

Regulatory Oversight Committee – Expectations, Duties, and Best Practices

Presented to the Futures Industry Association
Law & Compliance Division Conference

Managing an Effective Compliance Program

April 26, 2023 – April 28, 2023

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I. Introduction

Last month, Commodity Futures Trading Commission (“CFTC”) Chairman Rostin Behnam laid out his regulatory agenda.² Among the topics Chair Behnam addressed, several of the thematic areas directly impact the expectations for and operations of an effective compliance program for designated contract markets (“DCMs”).

As recent months have demonstrated, market volatility, global events, and economic uncertainty can impact both trade volumes and potential conflicts of interest in decision-making of a DCM. In order to ensure independence in the operation of the DCM, address potential conflicts of interest, and the assess functioning of the DCM compliance function, the CFTC has published guidance that a DCM should establish a Regulatory Oversight Committee (“ROC”) as a standing committee, consisting of only public directors to assist the DCM in minimizing actual and potential conflicts of interest. Pursuant to the CFTC Guidance, the ROC should oversee the contract market's regulatory program on behalf of the board.

This paper sets forth the framework for a successful ROC and offers some industry best practices to ensure that the ROC is meeting its regulatory obligations and best supporting the DCM's board and the exchange.

II. What is a Regulatory Oversight Committee

CFTC Core Principle 16 requires DCMs to establish and enforce rules to minimize conflicts of interest in decision-making processes and to establish a process for resolving such conflicts of interest.³ To assist in minimizing actual and potential conflicts of interest, CFTC regulations require the board of directors of the DCM to establish a ROC as a standing

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² Keynote Address of Chairman Rostin Behnam at the ABA Business Law Section Derivatives & Futures Law Committee Winter Meeting (Feb. 3, 2023) available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabeznam31>.

³ Core Principle 16, 17 C.F.R. § 38.850.

committee consisting of only public directors.⁴ The ROC is tasked with overseeing the DCM's regulatory program on behalf of the board of directors.⁵

Any conflict-of-interest concerns where the DCM might prioritize profitability over reasonable controls will be addressed through regular CFTC oversight of the DCM, including through examinations.⁶ However, in promulgating rules around risk mitigation, the CFTC has acknowledged that DCMs are best positioned to determine what risk controls and rules are appropriate to prevent, detect, and mitigate disruptions on their respective markets.⁷

For example, during in examination, CFTC staff may consider the following:

- Whether sufficient financial and staff resources are being allocated to the DCM's compliance functions;
- The background and qualifications of the DCM's ROC members and compliance officers; and
- Any role that non-compliance personnel might be taking in the DCM's market monitoring and investigations processes.⁸

III. ROC and DCM Requirements

By overseeing the DCM's core regulatory functions, the ROC operates to minimize conflicts of interest in the ordinary course of business and ensure that the DCM remains free from improper influence. The CFTC notes that while ROCs are intended to insulate self-regulatory functions and personnel from improper influence, ROCs are not expected to assume managerial responsibilities, or to isolate self-regulatory functions and personnel from others within the DCM.⁹ As such, the DCM's chief regulatory officer should assist in the ROC's oversight and insulation.

In order to address conflicts of interest, Part 38 guidance advises DCMs to include methods to ascertain the presence of conflicts of interest and to make decisions in the event of such a conflict.¹⁰ This includes setting proper limitations on the use or disclosure of material non-public information gained through the performance of official duties by board or committee members. Specifically, DCMs should be vigilant with regards to conflicts between and among any of their self-regulatory responsibilities, their commercial interests, and the several interests

⁴ Guidance on, and Acceptable Practices in, Compliance with Core Principles, Core Principle 16, 17 C.F.R. § 38 app. B.

⁵ *Id.*

⁶ Electronic Trading Risk Principles, 86 Fed. Reg. 2048, 2050 (Jan. 11, 2021), *available at* <https://www.govinfo.gov/content/pkg/FR-2021-01-11/pdf/2020-27622.pdf>.

⁷ *Id.*

⁸ *Id.*

⁹ Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations ("SROs"), 72 Fed. Reg. 6936 (Feb. 14, 2007), *available at* <https://www.govinfo.gov/content/pkg/FR-2007-02-14/pdf/E7-2528.pdf>.

¹⁰ *Supra* note 4.

of their management, members, owners, customers and market participants, other industry participants, and other constituencies.¹¹

CFTC guidance recognizes the ROC as one of the elements of acceptable practices for minimizing conflicts of interest.

The ROC is required to perform the following functions:

1. Monitor the DCM's regulatory program for sufficiency, effectiveness, and independence;
2. 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;
3. Review the size and allocation of the regulatory budget and resources; and the number, hiring and termination, and compensation of regulatory personnel;
4. Supervise the contract market's chief regulatory officer, who will report directly to the ROC;
5. 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;
6. Recommend changes that would ensure fair, vigorous, and effective regulation; and
7. Review regulatory proposals and advise the board as to whether and how such changes may impact regulation.

With respect to disciplinary processes, DCMs must minimize conflicts of interest through composition rules for disciplinary panels. Such rules should preclude any group or class of industry participants from dominating or exercising disproportionate influence on such panels.¹²

DCMs can further minimize conflicts of interest by including in all disciplinary panels at least one person who would qualify as a public director, except in cases limited to decorum, attire, or the timely submission of accurate records required for clearing or verifying each day's transactions.¹³ If the rules of the DCM provide for an appeal to the board of directors, or to a committee of the board, that appellate body must also include at least one person who would qualify as a public director.

IV. Public Director Requirements

The ROC must consist entirely of public directors. For an individual to qualify as a public director, they must first be found, by the board of directors, on the record, to have no material

¹¹ *Id.* at Subparagraph (b).

¹² *Id.*

¹³ *Id.*

relationship with the DCM. A material relationship is one that reasonably could affect the independent judgment or decision making of the director.¹⁴

There are certain circumstances in which a “material relationship” may be found, including:

1. The director is an officer or employee of the contract market or an 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.
2. The director is a member of the contract market, or an officer or director of a member.
3. The director, or a firm with which the director is an officer, director, or partner, receives more than \$100,000 in combined annual payments¹⁵ from the contract market, or any affiliate of the contract market, for legal, accounting, or consulting services.¹⁶

Any of the relationships described above would also apply to a member of the director’s “immediate family,” i.e., parents, spouse, children and siblings. These disqualifying circumstances are also subject to a one-year look back.¹⁷

The DCM is required to establish and enforce appropriate fitness standards for its directors, members of any disciplinary committee, members of the contract market, and any other person with direct access to the facility.¹⁸ This also means having appropriate eligibility criteria, including standards for the collection and verification of information supporting compliance with such standards. For example, those with governing obligations or responsibilities within the DCM, or those who exercise disciplinary authority, should not have a significant history of serious disciplinary offenses. DCM standards should also include providing the CFTC with the fitness information for public directors, whether it be through registration information, certification to the fitness of such persons, an affidavit of such persons’ fitness by the DCM’s counsel or other information substantiating the fitness of such persons.¹⁹ If a DCM provides certification of the fitness of such a person, the CFTC believes that such certification should be based on verified information that the person is fit to be in his or her position.²⁰

V. ROC Best Practices

Adopting and adhering to best practices will allow the ROC to provide independent oversight of the policies and programs to ensure effective administration of the DCM’s self-

¹⁴ *Id.*

¹⁵ Compensation for services as a director of the contract market or as a director of an affiliate of the contract market 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.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

regulatory responsibilities. Foremost, DCMs should maintain policies that are intended to ensure the continuing independence of the DCM's compliance functions and to insulate it from any commercial interest when detecting possible violations, investigating possible violations, and applying sanctions.