission seeks to ensure adequate representation of a public voice that otherwise is not guaranteed any formal standing within a DCM, and which receives no effective representation under any regulatory regime other than the Commission's.

Some commenters argued that the proposed Public Director Acceptable Practice, and the bright-line tests in particular, do not take into account different types of DCM memberships and the different degrees of conflict which they may or may not engender. Although different commenters focused on different groups of industry participants, their underlying argument was the same: that industry participants should be permitted to serve as public directors to a lesser or greater extent. The Commission's response to this and similar comments summarized above is two-fold.

First, if DCMs value the presence of industry insiders on their boards, they may place them among the 65% of directors who are not required to be public under the final acceptable practices. The Commission has facilitated this option by reducing the required ratio of public directors. Second, and as stated previously, the purpose of the Public Director Acceptable Practice is to ensure independent decision making and strong consideration of the public interest by DCM boards of directors. While all directors are required to consider DCMs' statutory obligations and public responsibilities, public directors are particularly meaningful because they have no fiduciary duty to lessees or lessors of trading seats, corporate members, persons who trade small amounts, or any other persons affiliated with the futures industry and inquired about in the comments. Allowing persons with current industry affiliation to serve as public directors would necessarily reintroduce into board deliberations and ROC oversight the very conflicts of interest that Core Principle 15 and the new acceptable practices seek to minimize.

The Commission also notes that the most significant determination to be made under the Public Director Acceptable Practice is the board's finding that a potential public director has no material relationship with the DCM. The Commission has left this determination to the board's discretion, and offers the bright-line tests only as a beginning to the board's inquiry. The material relationship test requires a DCM's board to make an affirmative, on-the-record finding that a director has no material relationship with the DCM, and to disclose the basis for that determination. The bright-line tests simply facilitate the board's inquiry by noting obviously material relationships, and freeing the board to focus on other relationships that may be less apparent but that are equally detrimental to impartial representation of the public interest. As such, the bright-line tests, like any other acceptable practices, must be sufficiently detailed to merit the benefits accorded to a safe-harbor. Consistent with this approach, the Commission reaffirms the familial relationships excluded under the bright-line tests, the one-year look-back provision, and all other elements of the proposed Public Director Acceptable Practice, except for those specifically treated in Section IV.[76]

4. Comments With Respect to the Regulatory Oversight Committee Acceptable Practice.

The proposed Regulatory Oversight Committee Acceptable Practice called upon DCMs to establish a board-level ROC, composed solely of public directors, to oversee regulatory functions. Many commenters focused on the composition of the proposed ROC, voicing many of the same concerns they had with respect to the proposed 50% public director board requirement. Two DCMs commented that each DCM should be permitted to determine whether to establish a ROC, the extent of the ROC's responsibilities, and the most appropriate

[76] In Section IV, the Commission makes clarifications with respect to, *inter alia*, the manner in which DCMs select their public directors, the compensation of public directors, and public directors serving on both a parent company and a subsidiary DCM ("overlapping public directors").

composition thereof. One DCM argued that the level of public representation should be the same for ROCs and boards.

A number of commenters expressed concern with the difficulty in recruiting qualified public directors (similar to the concerns expressed with respect to recruiting qualified directors for the board generally) to serve on ROCs, and noted the need for experience, expertise, and diversity on any such body. One DCM commented that an ROC should be able to include public representatives who are not public directors of the exchange, but who are otherwise qualified to be.

The FIA and a large FCM supported the proposed Regulatory Oversight Committee Acceptable Practice. The FCM commented that adoption of the proposal will enhance the credibility and effectiveness of DCMs in their capacity as self-regulators.

One DCM commented that while an ROC is an appropriate way to reinforce impartiality in DCM self-regulation, it may not be the best approach for all DCMs (particularly smaller ones) to charge the committee with managerial duties and overseeing daily market regulation functions. Another DCM commented that ROCs should not remove DCMs' chief regulatory officers from the appropriate direction and input of DCM management. Commenters also argued that ROCs' proposed duties could conflict with the responsibilities of the chief executive officer, the board, and DCM personnel, and could well undercut their authority.

Many commenters addressed ROCs' stated responsibilities. Several of these commenters argued that the level of authority assigned to an ROC's public directors is contrary to commonly accepted corporate management best practices because management functions are removed from management and become directors' responsibilities. A number of commenters offered recommendations as to what should be the responsibilities of an ROC. One DCM requested that

the Commission clarify that if an ROC were to have any authority with respect to overseeing budgets and the hiring and compensation of regulatory officers and staff, that such authority would supplement rather than replace these normal management and board responsibilities. It was further argued that the Commission should make clear that it is not the function of an ROC to plan or conduct trade practice investigations or market surveillance or to review the results of particular investigations or audits, but rather to serve an oversight role. It also was suggested that the Commission should remove language that states that an ROC shall supervise the DCM's CRO because it is inconsistent with the Commission's stated position that an ROC should not serve as a manager. Another DCM commented that ROCs should be granted unhindered access to regulatory staff along with the authority to ensure that regulatory staff has sufficient resources and that nothing interferes with staff's fulfillment of the regulatory program.

In other comments addressing the proposed responsibilities of ROCs, a large FCM and the FIA contended that ROCs (or their chairmen) should approve the composition of DCM disciplinary panels. The FIA also recommended that ROCs be granted the power to hire, supervise, and determine the compensation of DCMs' CROs and set (or recommend to the board) DCMs' self-regulatory budgets. Further, in the interest of more transparency for DCM rulemakings, the FIA recommended that ROCs should consider and approve any new DCM rule or rule change or, if the Commission elects not to call for committee approval of all such rules and rule changes, than any new DCM rule or rule change that a DCM decides to self-certify to the Commission.

4a. The Commission's Response to Comments on the Regulatory Oversight Committee Acceptable Practice.

Criticisms of the proposed ROC Acceptable Practice often mirrored those leveled against the proposed Board Composition Acceptable Practice and the proposed acceptable practices in

general. After careful consideration, the Commission has determined to implement the ROC Acceptable Practice for Core Principle 15 as proposed.[77]

The Commission stresses that ROCs are oversight bodies, and that the enumerated powers granted to them in the ROC Acceptable Practice merely complement normal board functions. ROCs are not intended to supplant their boards of directors, nor are they expected to assume managerial responsibilities or to perform direct compliance work. Under the acceptable practices for Core Principle 15, DCM self-regulation remains exactly that—self-regulation, but with a stronger and more defined voice for the public responsibilities inherent to all DCMs. Properly functioning ROCs should be robust oversight bodies capable of firmly representing the interests of vigorous, impartial, and effective self-regulation. ROCs should also represent the interests and needs of regulatory officers and staff; the resource needs of regulatory functions; and the independence of regulatory decisions. In this manner, ROCs will insulate DCM self-regulatory functions, decisions, and personnel from improper influence, both internal and external.

Many of the comments in opposition to the ROC Acceptable Practice—for example, that whether to establish ROCs should be left at DCMs' discretion and that it will be difficult to find qualified public directors—have already been addressed, and the Commission's previous responses need only brief summarizing here. The Commission strongly believes that new

[77] As stated in the proposing release, the Commission emphasizes that ROCs are expected to identify aspects of their DCMs' regulatory system that work well and those that need improvement, and to make any necessary recommendations to their boards for changes that will help to ensure vigorous, impartial, and effective self-regulation. ROCs should be given the opportunity to review, and, if they wish, present formal opinions to management and the board on any proposed rule or programmatic changes originating outside of the ROCs, but which they or their CROs believe may have a significant regulatory impact. DCMs should provide their ROCs and CROs with sufficient time to consider such proposals before acting on them. ROCs should prepare for their boards and the Commission an annual report assessing the effectiveness, sufficiency, and independence of the DCM's regulatory program, including any proposals to remedy unresolved regulatory deficiencies. ROCs should also keep thorough minutes and records of their meetings, deliberations, and analyses, and make these available to the Commission upon request. In the future, when reviewing DCMs' compliance with the core principles, the Commission will examine any recommendations made by ROCs to their boards and the boards' reactions thereto.

structural conflicts of interest within self-regulation require an appropriate response within DCMs. The Commission further believes that ROCs, consisting exclusively of public directors, are a vital element of any such response. With respect to those public directors, the Commission is confident that DCMs can recruit a sufficient number of qualified persons, as they have done for their boards in the past. Finally, the Commission notes that while DCMs must respond to conflicts between their regulatory responsibilities and their commercial interests; the exact manner in which they do so remains at their discretion.

A second line of comments with respect to the ROC Acceptable Practice argued that ROCs should include industry directors, and that the ratio of public directors on ROCs should be the same as on boards. The Commission believes that these comments ignore the very purpose of the ROC Acceptable Practice. As stated previously, the new acceptable practices ensure that DCMs' decision-making bodies include an appropriate number of persons who are not conflicted by industry ties. For ROCs—the overseers of DCMs' regulatory functions—the appropriate number is 100% public. The Commission believes that anything less invites into regulatory oversight operations precisely those directors whose industry affiliations lend themselves to conflicts of interest in decision making.

What constitutes a "sufficient" number of public persons for DCM decision making depends upon the decision-making body in question and its responsibilities. Thus, DCM disciplinary panels are required to be diverse and have only one public person because their responsibility—expert and impartial adjudications—often requires a detailed knowledge of futures trading best provided by industry participants. At the same time, that expertise is balanced by the impartiality of at least one public panelist and a diversity of industry representatives. For boards of directors, however, with both regulatory responsibilities and

commercial interests, the minimum 35% ratio properly recognizes boards' dual role as the ultimate regulatory and commercial authorities within DCMs. Industry directors on DCMs' boards are fully justified precisely because of the numerous commercial decisions that they must make.

Within this construct, ROC's discrete regulatory responsibilities assume added significance. The sole purpose of ROCs is to insulate self-regulatory functions, personnel, and decisions from improper influence, and to advocate effectively on their behalf. ROCs make no direct commercial decisions, and therefore, have no need for industry directors as members. The public directors serving on ROCs are a buffer between self-regulation and those who could bring improper influence to bear upon it. The Commission notes that at least three DCMs—CME, NYBOT, and U.S. Futures Exchange—have already established board-level committees similar to the ROCs described in the ROC Acceptable Practice, and they consist exclusively of public directors. The same is true of the securities exchange parent company of one DCM that submitted comments.

Commenters who requested greater industry participation on ROCs should recall that ROCs will be subject to the final authority of their boards of directors, which may include a sufficient number of industry directors. DCM boards, including industry directors, will have ample opportunity to consult with and advise ROC public directors, to interact with regulatory officers and personnel, and ultimately to enact any regulatory policies or decisions that they deem appropriate. As stated previously, ROCs are designed to insulate self-regulation, not isolate it. At the same time, under the ROC Acceptable Practice, ROCs have the absolute right to whatever resources and authority they may require to fulfill their responsibilities, including resources within their DCMs. More specifically, ROCs have the authority and resources

necessary to conduct their own inquiries; consult directly with their regulatory officers and staffs; interview DCM employees, officers, members, and others; review relevant documents; retain independent legal counsel, consultants, and other professional service providers and industry experts; and otherwise exercise their independent analysis and judgment as needed to fulfill their regulatory responsibilities.[78]

The related concern that ROCs will undercut the authority of DCM boards of directors is misplaced. ROCs should function as any other committee of the board, making recommendations which are afforded great weight and deference, and reaching final decisions if such power is delegated to it, but ultimately subject to the board's authority. The very text of the ROC Acceptable Practice calls for ROCs to "monitor," "oversee," and "review," none of which implies binding authority or a usurpation of the full board of directors. At most, it implies a change in workflow.[79]

Similarly, concerns that ROCs will become managerial bodies or interfere with established managerial relationships are equally misplaced. To be clear, the Commission expects ROCs to oversee DCMs' self-regulatory functions and personnel, not to manage them. ROCs' responsibilities, detailed in Section 3 of the final acceptable practices, include traditional oversight functions or functions that can easily be delegated to a DCM's CRO.[80] Some examples

[78] ROCs should not rely on outside professionals or firms that also provide services to the full board, other board committees, or other units or management of their DCMs.

[79] For example, whereas the compensation of senior DCM executives typically may be recommended to the board by a compensation committee, the compensation of the CRO will be recommended by the ROC. This provides insulation to the CRO and the regulatory personnel beneath him or her, but does not infringe upon the board's final decision-making authority. Similarly, a ROC, rather than a budget committee, should be the body that formally recommends the appropriate level of regulatory expenditures for the DCM. Again, the salutary effect is to insulate a crucial self-regulatory decision, but not to remove it from the ultimate purview of the full board of directors. In these and similar instances, the Commission will be in a position to evaluate how boards treat ROC recommendations, thus adding Commission review as an additional level of self-regulatory insulation.

[80] The text of the final acceptable practices makes clear that ROCs' shall "supervise the contract market's chief regulatory officer, who will report directly to the ROC." This two-way relationship—delegation of certain responsibilities from the ROC to the CRO combined with supervision of the CRO by the ROC—is a key element of the insulation and oversight provided by the ROC structure. It permits regulatory functions and personnel, including the CRO, to continue operating in an efficient manner while simultaneously protecting them from any improper influence which could otherwise be brought to bear upon them. The ROC Acceptable Practice identifies key levers

of traditional committee responsibilities that can easily be performed by an ROC without undue interference in managerial relationships include: recommending rule changes or going on the record as opposed to a rule change originating elsewhere within the DCM; determining an appropriate regulatory budget in conjunction with the CRO and then forwarding that determination for consideration by the full board; arriving at employment decisions with respect to senior regulatory personnel and then forwarding those determinations for consideration by the full board; annual review and reporting on regulatory performance to the full board, *etc*.

ROCs' most important responsibility will simply be to insulate self-regulatory functions and personnel from improper influence. Such insulation does not usurp established authority, but rather acts as a filter through which it must pass, and be cleansed of any efforts to exercise improper influence or drive regulatory decisions according to commercial interest. One facet of the insulation provided by an ROC clearly is the relationship between it and its CRO, and through him or her, all regulatory functions, personnel, and decisions. The Commission has endeavored to identify the levers of influence that may be used to pressure an individual, or an entire regulatory department, and to place ROCs alongside those levers. Matters such as the hiring, termination, and compensation of regulatory personnel, and size of regulatory budgets, are clearly areas where insulation from improper influences may be beneficial. The insulation provided by the ROC Acceptable Practice, however, need not interfere with the established relationships between management, staff, and others necessary to effective self-regulation.

5. Comments With Respect to the Disciplinary Committee Acceptable Practice.

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of influence, including authority over the conduct of investigations, the size and allocation of the regulatory budget, and employment and compensation decisions with respect to regulatory personnel, among others, and then places them within the insulated ROC/CRO-regulatory personnel relationship. While in no way diminishing the ultimate authority of the board of directors, this three-part relationship is intended to protect regulatory functions and personnel, including the CRO, from improper influence in the daily conduct of regulatory activities and broader programmatic regulatory decisions.

Several commenters addressed the proposed Disciplinary Panel Acceptable Practice provision that all DCM disciplinary panels include at least one public participant and that no panel be dominated by any group or class of DCM members. The FIA and large FCMs that commented were generally supportive of the proposed Disciplinary Panel Acceptable Practice, with the FIA commenting that one public member of a DCM disciplinary panel should be a prerequisite for safe harbor relief, but that a 50% public independent member standard for such panels would be much more in keeping with the spirit of the proposed acceptable practices. One large FCM noted that the proposal's composition requirement would avoid the perception of conflict and lack of fairness and impartiality. Another large FCM commented that it supports the proposed provision that would require rules precluding any group or class of industry participants from dominating or exercising disproportionate influence on disciplinary panels.

Although two large DCMs commented that it is not necessary for the Commission to prescribe diversity on disciplinary panels, most of the smaller DCMs that commented in this area were supportive of the proposed acceptable practice. One smaller DCM that hires hearing officers to determine whether to bring a disciplinary action, however, commented that this proposed acceptable practice is not necessary for that DCM as it did not have any widespread inadequacies.

Two commenters addressed what should be the qualifications of the public person serving on disciplinary panels; one agreed that having a public person on disciplinary panels is a sound proposition, but recommended that such person need not be subject to the same qualifying criteria as public directors. Another requested that the Commission clarify that the proposed board determination and reporting requirements with respect to public directors generally are unnecessary for public persons serving on disciplinary panels. The same commenter also

requested clarification that the Disciplinary Panel Acceptable Practice's exclusion of decorum or attire cases from the requirement that one public person serve on disciplinary panels also applies to cases limited to certain recordkeeping matters (*e.g.*, the timely submission of accurate records required for clearing or verifying each day's transactions or other similar activities).

5a. The Commission's Response to Comments on the Disciplinary Panel Acceptable Practice.

After carefully reviewing these comments, the Commission is satisfied that the Disciplinary Panel Acceptable Practice should be implemented as proposed. The Commission believes that fair disciplinary procedures, with minimal conflicts of interest, require disciplinary bodies that represent a diversity of perspectives and experiences. The presence of at least one public person on disciplinary bodies also provides an outside voice and helps to ensure that the public's interests are represented and protected. This approach is consistent with the Commission's overall objective of ensuring an appropriate level of public representation at every level of DCM decision making, while simultaneously calibrating the required number of public persons to the nature and responsibility of the decision-making body in question.

The Disciplinary Panel Acceptable Practice accomplishes these dual objectives of diversity and public representation, while also maintaining the expertise necessary to evaluate sometimes complex disciplinary matters. The Commission also is comfortable that its RER process is well-positioned to evaluate the performance of DCM disciplinary committees and panels, such that a substantially higher proportion of public representation or other ameliorative steps are not required. RERs typically examine all of a DCM's disciplinary cases during a target period in detail, including reviews of disciplinary committee and panel minutes, investigation reports, settlement offers, and sanctions imposed. The Commission also pays careful attention to the recommendations of DCM compliance staff, to disciplinary bodies' responses to those

recommendations, and to the analysis and rationale offered by disciplinary bodies in support of their decisions. If disciplinary committees and panels are underperforming, the Commission will be able to recognize any shortcomings and take appropriate measures.

The work of disciplinary panels requires more specialized knowledge of futures trading than almost any other governing arm of a DCM. Neither the strategic business decisions made by boards of directors, nor the oversight conducted by ROCs, for example, require as much technical futures trading expertise as disciplinary panel service. Accordingly, the Commission believes that increasing the proportion of public representatives on disciplinary panels to 50%, as suggested by one commenter, would eliminate too much expertise from the disciplinary process and is unwarranted.

The Commission recognizes that a small number of DCMs may have unique disciplinary structures. However, the Commission strongly believes that diverse panels, including at least one public person, are appropriate for all DCMs. Should an individual DCM choose to comply with this element of Core Principle 15 by other means, the Commission will examine and monitor it to ensure full core principle compliance.

Other specific requests for modifications and/or clarifications with respect to the Disciplinary Panel Acceptable Practice are treated separately in Section IV(E) below.

IV. Specific Requests for Modifications and/or Clarifications that the Commission has Determined to Grant or Deny.

Several commenters made specific requests for modifications and/or clarifications that the Commission has determined to grant in some instances and deny in others. The specific modifications and/or clarifications do not represent changes in the proposed acceptable practices, but rather implement the Commission's original intent. They are described below.

A. Phase-in Period for the New Acceptable Practices.

Several commenters indicated concern that adoption of the proposed acceptable practices, particularly the requirement to restructure the board, would be burdensome, time consuming and costly. For instance, one large DCM commented that implementation of the acceptable practices would necessitate major changes and cause significant disruption for DCMs, virtually none of which currently meet the proposed 50% public director standard (or the minimum 35% standard adopted in this final release). Another large DCM commented that publicly held DCMs implementing the acceptable practices would have to amend their certificates of incorporation, by-laws, and various public disclosures and respond to any shareholder challenge. As a result of the perceived time requirement, several commenters requested that, if the proposals are adopted, the Commission should provide for an adequate phase-in period.

The Commission hereby grants an appropriate phase-in period. The new acceptable practices for Core Principle 15 are effective 30 days after publication in the *Federal Register*. Under the phase-in period described below, DCMs may take up to two years or two regularly-scheduled board elections, whichever occurs first, to fully implement the new acceptable practices or otherwise demonstrate full compliance with Core Principle 15. The Commission expects that DCMs will begin making preparations and taking conforming steps early in the phase-in period. Accordingly, six months after publishing these acceptable practices in the *Federal Register*, the Commission will survey all DCMs to evaluate their plans for full compliance with Core Principle 15. The Commission also will monitor all DCMs throughout the phase-in period to evaluate their progress toward full compliance.

Although DCMs are not required to implement the new acceptable practices, the Commission has determined that full compliance with Core Principle 15 requires all DCMs to

address structural conflicts of interest between their regulatory responsibilities and their commercial interests or those of their numerous constituencies. Such measures must be present throughout DCMs' decision-making processes. DCMs choosing to adopt measures other than the final acceptable practices adopted herein should consider and address key areas of decision making that are subject to conflicts of interest. These may include decisions with respect to regulatory budgets, expenditures, and funding; employment, compensation, and similar decisions involving regulatory personnel; the constitution of disciplinary panels; the promulgation of rules with a potential regulatory impact; decision making with respect to the investigation, prosecution, and sanctioning of disciplinary offenses; and the chain of command in compliance programs (including trade practice surveillance, market surveillance, and financial surveillance) beyond regulatory officers. The Commission will consider all of these factors in evaluating compliance with Core Principle 15.

B. Selection of Public Directors.

With respect to the placement of public directors on boards, one DCM commented that the proposing release calls upon DCMs to "elect" boards composed of at least 50% public members, but that at that particular DCM public governors are not elected but are identified and appointed by the board itself. Further, election of public members might discourage potential candidates because having to stand for election creates the potential for elected individuals to be beholden to their electing constituency, especially if the position is compensated. Another commenter noted that the proposing release suggests a role for nominating committees in the selection of public directors, and asked for clarification that nominating committees are not required to be involved. Conversely, the FIA recommended that a subgroup of public directors should serve as a nominating committee to select new or re-nominate existing public directors.

The Commission hereby clarifies that DCMs may select their public directors in the manner most appropriate to them. Compliance with the new acceptable practices for Core Principle 15 does not require the use of nominating committees, the "election" of public directors, or the selection of public directors by any pre-specified means. DCMs are free to select their public directors by any process they choose, as long as their public directors meet the requirements set forth in the new acceptable practices. In addition, the Commission expects that the tenures and terms of public directors will be no less secure than that of other directors of the DCM. For example, if other directors can be removed only for cause, then that same protection should extend to public directors. Similarly, if other directors are selected for two-year terms, then public directors should be as well, *etc*.

The Commission considered FIA's request for a special nominating committee for public directors. However, in promulgating these acceptable practices, the Commission has been careful to focus on outcomes—the insulation of regulatory functions, a pure public voice in board deliberations, and fair disciplinary proceedings—while providing only as much instruction as necessary to achieve the safe harbor.

C. Compensation of Public Directors.

As summarized in Section III above, several commenters requested clarifications or amendments with respect to the compensation of public directors under the Public Director Acceptable Practice. Section (b)(2)(iii) of the proposed acceptable practices specified that a public director may not receive more than $100,000 in payments from the DCM (or any affiliate of the DCM, or from a member or anyone affiliated with a member) other than for services as a director. One commenter asked whether deferred compensation for prior services would count toward the $100,000 payment limit for public directors. It does not. The Commission hereby

affirms that public directors may receive deferred compensation for prior services in excess of $100,000, and that such compensation will not count towards the $100,000 payment limit for public directors. To comply with the acceptable practices, DCMs must ensure that any such compensation is truly deferred compensation for prior services. Thus, the agreement by which the public director is being compensated should predate his or her selection as a public director. Furthermore, it should in no way be conditioned upon the directors' future performance, services, or behavior, and in no way be revocable by the compensating party.

FIA requested clarification that the $100,000 payments cap for public directors, for services other than as a director, is a cumulative cap on compensation from DCMs and their membership. The Commission hereby confirms that FIA's understanding is correct. The $100,000 payment cap is an annual, cumulative cap on payments to the public director from all "relevant" sources (*i.e.*, the DCM, any affiliate of the DCM, or any member or affiliate of a member of the DCM) combined. As explained previously, the $100,000 cap also includes indirect payments made by a DCM, its affiliates, and its members or affiliates of its members to the director. In addition, the $100,000 payment cap is an annual cap, as summarized above.

Finally, FIA argued that the Commission should preclude public directors from receiving any compensation from the DCM, but that compensation received by a director's firm, rather than the director itself should not count towards any compensation cap. The Commission considered both comments carefully, but determined that neither is appropriate. The Public Director Acceptable Practice's compensation cap, higher than that requested by FIA, combined with its narrow limits on where such compensation may originate, strikes the proper balance between an effective but not overly restrictive definition of public director.

The Commission strongly believes that significant compensation paid by a DCM or its affiliates to a firm could adversely impact the independence of a director affiliated with that firm. In the Commission's opinion, any such relationship between a DCM and a director, through the director's firm, clearly rises to the level of a "material relationship" that would preclude the director from serving as a public director. Accordingly, the Commission hereby clarifies that a director affiliated with a firm receiving over $100,000 in compensation from the DCM or an affiliate of the DCM may not qualify as a public director.

D. Overlapping Public Directors.

At least one commenter requested clarification with respect to overlapping public directors at DCMs whose ownership structures include a parent-subsidiary relationship. In the proposed acceptable practices, Sections (b)(2)(1) and (b)(2)(5), when read together, suggested that the same person could not serve as a public director at both the parent company and its subsidiary DCM. The question is most likely to arise in the context of DCMs that are subsidiaries of publicly traded companies, and whose boards of directors overlap in whole or in part with those of their public parents.

The Commission hereby clarifies that overlapping public directors are permitted. However, such directors must still meet the Commission's definition of public director, as set forth in the Public Director Acceptable Practice. In effect, overlapping public directors must carry the Commission's definition of "public" director from their DCMs to the holding companies' boards of directors. Conforming language has been added to the final acceptable practices.

E. Jurisdiction of Disciplinary Panels and Definition of "Public" for Persons Serving on Disciplinary Panels.

One commenter asked the Commission to confirm that DCM disciplinary panels considering cases involving the timely submission of accurate records required for clearing or verifying each day's transactions need not include a public person. The Commission included such language in the preamble to the proposed Disciplinary Panel Acceptable Practices, but neglected to include it in the text of the acceptable practices themselves. The Commission is correcting that oversight and modifying the final acceptable practices for Core Principle 15 to make clear that disciplinary panels considering cases involving the timely submission of accurate records required for clearing or verifying each day's transactions need not include a public member.

The same commenter requested clarification that public members of DCM disciplinary panels need only meet the "bright-line" tests for public directors contained in Section 2(B)(i-v) and (2)(C) of the new acceptable practices. That was, in fact, the Commission's intent. Public members of disciplinary panels are not subject to the broader "no material relationship" test of Section (2)(A), nor the disclosure requirements of Section (2)(D). The Commission is confident that the new bright-line tests, combined with DCMs' existing personal conflicts of interest provisions, are sufficient to ensure impartial public representatives on disciplinary panels. Furthermore, the Commission also believes that requiring DCMs to conduct and disclose a material relationship test for disciplinary panel members would constitute an unjustifiable burden at this time. Conforming changes have been made in the final acceptable practices.

F. "No Material Relationship Test."

Section 2(B)(ii) of the proposed acceptable practices precludes a DCM director from being considered public if he or she is a member of the DCM, or employed by or affiliated with a member. A director is "affiliated with a member" if he or she is an officer or director of the

member. The Commission hereby adds an additional element to that definition: a DCM director is affiliated with a member if he or she has any relationship with the member such that his impartiality could be called in question in matters concerning the member.

The Commission believes that this additional element of "affiliated" is a natural outgrowth of its original proposal. In particular, the proposed acceptable practices already precluded a DCM's public directors from also serving as employees, officers, or directors of a member. Combined with the materiality test of Section (2)(A), the Commission's intent to capture a broad array of relationships is clear. Properly applied, the proposed Public Director Acceptable Practice already excluded from service as public directors persons whose relationship with a member firm could call their impartiality into question. Whether the relevant relationships are employment, or similar to employment—independent contracting, legal services, consulting, or other relationships—they are precluded by the Public Director Acceptable Practice. Conforming language has been added to the final acceptable practices.

G. Elimination of ROCs' Periodic Reporting Requirements.

Finally, the Commission is removing certain language from Section 3(B)(v) of the proposed acceptable practices. Among other things, this section called for ROCs to "prepare periodic reports for the board of directors and an annual report assessing the contract market's self-regulatory program…." While the annual reporting obligation remains in full effect, the Commission has determined that an explicit requirement to prepare periodic reports for the board is unnecessary at this time. DCM boards of directors are free to request reports, updates, and information from committees whenever they wish, and committees are free to provide them even if not requested. Nothing in the ROC Acceptable Practice is intended to change that dynamic.

V. Related Matters

A. Cost-Benefit Analysis.

Section 15(a) of the CEA,[81] as amended by Section 119 of the CFMA, requires the Commission to consider the costs and benefits of its action before issuing a new regulation or order under the CEA. By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of its action or to determine whether the benefits of the action outweigh its costs. Rather, Section 15(a) simply requires the Commission to "consider the costs and benefits" of the subject rule or order.

Section 15(a) further specifies that the costs and benefits of the proposed rule or order shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may, in its discretion, give greater weight to any one of the five enumerated areas of concern and may, in its discretion, determine that, notwithstanding its costs, a particular rule or order is necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the CEA.[82]

In the proposing release, the Commission considered the costs and benefits of the acceptable practices, requested comment on the application of the criteria contained in Section 15(a) of the CEA, and invited commenters to submit any quantifiable data that they might have.

DCM commenters asserted that the costs of compliance outweighed any benefit, particularly the costs of amending governing documents in the manner required by Delaware corporate law. A number of DCMs and individuals contended that the Board Composition

[81] 7 U.S.C. § 19(a).

[82] *E.g, Fishermen's Dock Co-op., Inc. v. Brown*. 75 F.3d 164 (4th Cir. Va. 1996); *Center for Auto Safety v. Peck*, 751 F.2d 1336 (D.C. Cir. 1985)(agency has discretion to weigh factors in undertaking costs-benefits analyses).

Acceptable Practice (and the other proposed acceptable practices) is unnecessary and that the Commission's cost-benefit analysis is flawed. Commenters asserted that the acceptable practices present no or minimal benefit, since the Commission failed to demonstrate any problems in the futures industry to warrant issuance of any of the acceptable practices.[83] Several commenters distinguished between securities industry reforms, which followed public scandals, and the recent absence of such events in the futures industry.[84]

As noted above, however, the Commission identified significant futures industry trends, including increased competition and changing ownership structures, which justify the acceptable practices as a prophylactic measure to minimize conflicts of interest in DCM decision making and to promote public confidence in the futures markets in the altered landscape. Minimizing conflicts and promoting public confidence in the futures markets are significant benefits for the futures industry, market participants, and the national public interest served by the futures markets.

KCBT and NYBOT commented that, as small, non-public DCMs, they do not present the types of conflicts the Commission sought to address in expanding public participation on DCM governing boards.[85] HedgeStreet, a small electronic DCM, expressed similar views.[86] The Commission sees no rational basis for the proposition that size insulates a DCM from conflicts of interest. The potential impact arising from an improperly managed conflict may well be less at a smaller DCM than at a large one. The *magnitude* of potential harm is not the appropriate standard for taking prophylactic measures. What matters is whether the means proposed will

[83] *See, e.g.*, CME CL 29 at 9; NYMEX CL 28 at 10-11; NYBOT CL 22 at 4; CBOT CL 21 at 3.
[84] *See, e.g.*, NYMEX CL 28 at 11-13; CME CL 29 at 9; NYBOT CL 22 at 2; Comment of Donald L. Gibson, CL 25 at 1.
[85] KCBT at CL 8 at 2; NYBOT CL at 4. NYBOT has informed the Commission of its intent to be acquired by ICE and run as a for-profit subsidiary. Accordingly, its comment has little relevance to its own contemplated future circumstances.
[86] *See* HedgeStreet CL 17.

impact small DCMs disproportionately. Neither KCBT, NYBOT, nor HedgeStreet have identified a disproportionate burden. Nor have they shown how their status as non-public DCMs immunizes them from conflicts. As the Commission made clear in proposing the acceptable practices, DCMs that become public, stockholder-owned corporations face an additional, new layer of conflict. Conflicts are inherent in other forms of ownership as well. Such conflicts may be minimized at all sizes and forms of DCMs by an increase in the percentage of public directors.

If any DCM faces a particular burden peculiar to its individual circumstances in complying with the acceptable practices, that DCM may, as a matter of statute, choose an alternative method of complying with Core Principle 15 that is responsive to its circumstances. However, such DCM must still demonstrate, to the Commission's satisfaction, that its alternative method effectively addresses conflicts of interest in decision making under Core Principle 15, including structural conflicts of interest.

DCM commenters asserted that complying with the Board Composition Acceptable Practice will be an expensive undertaking requiring amendment of corporate charters and other documents, and that the Commission gave too little consideration to these costs. For example, NYMEX states:

> The process of preparing . . . bylaw changes requires a commitment of time both by in-house exchange staff as well as by specialized legal advisors. This process can be fairly time-intensive with regard to review by such professionals of various drafts of amendments and other material for shareholders in relation to the successive SEC filings. There are the obvious costs generated by numerous runs by the applicable print shop specializing in SEC filing productions as well as the not inconsiderable costs of overnight shipping of the shareholder materials to hundreds if not thousands of shareholders of record.[87]

[87] NYMEX CL at 20 n.32.

Arguments such as these are not persuasive. NYMEX describes a process, and asserts that it entails a cost, but fails even to estimate that cost, or to place the cost in any kind of context that would allow the Commission to judge the level of burden. Other comments alleging burdensome costs are similarly flawed. The Commission has no basis to conclude that compliance is other than a reasonable cost of doing business in an industry subject to federal oversight. Moreover, the costs may be phased in over a period of time. In this final release, although the acceptable practices will be effective immediately, the Commission is adopting a phase-in period of two years or two board election cycles, whichever occurs first.

The DCMs' contentions that any level of compliance is burdensome because they already are subject to other governance regimes miss the mark. CME, CBOT, and NYMEX essentially contended that the governance provisions of the Delaware General Corporation Law under which they are organized, and the NYSE Listing Standards, contain sufficient provisions to assure sound governance.[88] The member-owned DCMs, NYBOT, KCBT, and their supporters, state that the diversity standards of Core Principle 16 provide an adequate bulwark against conflicts of interest, and that the membership presence on their boards will be diluted if a large contingent of public directors is admitted.[89] These arguments overlook the overarching purpose of the Board Composition Acceptable Practice, which is expressly to minimize conflicts of interest by addressing the keystone of all corporate decision making—the board of directors.

CME stated that the responsibility imposed on public directors to act in the public interest actually conflicts with the duty owed to shareholders under Delaware corporate law and the NYSE Listing Standards.[90] The Commission's review of corporate law authority reveals no such conflict. These proposals are entirely consistent with bedrock corporate law principles: as

[88] CME CL 29 at 14; CBOT CL 21 at 6-7; NYMEX CL 28 at 5-6, 15.
[89] NYBOT CL 22 at 3-4; KCBT CL 8 at 1-2; for their supporters, *see, e.g.*, comment of Michael Braude, CL 10 at 1.
[90] CME CL 29 at 8.

Delaware corporations, they are run "by or under the Board of Directors."[91] Directors act as fiduciaries of stockholders, to be sure, but that does not mean the performance of their duties is limited to serving the narrow interests of stockholders. Those affairs include complying with the various statutes to which the corporation is subject. Shareholders are well-served or ill-served by the quality of the directors' discharge of their statutory duties.

Corporate law experts generally agree that outside directors benefit corporate governance generally. "[M]ost persons in academia and business agree that outside directors play an important role in the effective functioning of the board."[92] The suggestion of some commenters that public directors have an inherent conflict between the public interest and their duty to shareholders is misplaced. The acceptable practices address DCM governing boards, not the boards of parent public holding companies. DCMs—and their governing bodies—are vested with a public interest duty under the plain text of the CEA. Moreover, the public interest duty applies to nonpublic as well as public directors. The Commission is aware of overlapping board memberships—*i.e.*, that the members of a DCM governing board may be the same individuals as those who serve on the parent board. This is entirely permissible. When an individuals sits, deliberates and acts in respect of the governance of the registered entity, he or she must do so consistently with the public interest mandate of the CEA.

A number of commenters who wrote in support of KCBT and NYBOT assumed that public directors will lack interest and experience, and add little to board deliberations.[93] These commenters, however, offered no empirical evidence to support their speculation. The Commission notes that many DCM boards already include public directors who have been

[91] Del. Code Ann. tit. 8, § 141(a).
[92] D. Pease, "Outside Directors: Their Importance to the Corporation and Protection from Liability," 12 Del. J. Corp. L. 25, 31 *et seq.* (1987)(citing extensive authority and noting the legal advantages of outside directors).
[93] *See, e.g.*, Comment of Dennis M. Erwin, CL 18 at 1; Comment of John Legg, CL 14 at 1; and Comment of Robert J. Rixey, CL 11 at 1.

deemed qualified and competent by the DCMs. As discussed previously, the boards of exchanges such as the KCBT, MGEX, NYMEX, NYBOT, and CME, are typically 20% or more non-member. Moreover, the acceptable practices do not preclude non-member producers, retired and former industry persons, academics, and others from being considered public directors, which should provide a significant pool of futures industry experience from which to draw. DCMs that fear adding public directors will expand their boards to an unwieldy size may comply with the acceptable practices by phasing in public directors into existing seats.

One commenter contended that in prior cost-benefit analyses, the Commission has addressed each of the five considerations under Section 15(a) separately, and that this approach would have facilitated public comment.[94] However, the Commission has not always addressed each consideration separately in its rulemakings, nor is it required by the statute to do so. Section 15(a) requires that costs and benefits be evaluated in terms of the five considerations, but the Commission may give greater weight to any one of them. The cost-benefit analysis in the proposed acceptable practices provided sufficient notice to the public regarding the considerations to which the Commission accorded the greatest weight. The same commenter asserted that the Commission should endeavor to apply the relevant factors separately to each major proposal.[95] Again, however, the statute does not require that the Commission apply the factors in this fashion, but allows it to consider the costs and benefits in light of the impact of its proposal as a whole. Finally, the commenter encouraged the Commission to consider regulatory alternatives in its cost-benefit analysis.[96] As noted above, however, the only alternative suggested by the commenters was that the Commission do nothing. They suggested no other alternative that would address the concerns cited by the Commission in proposing the acceptable

[94] NYMEX CL 32 at 20.
[95] *Id*.
[96] *Id*.

practices. In the Commission's judgment, these acceptable practices serve to protect the public interest in a manner that minimizes the costs to the industry while demonstrating compliance with Core Principle 15.

As was discussed in the proposing release, the acceptable practices described herein are safe harbors for compliance with Core Principle 15's conflict of interest provisions. They offer DCMs the opportunity to meet the requirements of Core Principle 15 through a regulatory governance structure that insulates their regulatory functions from their commercial interests. The Board Composition Acceptable Practice provides that DCMs implement boards of directors and executive committees thereof that are at least 35% public. The ROC Acceptable Practice further provides that all DCMs place oversight of core regulatory functions in the hands of board-level ROCs composed exclusively of "public" directors. The Public Director Acceptable Practice offers guidance on what constitutes a "public" director. In addition, the Disciplinary Panel Acceptable Practice suggests minimum composition standards for DCM disciplinary committees. As noted above, although the acceptable practices will be effective immediately, the Commission is allowing a phase-in period for DCMs to implement them.

The proposed acceptable practices are consistent with legislative and regulatory requirements, and voluntarily undertaken changes in governance practices in other financial sectors, such as the securities markets, and are intended to enhance protection of the public. The Commission has endeavored to establish the least intrusive safe harbors and regulatory requirements that reasonably can be expected to meet the requirements of Core Principle 15 of the CEA. These acceptable practices advance the Commission's mandate of assuring the continued existence of competitive and efficient markets and to protect the public interest in markets free of fraud and abuse. They nevertheless may be expected to entail some costs,

including, among the most foreseeable, those attendant to recruiting and appointing additional directors, amending corporate documents, making necessary rule changes and certifying them to the Commission, and appointing a Chief Regulatory Officer. In light of the reduction of the percentage of public board members from 50% in the Board Composition Acceptable Practice as proposed to at least 35%, and the phase-in period, the Commission believes that these costs will not impose a significant burden and can be borne over time. After considering the costs and benefits of the acceptable practices, and considering the comments received in response to its proposal, the Commission has determined to issue the acceptable practices for Core Principle 15 with respect to DCMs.

B. Paperwork Reduction Act of 1995.

The acceptable practices contain information collection requirements. As required by the Paperwork Reduction Act of 1995 (44 U.S.C. §3504(h)), the Commission has submitted a copy of this section and the acceptable practices to the Office of Management and Budget ("OMB") for its review.

The revision of collection of information has been reviewed and approved by the Office of Management and Budget pursuant to the Paperwork Reduction Act, under control number 3038-0052. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. In the Notice of Proposed Acceptable Practices, the Commission estimated the paperwork burden that could be imposed by the acceptable practices and solicited comment thereon. 71 FR 38740, 38748 (July 7, 2006). No specific or sufficiently material comment was received.

Copies of the information collection submission to OMB are available from the Commission Clearance Officer, Three Lafayette Centre, 1155 21st Street, NW, Washington DC 20581, (202) 418-5160.

C. Regulatory Flexibility Act.

The Regulatory Flexibility Act, 5 U.S.C. §601 *et seq*., requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The final acceptable practices affect designated contract markets. The Commission has previously determined that designated contract markets are not small entities for purposes of the Regulatory Flexibility Act.[97] Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. §605(b) that the final acceptable practices will not have a significant economic impact on a substantial number of small entities.

VI. Text of Acceptable Practices for Core Principle 15

List of Subjects in 17 CFR Part 38

Commodity futures, Reporting and recordkeeping requirements

In light of the foregoing, and pursuant to the authority in the Act, and in particular, Sections 3, 5, 5c(a) and 8a(5) of the Act, the Commission hereby amends Part 38 of Title 17 of the Code of Federal Regulations as follows:

PART 38—DESIGNATED CONTRACT MARKETS

1. The authority citation for Part 38 is revised to read as follows:

Authority: 7 U.S.C. 2, 5, 6, 6c, 7, 7a-2 and 12a, as amended by Appendix E of Pub. L. 106–554, 114 Stat. 2763A–365.

2. In Appendix B to Part 38 amend Core Principle 15 paragraph (b) by adding "Acceptable Practices" as follows:

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[97] Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, 47 Fed. Reg. 18618, 18619 (Apr. 30, 1982).

Appendix B to Part 38—Guidance on, and Acceptable Practices in, Compliance with Core Principles.

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Core Principle 15 of section 5(d) of the Act: CONFLICTS OF INTEREST

* * * * *

(b) *Acceptable Practices.* All designated contract markets ("DCMs" or "contract markets") bear special responsibility to regulate effectively, impartially, and with due consideration of the public interest, as provided for in Section 3 of the Act. Under Core Principle 15, they are also required to minimize conflicts of interest in their decision-making processes. To comply with this Core Principle, contract markets should be particularly vigilant for such conflicts between and among any of their self-regulatory responsibilities, their commercial interests, and the several interests of their management, members, owners, customers and market participants, other industry participants, and other constituencies. Acceptable Practices for minimizing conflicts of interest shall include the following elements:

(1) Board Composition for Contract Markets

(A) At least thirty-five percent of the directors on a contract market's board of directors shall be public directors; and

(B) The executive committees (or similarly empowered bodies) shall be at least thirty-five percent public.

(2) Public Director

(A) To qualify as a public director of a contract market, an individual must first be found, by the board of directors, on the record, to have no material relationship with the contract market. A "material relationship" is one that reasonably could affect the independent judgment or decision making of the director.

(B) In addition, a director shall not be considered "public" if any of the following circumstances exist:

(i) the director is an officer or employee of the contract market or a director, officer or employee of its affiliate. In this context, "affiliate" includes parents or subsidiaries of the contract

market or entities that share a common parent with the contract market;

(ii) the director is a member of the contract market, or a person employed by or affiliated with a member. "Member" is defined according to Section 1a(24) of the Commodity Exchange Act and Commission Regulation 1.3(q). In this context, a person is "affiliated" with a member if he or she is an officer or director of the member, or if he or she has any other relationship with the member such that his or her impartiality could be called into question in matters concerning the member;

(iii) the director, or a firm with which the director is affiliated, as defined above, receives more than $100,000 in combined annual payments from the contract market, any affiliate of the contract market, or from a member or any person or entity affiliated with a member of the contract market. Compensation for services as a director does not count toward the $100,000 payment limit, nor does deferred compensation for services prior to becoming a director, so long as such compensation is in no way contingent, conditioned, or revocable;

(iv) any of the relationships above apply to a member of the director's "immediate family," *i.e.*, spouse, parents, children, and siblings.

(C) All of the disqualifying circumstances described in Subsection (2)(B) shall be subject to a one-year look back.

(D) A contract market's public directors may also serve as directors of the contract market's parent company if they otherwise meet the definition of public in this Section (2).

(E) A contract market shall disclose to the Commission which members of its board are public directors, and the basis for those determinations.

(3) Regulatory Oversight Committee

(A) A board of directors of any contract market shall establish a Regulatory Oversight Committee ("ROC") as a standing committee, consisting of only public directors as defined in Section (2), to assist it in minimizing actual and potential conflicts of interest. The ROC shall oversee the contract market's regulatory program on behalf of the board. The board

shall delegate sufficient authority, dedicate sufficient resources, and allow sufficient time for the ROC to fulfill its mandate.

(B) The ROC shall:

(i) monitor the contract market's regulatory program for sufficiency, effectiveness, and independence;

(ii) oversee all facets of the program, including trade practice and market surveillance; audits, examinations, and other regulatory responsibilities with respect to member firms (including ensuring compliance with financial integrity, financial reporting, sales practice, recordkeeping, and other requirements); and the conduct of investigations;

(iii) review the size and allocation of the regulatory budget and resources; and the number, hiring and termination, and compensation of regulatory personnel;

(iv) supervise the contract market's chief regulatory officer, who will report directly to the ROC;

(v) prepare an annual report assessing the contract market's self-regulatory program for the board of directors and the Commission, which sets forth the regulatory program's expenses, describes its staffing and structure, catalogues disciplinary actions taken during the year, and reviews the performance of disciplinary committees and panels;

(vi) recommend changes that would ensure fair, vigorous, and effective regulation; and

(vii) review regulatory proposals and advise the board as to whether and how such changes may impact regulation.

(4) Disciplinary Panels

All contract markets shall minimize conflicts of interest in their disciplinary processes through disciplinary panel composition rules that preclude any group or class of industry participants from dominating or exercising disproportionate influence on such panels.

Contract markets can further minimize conflicts of interest by including in all disciplinary panels at least one person who would qualify as a public director, as

defined in Subsections (2)(B) and (2)(C) above, except in cases limited to decorum, attire, or the timely submission of accurate records required for clearing or verifying each day's transactions.

If contract market rules provide for appeal to the board of directors, or to a committee of the board, then that appellate body shall also include at least one person who would qualify as a public director as defined in Subsections (2)(B) and (2)(C) above.

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Issued in Washington, D.C., on _____ by the Commission.

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Eileen A. Donovan,
Acting Secretary of the Commission