

SEC Proposes to Clear-Up Clearing Agencies' Governance to Mitigate Directors' Potential Conflicts of Interest

August 29, 2022

Clearing agencies registered with the Securities and Exchange Commission (SEC) will have to make governance changes to their boards of directors under a new rule proposed by the SEC on August 8, 2022.

The SEC proposed the [new rule](#)¹ to mitigate the conflicts of interests inherent in clearing agency relationships. The rule follows episodes of market volatility in 2021 that included large fluctuations surrounding COVID-19 and the meme stock craze.

The new rule would amend Section 17Ad-25 of the Securities Exchange Act of 1934 (Exchange Act) to require additional management and governance requirements for clearing agencies that register with the SEC. The proposed rules provide specific new governance requirements on clearing board composition, independent directors, nominating committees and risk management committees. The rule also requires the board to oversee relationships with critical service providers and includes a board obligation to consider various stakeholder views and inputs.

Rationale

The SEC's rationale for proposing Rule 17Ad-25, titled Clearing Agency Governance and Conflicts of Interest, is to reduce the risk that conflicts of interest inherent in various clearing agency relationships substantially harm the security-based swaps or larger financial market. The SEC is proposing this rule to mitigate conflicts of interest, promote the fair representation of owners and participants in the governance of a clearing agency, identify responsibilities of the board, and increase transparency into clearing agency governance.

The SEC noted that those episodes of increased market volatility revealed certain vulnerabilities in the US securities market and the essential role clearing agencies play in managing the risk if securities transactions fail to clear.

The SEC observed three potential sets of conflicts of interest that the proposed rule attempts to address.

- I. The proposed rule addresses the different perspectives the various stakeholders involved in clearing agencies might have. In particular, a clearing agency owner's potential interest in protecting the equity and continued operation of the clearing agency diverges from a participant's potential interest in avoiding the allocation of losses from another defaulting participant. For instance, in the event of a loss, clearing agency participants might prefer to limit access to clearing, while owners may choose to expand the scope of products offered to collect fees.

¹ <https://www.sec.gov/rules/proposed/2022/34-95431.pdf>

- II. Larger clearing agency participants' priorities may diverge significantly from the interests of smaller clearing agency participants. In particular, when a small number of dominant participants exercise control over a registered clearing agency concerning services provided by that clearing agency, those participants might promote margin requirements that are not commensurate with the risks they take, thereby indirectly limiting competition and increasing profit margins for themselves. In other words, a registered clearing agency dominated by a small number of large participants might make decisions designed to provide them with a competitive advantage.
- III. Certain participants may exert undue influence to limit access to the clearing agency based on their own interests, and thus could limit the benefits of the clearing agency to indirect participants.

Rule Requirements

The proposed rule would impose these seven requirements:

- (i) define independence in the context of a director serving on the board of a registered clearing agency and require that a majority of directors on the board be independent, unless a majority of the voting rights distributed to shareholders of record are directly or indirectly held by participants of the registered clearing agency, in which case at least 34 percent of the board must be independent directors;
- (ii) establish requirements for a nominating committee, including with respect to the composition of the nominating committee, fitness standards for serving on the board, and documenting the process for evaluating board nominees;
- (iii) establish requirements for the function, composition, and reconstitution of the risk management committee;
- (iv) require policies and procedures that identify, mitigate or eliminate, and document the identification and mitigation or elimination of conflicts of interest;
- (v) require policies and procedures that obligate directors to report potential conflicts promptly;
- (vi) require policies and procedures for the board to oversee relationships with service providers for critical services; and
- (vii) require policies and procedures to solicit, consider, and document the registered clearing agency's consideration of the views of its participants and other relevant stakeholders regarding its governance and operations.

The proposing release will be published on SEC.gov and in the *Federal Register*. The public comment period will remain open for 60 days following publication of the proposing release on the SEC's website or 30 days following publication of the proposing release in the *Federal Register*, whichever period is longer.

CONTACTS

For more information, contact your Katten attorney or the following [Financial Markets and Funds](#) attorney.



Susan Light
+1.212.940.8599
susan.light@katten.com

Jacob C. Setton, an associate in the Financial Markets and Funds practice and candidate for admission to the New York State bar, contributed to this advisory.

Katten katten.com

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2022 Katten Muchin Rosenman LLP. All rights reserved.

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at kattenlaw.com/disclaimer.

08/29/22