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March 18, 2024

Mr. Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: RIN 3038–AF39 – Protection of Clearing Member Funds Held by Derivatives Clearing Organizations – 89 Fed. Reg. 286 (January 3, 2024)

Dear Mr. Kirkpatrick:

The Futures Industry Association [1] ("**FIA**") welcomes the opportunity to comment on the Commodity Futures Trading Commission's ("**CFTC**" or "**Commission**") notice of proposed rulemaking entitled "Protection of Clearing Member Funds Held by Derivatives Clearing Organizations" (the "**Proposed Regulation**").[2] FIA supports the regulatory purpose underlying the Proposed Regulation, namely, the extension of select segregation requirements to clearing member funds modeled on the current asset protection regime applicable to customer funds held by futures commission merchants ("**FCMs**"). The Commission's action is a constructive first step to close the gap between the protections available to customer property and those available to clearing member property.

But it is only a *first* step. Finalizing the Proposed Regulation in a vacuum may give market participants – and, in particular, retail customers – the mistaken impression that when they commit funds to a derivatives clearing organization ("**DCO**") clearing under the non-traditional models that the CFTC has begun to license, they will receive the same protections as customers of FCMs. This will not be the case. Insofar as the Proposed Regulation is intended to shore up gaps between the asset protection regimes of those non-traditional clearing models and the traditional model, it

[1] FIA is the leading global trade organization for the futures, options, and centrally cleared derivatives markets, with offices in London, Brussels, Singapore, and Washington, DC. FIA's mission is to support open, transparent, and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms, and commodities specialists from about 50 countries, as well as technology vendors, lawyers, and other professionals serving the industry. FIA's core constituency consists of firms that operate as clearing members in global derivatives markets.

[2] 89 Fed. Reg. 286 (Jan. 3, 2024).

falls far short of providing a level of protection that is the same as or even comparable to that afforded by the traditional model of intermediated clearing. We understand that Chairman Behnam has said publicly that "by the summer the Commission will consider a proposal specifically addressing potential risks, conflicts, and governance issues that may be raised by new market structures and affiliate relationships."[3] Still, we fear gaps will remain in the breadth and effectiveness of protections for customers in direct versus FCM-intermediated clearing models.

We urge the Commission to perform a holistic review of the Commodity Exchange Act ("**CEA**"), CFTC regulations and self-regulatory framework established thereunder to ascertain what steps the agency needs to take to provide the same robust protections to customers of DCOs and FCMs (as applicable) in these new models. U.S. derivatives markets are among the safest in the world because of the regulatory protections vouchsafed to market participants. We should not jeopardize the standing of these markets, much less the safeguarding of customer property, in the rush of new and untested models to market. At a minimum, until the full impact of these changes is adequately evaluated, confirmed to be within the scope of the CFTC's existing authority,[4] and comprehensively addressed, the CFTC should make clear that the customer protections created by these changes are not the same as those provided by FCMs.

We support adopting the rulemaking as proposed, subject to certain modifications discussed further herein. But we urge that in doing so, the Commission commit at the same time to delaying approval of any DCO clearing under what we refer to as the leveraged disintermediated model until the Commission has proposed and adopted regulations establishing an asset protection regime for members clearing on such DCOs that is substantively equivalent to the asset protection regime for customers clearing under the traditional model.

To assist the CFTC in this important effort, we set forth in the sections that follow how the Proposed Regulation may apply to the various clearing models. We believe this approach will clarify where the Proposed Regulation may fall short of its objective and require supplemental analysis and action with respect to each clearing model.

As we have made clear, our concerns are most salient where DCOs would operate under the leveraged disintermediated clearing model. We worry that model is not yet fit to the ambitious purposes its advocates have articulated for it, and, absent additional regulatory safeguards, may introduce significant risk to the clearing ecosystem. The CFTC should first do the critical work necessary to analyze how the Proposed Regulation will impact each of the clearing models – the

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[3] Keynote of Chairman Rostin Behnam at the FIA Boca 2024 International Futures Industry Conference, Boca Raton, FL, available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam43.

[4] We note the Commission's statement that the Proposed Regulation is within scope of the authority granted the Commission under Section 8a(5) of the CEA. 89 Fed. Reg. at 287. We have no reason to take exception to the Commission's view as applied to the traditional model or to the fully collateralized disintermediated model of clearing. But whether the CEA authorizes the CFTC to approve leveraged disintermediated clearing, in our view, merits more substantial analysis given how integrally the CEA's asset protection regime relies on the functional interrelationships between registered intermediaries, exchanges, and clearinghouses.

three it has already authorized and the one for which authorization is pending (and should remain so until that work is done).

We conclude the letter with comments on specific provisions of the Proposed Regulation.

Four Models of Derivatives Clearing

Traditional FCM Clearing

At the core of the CEA and CFTC regulations thereunder is a customer asset protection regime that is built on the foundation of traditional FCM clearing that the Commission describes in the opening paragraph of the Proposed Regulation.[5] As the Commission notes, the comprehensive protections of the traditional regime do not extend to the clearing members of DCOs (beyond a mandate to "protect and ensure the safety of [clearing member] funds in a manner that will minimize the risk of loss or delay in access by the DCO to [those] funds"), and the Commission's focus in regulating DCOs under Core Principle F has been "on the custody and safeguarding of customer funds."[6]

The Commission observes that "this approach was largely responsive to the historical prevailing model in which all or nearly all clearing members of a DCO are FCMs."[7] This observation prompts a threshold question: is the Proposed Regulation necessary for DCOs that still operate under that model?

We believe the traditional model of clearing is well-served by the proposed segregation mandate for proprietary funds. We understand that mandate mainly codifies existing best practices at DCOs operating under the traditional model.[8] That is to say, we believe that DCOs clearing under the traditional model are already: (i) segregating proprietary funds as belonging to clearing members; (ii) depositing proprietary funds under account names that clearly identify them as such; (iii) maintaining segregated proprietary funds in an amount sufficient in the aggregate to cover what is owed to clearing members; (iv) not commingling proprietary funds with customer funds or the DCOs' own funds; and (v) not using proprietary funds except as belonging to clearing members.[9] It follows that codifying these requirements should not unduly burden these DCOs. In addition, we believe that such codification offers important benefits to clearing members.[10]

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[5] Id.

[6] Id.

[7] Id.

[8] Id. at 298, 307.

[9] See proposed CFTC Regulation 39.15(f)(1), (f)(2), (f)(3)(ii), and (f)(4).

[10] Not the least of these benefits is enhanced legal certainty concerning the treatment of proprietary funds in the event of a DCO bankruptcy, see Proposed Regulation, 89 Fed. Reg. at 288, which will streamline and simplify the

We understand that the three additional requirements of the proposed segregation mandate for proprietary funds – namely, (vi) the restriction on investment of proprietary funds to instruments permitted under CFTC Regulation 1.25; (vii) the requirement that DCOs obtain acknowledgment letters specifically referencing proprietary funds accounts and in the form prescribed under the Proposed Regulation from depositories holding such accounts; and (viii) the daily reconciliation requirement for futures and cleared swaps proprietary funds (the eight components of the proposed segregation mandate, collectively, the "**Segregation Mandate**") – may require DCOs to conduct certain activities that they are not currently doing in the ordinary course. Nonetheless, we believe that, taken together, the proposed Segregation Mandate is a reasonable additional regulatory burden for all DCOs, including those clearing under the traditional model.[11]

Fully Collateralized Disintermediated Clearing

To date, the Commission has granted registration to five DCOs that clear directly for market participants without the intermediation of FCMs. Currently, the registration orders in force for four of the DCOs[12] permit direct clearing for individuals and require that disintermediated clearing of futures and cleared swaps be fully collateralized,[13] and to the extent that they are permitted to offer clearing for futures, options on futures, or cleared swaps on a margined basis, such clearing

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analysis required of clearing members subject to the "legal review" requirement under the Basel III capital rules. See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,017, 62,100 (Oct. 11, 2013) (codified at 12 C.F.R. 3.133 and 217.133).

[11] See proposed CFTC Regulation 39.15(e), (g).

[12] See Proposed Regulation, 89 Fed. Reg. at 287, 301, 303. Those DCOs are: CBOE Clear Digital, LLC; CX Clearinghouse, L.P.; LedgerX, LLC; and North American Derivatives Exchange Inc. ("**NADEX**").

[13] A contract is considered fully collateralized if at all times the DCO holds margin collateral sufficient to cover the maximum possible loss either counterparty (clearing member) to the contract could incur upon liquidation or expiration. See CFTC Regulation 39.1 (a "fully collateralized position" means "a contract cleared by a [DCO] that requires the [DCO] to hold, at all times, funds in the form of the required payment sufficient to cover the maximum possible loss that a party or counterparty could incur upon liquidation or expiration of the contract"). See also, CFTC Letter 21-13 (May 3, 2021) (no-action letter in favor of CX Clearinghouse); CFTC Letter 17-35 (July 24, 2017) (LedgerX exemptive order); CFTC Letter 14-05 at FN 7 (January 16, 2014) (no-action letter issued in favor of NADEX). Importantly, the rules of the DCOs operating under the fully collateralized disintermediated model require clearing members to post collateral that satisfies the full collateralization standard in advance of trading.

must be intermediated by FCMs.[14] The fifth DCO offers leveraged clearing for firms in a limited class of energy products and environmental commodities.[15]

We believe that the Segregation Mandate is also appropriate for DCOs operating under the fully collateralized disintermediated clearing model, no less than for the traditional model. Full collateralization insulates a DCO from the credit or default risk presented by clearing members under a margined clearing model, obviating the need for such DCOs to comply with a wide range of Part 39 requirements.[16] But full collateralization does not ensure that a DCO will adhere to the requirements of the Segregation Mandate; and, as for DCOs under the traditional model, we do not believe that requiring these DCOs to do so would constitute an undue burden.

Vertically Integrated Clearing

In the vertically integrated model, a trading facility – a designated contract market ("**DCM**") or swaps execution facility – is affiliated with a DCO and an intermediary (an FCM or swap dealer) to create a vertical silo that offers execution and clearing for futures or swaps "directly" to market participants (including possibly retail investors where the exchange is a DCM) through a structure that, on its face, is "intermediated."[17] Commission Staff has requested comment on the potential issues that may arise from the operation of such structures, to which we have responded.[18]

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[14] See Order of Registration for CBOE Clear Digital, LLC (June 5, 2023) (permitting clearing of "digital asset futures on a margined basis for futures commission merchants"); Order of Registration for CX Clearinghouse, L.P. (Aug. 3, 2018); Order of Registration for LedgerX, LLC (Sept. 2, 2020); Order of Registration for North American Derivatives Exchange (Jan. 16, 2014).

[15] ICE NGX Canada Inc. ("**NGX**") is a unique sub-class of DCO. NGX "clears physically delivered energy contracts directly for clearing members with a net worth exceeding CAD $5,000,000 or assets exceeding CAD $25,000,000." Proposed Regulation, 89 Fed. Reg. at 287 FN 18. NGX thus offers "leveraged disintermediated" clearing in the sense that its clearing model is not fully collateralized, but importantly for purposes of the issues presented here, permits participation only by business entities and precludes participation by individuals. Thus, the concerns we raise in this letter with respect to leveraged disintermediated clearing generally do not pertain to NGX.

[16] See, e.g., CFTC Letters 14-04 and 14-05 (no-action relief in favor of NADEX from the obligation under Part 39 of the CFTC Regulations to comply with requirements relating to financial resources, reporting, stress testing, participant and product eligibility, risk management and right of clearing members to transfer positions).

[17] See Financial Stability Oversight Council, Annual Report 2023 at 42 (Dec. 14, 2023) (stating that "it is common for crypto-asset platforms to be structured as vertically integrated entities that offer multiple types of products and services" which in traditional finance are "usually offered by entities that are separately registered and regulated").

[18] See Request for Comment on the Impact of Affiliations on Certain CFTC-Regulated Entities (June 27, 2023) (available here), (the "**Affiliations RFC"**), and Letter from Allison Lurton, General Counsel and Chief Legal Officer, FIA, to Christopher Kirkpatrick, Secretary, CFTC (available here). Since the Affiliations RFC, the Commission has proposed new rules and amendments to its existing regulations for DCMs and swap execution facilities that would establish governance and fitness requirements with respect to market regulation functions, as well as related conflict of interest requirements. We are pleased to see noted in the proposal that the Commission anticipates proposing additional regulations that will address issues identified as a result of the Affiliations RFC, including additional concerns raised by commenters about conflicts of interest. See Proposed Rule: Requirements for Designated Contract

We support application of the Segregation Mandate to vertically integrated DCOs. But the more pressing regulatory issues for these structures relate to the management and mitigation of the conflicts of interest built into them, a notable focus of the Affiliations RFC.[19] Accordingly, we recommend that the Commission give careful consideration to the risks posed by conflicts in this clearing model, which will not be resolved by application of the Segregation Mandate.

Leveraged Disintermediated Clearing

We understand "leveraged disintermediated clearing" to involve four elements: (i) a registered DCO that solicits and offers clearing services; (ii) directly (rather than intermediated through an affiliated or unaffiliated FCM clearing member); (iii) to retail participants (that is, persons who are not eligible contract participants under Section 1a(18) of the Commodity Exchange Act); (iv) for futures contracts and options on futures that are margined (as distinct from fully collateralized). To date, the Commission has not authorized any DCO to offer leveraged disintermediated clearing. [20] We are concerned that adoption of the Segregation Mandate may foster the misimpression that DCOs that offer leveraged disintermediated clearing subject to that Segregation Mandate will offer customer asset protections comparable to those available under the traditional FCM clearing model. We do not believe that the Segregation Mandate meets that purpose; clearing members accessing leveraged disintermediated clearing would continue to be at a material disadvantage compared to customers of FCMs under the traditional model.

Specifically, as proposed, the Segregation Mandate would fail to implement the following protections for clearing members of leveraged disintermediated DCOs that current rules provide for customers of FCMs under the traditional model[21]:

- **No Minimum Financial Resources to Protect Proprietary Funds**. Although the proposed segregation regime for proprietary funds includes a requirement that a DCO treat

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Markets and Swap Execution Facilities Regarding Governance and the Mitigation of Conflicts of Interest Impacting Market Regulation Functions (preprint version at FN 118). The Commission has also approved an application for registration from a DCO that is vertically integrated with a DCM and FCM. See Order of Registration In the Matter of the Application of Bitnomial Clearinghouse LLC For Registration as a Derivatives Clearing Organization (Dec. 15, 2023). In addition to the registered DCO, Bitnomial operates a DCM, Bitnomial Exchange LLC, and an FCM, Bitnomial Clearing LLC. Notably, Bitnomial's DCO registration order does not limit its clearing activities to fully collateralized clearing.

[19] Questions about conflicts of interest featured in nine of the 37 questions posted in the Affiliations RFC.

[20] In making this statement we assume that in a vertically integrated DCO, retail investors would only be able to access clearing through the affiliated FCM (or alternatively, through a non-affiliated FCM clearing member). In March 2022, LedgerX, LLC d/b/a FTX US Derivatives sought to amend its order of registration to allow it to offer leveraged disintermediated clearing of futures and options on futures. See Request for Comment on FTX Request for Amended DCO Registration Order (Mar. 10, 2022) (available here) ("**FTX Petition**"). That petition was subsequently withdrawn. See CFTC Release 8626-22 (available here). As noted above, we note the example of NGX, but view that model as materially different from leveraged direct clearing offered widely to retail participants.

[21] Some of the gaps here enumerated are present under the other models of clearing, but all of them are more salient in the Leveraged Disintermediated model.

and deal with clearing member funds "as belonging to such clearing member,"[22] there is no requirement that a leveraged disintermediated DCO maintain financial resources or capitalization sufficient to backstop proprietary fund obligations to clearing members. Likewise, there is no provision in the Proposed Regulation concerning the sizing of guaranty funds by DCOs that do not require their clearing members to contribute to such guaranty funds (as is likely for leveraged disintermediated DCOs[23]).

- **Fellow Clearing Member Risk**. To the extent that leveraged disintermediated clearing co-exists on the same platform with intermediated clearing, a DCO could be subject to the potentially dilutive effect of non-intermediation: thinly capitalized clearing members settling side-by-side with FCM clearing members capitalized in accordance with applicable law and regulation. This creates risk analogous to "fellow customer risk" under the traditional model of clearing: the risk that a default of one or more FCM customers results in losses to the FCM sufficient in magnitude to cause the FCM to default to a DCO – specifically, the risk that cascading defaults of the non-FCM clearing members causes DCO losses sufficient to imperil the assets of non-defaulting FCM clearing members.

- **No Prohibition on Encumbering Proprietary Funds**. DCOs operating under the traditional clearing model are prohibited from granting to a third party a security interest in or a lien on customer property for the purpose of securing an obligation of the DCO.[24] No analogous prohibition applies to the handling of proprietary funds by DCOs operating under the leveraged disintermediated model.

- **No Mandated AML/KYC Diligence**. Since a DCO is not a "financial institution" under the Bank Secrecy Act and its implementing regulations, DCOs are not subject to the same

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22 See proposed CFTC Regulation 39.15(f)(1) and (f)(4).

23 In the FTX Petition the clearinghouse proposed that it would be sole contributor to the guaranty fund. See LedgerX LLC dba FTX US Derivatives – Letter re: Financial Resource Requirements 2-8-2022 (available here). See also Rule 819 of the Bitnomial Exchange LLC and Bitnomial Clearinghouse, LLC Rulebook (Dec. 2023) (providing that the Clearinghouse is "solely responsible for the capitalization of the Guaranty Fund" and that "Clearing Members are not required to make a contribution to the Guaranty Fund"). By contrast, a disintermediated DCO that requires its members to fully collateralize all positions cleared through the DCO does not (and does not need) to maintain guaranty fund resources, since full collateralization ensures that it has enough funds on deposit to cover each participant's maximum loss. See CFTC Letter 17-35 (July 24, 2017) (LedgerX exemptive order); see also CFTC Letter 14-05 (Jan. 16, 2014) (stating that "[b]ecause full collateralization is one way to protect against a clearing member default, it is the Division's view that NADEX is in compliance with Regulation 39.11(a)(1)" – that is, the requirement that a DCO have sufficient financial resources available to protect itself in the event that one of its clearing members defaults).

24 CFTC Regulation 1.20(g)(5)(ii); see also CFTC Regulation 1.20(g)(4)(ii) (requiring DCOs to obtain an acknowledgment letter from each of its depositories for futures customer funds, providing in relevant part that the depository acknowledges and agrees that such funds may not be used to secure or guarantee any obligations that the DCO may have to the depository). See also CFTC Regulation 22.5(a) (incorporating by reference the requirements of CFTC Regulation 1.20(g) to DCO's deposits of Cleared Swaps Customer Collateral).

AML and KYC compliance obligations of FCMs.[25] To the extent disintermediated DCOs are not subject to these same requirements, clearing member funds in such structures are at risk of seizure if commingled with the illicit funds of sanctioned entities and persons.

- **No Minimum Standards for Depositories of Proprietary Funds**. Under current rules, DCOs must "hold funds and assets belonging to clearing members . . . in a manner which minimizes the risk of loss or of delay in the access"[26] by the DCO to such funds and assets. There are no additional requirements analogous to those applicable to FCMs concerning eligibility of depositories for proprietary funds, and the Proposed Regulation does not propose any.[27]

- **No Required Customer Disclosures.** FCMs must disclose to each of its customers all information about itself – including its business, operations, risk profile, and affiliates – that would be material to the customer's decision to entrust such funds to and otherwise do business with the FCM and that is otherwise necessary for full and fair disclosure, in accordance with the detailed specifications in CFTC Regulation 1.55(k).[28] DCOs are not subject to analogous disclosure obligations to their members.

- **Diminished Risk Management Checks and Balances**. The CEA's customer asset protection regime is founded on a matrix of independent and complementary functional relationships between registered intermediaries, exchanges, and clearinghouses, each of which is charged under the statute and the CFTC regulations thereunder with mutually reinforcing risk management obligations. Integral to this system are the checks and balances within it. FCM clearing members are required to implement controls around financial and liquidity risk arising from their clearing activity on behalf of themselves, their affiliates and their customers[29]; and DCMs and DCOs have regulatory oversight authority over their members and clearing members designed to supplement and augment the Commission's regulatory and enforcement jurisdiction.[30] Consolidation of these

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25 See 31 C.F.R. 1010.100(t) (definition of "financial institution" under U.S. Treasury regulations implementing the Bank Secrecy Act).

26 CFTC Regulation 39.15(c).

27 See CFTC Regulation 1.11(e)(3)(i) (requiring FCMs to implement a "process for the evaluation of depositories of segregated funds," including, "at a minimum, documented criteria that any depository . . . must meet, including criteria addressing the depository's capitalization, creditworthiness, operational reliability, and access to liquidity," as well as a program "to monitor an approved depository on an ongoing basis to assess its continued satisfaction of" the FCM's established criteria).

28 CFTC Regulation 1.55(k).

29 CFTC Regulation 1.73; see Clearing Member Risk Management, 76 Fed. Reg. 45724, 45725 (Proposed Rulemaking, Aug. 1, 2011).

30 See Appendix B to Part 38 of the CFTC Regulations at section (b)(3) of Core Principle 16 (requiring DCMs to establish a regulatory oversight committee to oversee its regulatory program for sufficiency, effectiveness and independence); CFTC Regulation 39.13(h)(5).

separately delineated functions (for example, when FCM customers become clearing members) risks weakening this system .

- **No Registration of Sales Personnel and Comparable Supervisory Obligations**. Leveraged disintermediated DCOs are not required to provide clearing members with firm-specific disclosures (for example, concerning the ways the clearing member asset protection falls short of the asset protection regime to which FCMs are subject) or privacy notices to participants who are "consumers" (again, only required of "financial institutions" subject to the Gramm-Leach-Bliley Act ("**GLB Act**"), and thus not DCOs[31]). Moreover, DCOs are not required to register their sales personnel as "associated persons,"therefore such personnel are not required to undergo background tests, competency exams and ethics training required of registered APs[32]). And DCOs are not required to adequately supervise all persons directly or indirectly handling clearing member accounts.[33]

We elaborate on these concerns in the following section.

Gaps Between the Proposed Member Asset Protection Regime as Applied to Leveraged Disintermediated DCOs and the Existing Customer Asset Protection Regime Applicable to Traditional FCM Clearing[34]

Financial Resources of Leveraged Disintermediated DCOs

Leveraged disintermediated clearing relies primarily on real-time market risk management and auto-liquidation mechanisms to control for the credit risk presented by "clearing members" that

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[31] See 15 U.S.C. 6809(3) (definition of "financial institution" under the GLB Act).

[32] See National Futures Association Registration Rules 206 and 401. DCMs and DCOs are not required to be members of the NFA. Although six DCMs are NFA members by virtue of having been involved in its founding (three of which have representatives on its Board of Directors), no DCOs are. NFA has no regulatory authority over either DCMs or DCOs.

[33] See CFTC Regulation 166.3 (providing that each "*Commission registrant*" other than associated persons who have no supervisory duties "must diligently supervise the handling by its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its *business as a Commission registrant*" (emphasis supplied)). The term "Commission registrant" as used in Regulation 166.3 means "a person registered under the Act as a futures commission merchant, retail foreign exchange dealer, introducing broker, floor broker, commodity pool operator, commodity trading advisor, or associated person under CFTC Regulations not to include DCMs and DCOs." See CFTC Regulation 166.5(a)(3). See also CFTC Regulation 1.3 (defining "Registrant" to mean: "a commodity pool operator; commodity trading advisor; futures commission merchant; introducing broker; leverage transaction merchant; floor broker; floor trader; major swap participant; retail foreign exchange dealer; or swap dealer that is subject to these regulations; or an associated person of any of the foregoing other than an associated person of a swap dealer or major swap participant").

[34] The Commission may wish to consider subjecting fully collateralized disintermediated DCOs to elements of the supplemental protections we discuss here in connection with leveraged disintermediated DCOs, since the gaps

are, in many instances, thinly capitalized (and in any event, are not subject to capital requirements that would apply under the traditional FCM clearing model). Such mechanisms are not sufficient by themselves to protect the financial integrity of a leveraged disintermediated DCO. Prescriptive financial resources (capital) requirements and a right-sized guaranty fund are essential as well.

The collapse of FTX brings into stark view the risks presented by permitting leveraged disintermediated DCOs to operate under the proposed segregation regime for proprietary funds without such minimum standards. The FTX Petition included a $250 million guaranty fund to be funded solely by FTX. Leaving aside whether FTX would ever have actually set aside its own monies for that purpose,[35] it was far from clear at the time that the $250 million figure was right-sized for purpose (particularly in light of FTX's representation at the time that the proposed fund would obviate the need to deploy loss mutualization tools in a clearing member default, such as assessments of non-defaulting clearing members or variation margin gains haircutting).[36]

In traditional FCM clearing, the primary purpose of DCO skin-in-the-game ("**SITG**") "is to incentivize management of market and other risks, rather than serve as a significant resource to absorb losses arising from a clearing member's default."[37] In the case of traditional DCOs the primary loss-absorbing resources "should be paid-in by the defaulter in the form of initial margin and its default fund contribution."[38] In the case of a leveraged disintermediated DCO, by contrast, the "clearing members" are market participants, including retail investors, who do not contribute to the default fund, and clearing member default management relies primarily on "a 24/7/365 real-time margining system coupled with automatic liquidation of under-margined accounts."[39]

It follows that a critical component of an effective clearing member segregation regime for leveraged disintermediated DCOs is a requirement that the DCO maintain capital, financial resources, and SITG sufficient to ensure that in the event of a clearing member default, a deficit in the defaulting member's account would not end up being funded by a non-defaulting clearing member.

between the FCM customer asset protection regime and the clearing member asset protection regime exist for clearing members under the fully collateralized model as they do under the leveraged model of disintermediated clearing.

[35] See Second Interim Report of John J. Ray III to the Independent Directors: The Commingling and Misuse of Customer Deposits at FTX.com (June 26, 2023) at 5 (stating that "from the inception of the FTX.com exchange, the FTX Group commingled customer deposits and corporate funds, and misused them with abandon").

[36] See Letter from Allison Lurton, General Counsel and Chief Legal Officer, FIA, to Christopher Kirkpatrick, Secretary, CFTC (Sept. 2, 2020 (May 11, 2022), at 8 ("**FIA FTX Comment**") (available here).

[37] DCO Capital and Skin in the Game: Areas for Discussion, Report of the Central Counterparty Risk and Governance Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission (July 1, 2021).

[38] Id.

[39] FIA FTX Comment at 5.

AML/KYC and Privacy

FCMs are required under CFTC regulations to comply with applicable provisions of the Bank Secrecy Act and the regulations promulgated by the Department of the Treasury thereunder ("**AML/KYC Applicable Law**").[40] Traditional DCOs may rely on, and indeed require that,[41] their clearing members establish policies and procedures reasonably designed to achieve such compliance. Leveraged disintermediated DCOs have no intermediaries on which to rely for this gatekeeping activity, and should therefore be made subject, by Commission rulemaking, to AML/KYC Applicable Law as if they were financial institutions.[42]

Likewise, DCOs rely on their FCM clearing members to discharge obligations to customers who are consumers under the GLB Act and the Fair Credit Reporting Act ("**FCRA**"). Specifically, Part 160 of the CFTC's regulations implementing the GLB Act requires FCMs (but not DCOs) (i) to provide notice to consumers about their privacy policies and practices; (ii) describe the conditions under which FCMs may disclose nonpublic, consumer information to nonaffiliated third parties; and (iii) provide a method for consumers to prevent such disclosure (subject to certain exceptions). And Part 162 of the CFTC regulations implementing the FCRA prohibit FCMs (but not DCOs) from using certain consumer information obtained from an affiliate to make solicitations to that consumer for marketing purposes and require FCMs (but not DCOs) that possess or maintain consumer information in connection with their business activities to develop and implement a written program and procedures for the proper disposal of such information.[43]

Disclosure and Supervision

Because they are "members," not "customers,"[44] market participants (including retail investors) who adhere to membership agreements with leveraged disintermediated DCOs are not required to receive regulatory risk disclosures. Likewise, the representatives of leveraged disintermediated

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[40] See Part 42 of the CFTC Regulations (making FCMs and introducing brokers subject to AML/KYC Applicable Law through incorporation by reference thereto).

[41] See, e.g., CME Rule 981 (requiring clearing members to develop, implement and monitor compliance with such policies and procedures).

[42] We note that the CFTC's General Counsel has stated that its analysis of whether the CFTC has the authority under the CEA to impose AML/KYC requirements on DCOs is ongoing. Proposed Regulation, 89 Fed. Reg. at 306 (Dissenting Statement of Commission Christy Goldsmith Romero). Should it conclude that the CFTC lacks such authority, then of course we would support and urge the Commission to seek an amendment to its statutory authority through Congressional action.

[43] See generally Parts 160 and 162 of the CFTC Regulations (incorporating by reference requirements under the GLB Act and the Fair Credit Reporting Act).

[44] See Proposed Regulation, 89 Fed. Reg. at 287 ("Commission regulations define a 'customer' as any person who uses an FCM, introducing broker, commodity trading advisor, or commodity pool operator as an agent in connection with trading in any commodity interest, and therefore [the customer protection regime for 'customers' under the CEA and CFTC Regulations] does not apply to the funds of any person who clears trades directly through a DCO, who is a 'clearing member.'") (citing the definition of "customer" under CFTC Regulation 1.3).

DCOs are largely unconstrained by applicable law and regulation in their solicitation of potential participants.

Taken together, these omissions from the proposed segregation regime present material risk. Leveraged disintermediated DCOs (including affiliate exchanges and intermediaries in vertically integrated structures) are highly novel, and the Commission's regulatory experience with them is still nascent and evolving. If the Commission is intent on licensing these structures, they must ensure in doing so that the disclosures provided to prospective participants (especially retail participants) are complete and accurate, and that the representatives of the entities soliciting the general public to invest are appropriately licensed and supervised.

Representatives of an FCM involved in soliciting orders, customers, or customer funds on behalf of the FCM (or who supervise persons so engaged) are required to register with the CFTC – a process that necessitates a background check by the National Futures Association ("**NFA**"), a passing score on one or more proficiency tests, and membership in the NFA, including adherence to its rules and by-laws.[45] NFA rules include a prohibition on associated persons from communications that (1) operate as a fraud or deceit; (2) employ or are part of a high-pressure approach; or (3) suggest that commodity interest trading is appropriate for all persons.[46] An FCM's duty of supervision includes an obligation for supervisory employees to review and approve all promotional material prior to first use by an associated person of the FCM.[47] None of these regulations and procedures apply to the representatives of any DCO – a gap that is particularly consequential for disintermediated DCOs that solicit retail participation, on either a fully collateralized or a leveraged basis.

In sum, the Commission must take care in adopting any final rule to insulate the market for leveraged disintermediated DCO services against the mistaken impression that it has solved for the problems that were presented by the FTX petition in 2022 to amend its order of registration. The Proposed Regulation falls far short of that objective. We urge the Commission to ensure that the proposed Segregation Mandate for proprietary funds is appropriately supplemented by clearing member protections targeted at leveraged disintermediated DCOs.

Comments on Provisions of the Proposed Regulation

Definition of Proprietary Funds

As a threshold matter, we recommend that the term "proprietary funds" be replaced by the term "member funds." "Proprietary funds" is already widely used in the industry to refer to funds (including securities and other property) held by any individual, partnership, corporation or other

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[45] See NFA Registration Rules 206 and 401.

[46] NFA Compliance Rule 2-29.

[47] NFA Interpretive Notice 9003 – NFA Compliance Rule 2-29: Communications with the Public and Promotional Material.

type of association (therefore including not just FCMs but also DCOs) for such person's or entity's "proprietary account" – a defined term under the CFTC regulations.[48] Such references risk creating confusion about the status of an account, particularly in default management situations. An FCM typically deposits funds held to margin "proprietary accounts" (i.e., "proprietary funds" in the currently widely used sense) with banks, other FCMs or foreign brokers (where they may become customer funds, assuming the other FCM is not an affiliate), or with a DCO or CCP. Likewise, a DCO may deposit its "proprietary funds" – its own funds, but also, potentially, funds held for its proprietary account – typically at a bank.[49] Thus, the scope of what constitutes "proprietary funds" in current usage is much broader than funds received and held by a DCO from its clearing members. By contrast, the term "member funds" aligns neatly with the term "member property," as defined under Part 190 of the CFTC regulations, and is much less susceptible to confusion arising from the wider range of situations in which a trustee in bankruptcy might come across accounts holding "proprietary funds."[50]

Definition of Proprietary Funds to Include Guaranty Fund Contributions

The Commission asks whether "classification of guaranty fund contributions as proprietary funds [would] inhibit DCOs' current guaranty fund programs?"[51] The question points to a well-founded concern. As the Commission has noted, margin collateral and guaranty fund contributions serve different functions as default resources of a DCO:

> "[Margin collateral] is designed to cover most (*e.g.*, 99%), but not all, potential losses incurred by a Clearing Member. DCOs cover the 'tail risk' (*i.e.*, the risk that a Clearing Member will incur, and default on, a loss exceeding the margin collected) by means of what is sometimes referred to as a default resources package, or 'waterfall.' Elements of the waterfall may include a contribution of a specified amount of the DCO's own capital, pre-funded contributions from Clearing Members (a 'guaranty fund'), or (to a limited extent), a power by the DCO to assess additional contributions from Clearing Members. Unlike margin, a Clearing Member's contribution to the guaranty fund will generally be

48 See CFTC Regulation 1.3 (definition of "proprietary account").

49 In the liquidation of a clearing member a DCO may find itself holding funds that are the property of an affiliated exchange – engaged in liquidating transactions intended to reduce its exposure to the clearing member in default. Those funds would be funds held by the DCO for its "proprietary account" – that is to say, "proprietary funds."

50 "Member property means, in connection with a clearing organization bankruptcy, the property which may be used to pay that portion of the net equity claim of a member which is based on the member's house account at the clearing organization, including any claims on behalf of non-public customers of the member." CFTC Regulation 190.01. "House account means, in the case of a clearing organization, any commodity contract account of a member at such clearing organization maintained to reflect trades for the member's own account or for any non-public customer of such member." Id.

51 Proposed Regulation, 89 Fed. Reg. at 292.

> usable to meet the default of another Clearing Member. In other words, the guaranty fund is 'mutualized.'"[52]

In light of these distinct purposes, it is critical that DCOs be required at all times to maintain accurate records of guaranty fund amounts[53] on hand and legally certain access thereto. Commingling guaranty funds with house margin collateral in accounts simply denominated as "proprietary funds" (or "member funds") risks creating legal uncertainty concerning how such funds may be disposed of or used by a DCO looking in a crisis to manage and mitigate risk created by a clearing member default. That risk may only be "tail" in nature; but in a DCO's risk matrix, tail risk where the severity of potential damage is critical or catastrophic (i.e., insolvency and wind-down) may be unacceptable.[54]

We recommend that the Commission create separate segregation requirements for proprietary funds that constitute contributions to a guaranty fund, and proprietary funds held as margin for proprietary futures, foreign futures, or cleared swaps positions (or as premiums on options thereon), and furthermore require that DCOs hold each such class of proprietary funds separately from the other. In addition, we recommend that the Commission amend the reconciliation requirement to include a separate reconciliation requirement for guaranty fund contributions.[55]

Permitted Depositories

We recommend that CFTC Regulation 39.15(c) be amended to require all DCOs to hold proprietary funds exclusively in banks or trust companies (which may include a Federal Reserve Bank), as well as in money center central banks consistent with the provisions of proposed CFTC

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[52] Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336, 6338 (Final Rule, Feb. 7, 2012).

[53] The Commission has recently proposed that systemically important DCOs and subpart C DCOs be required to "maintain information systems and controls that are designed to enable the [DCO] to provide data and information electronically, as requested by the Commission for purposes of resolution planning and during resolution" that includes "[i]nformation concerning clearing members, including (for both house and customer accounts) information regarding collateral, variation margin, and contributions to default and guaranty funds." See proposed CFTC Regulation 39.39(f)(2) in Derivatives Clearing Organizations Recovery and Orderly Wind-Down Plans; Information for Resolution Planning, 88 Fed. Reg. 48968, 49008 (Notice of Proposed Rulemaking, July 28, 2023).

[54] By way of example, a DCO managing a clearing member default demands guaranty fund contributions from an account designated by a depository as a "proprietary funds" account and is requested by the depository to represent in writing that its rules and agreements with clearing members permit guaranty fund contributions to be used by the DCO to mutualize losses resulting from a default by a clearing member. That is, in effect the depository would be looking to cover its perceived liability under proposed CFTC Regulation 39.16(f)(4)(B)(ii) – which prohibits any person, including a depository of segregated proprietary funds, to "hold, dispose of, or use any funds as belonging to any person other than the clearing members of the [DCO] which deposited the funds." While lawyers for the DCO and depository grapple over the terms of the representation, the DCO would be without funds that it had expected to have access to on demand.

[55] Should the Commission adopt a final rule permitting guaranty fund contributions to be commingled with proprietary margin collateral, a requirement that DCOs separately reconcile guaranty fund amounts and proprietary margin assets would operate as partial mitigation of the risk we highlight here.

regulations 39.15(b)(3) and 39.15(f)(2) (permitting a DCO to hold proprietary funds therein and proposing modified acknowledgment letter terms for such accounts. CFTC Regulation 39.15(c) should be amended as well to require DCOs to have a process for evaluating depositories of segregated customer and proprietary funds, including, as a minimum, documented criteria that any such depository – including an entity affiliated with the DCO – must meet (including, without limitation, the depository's capitalization, creditworthiness, operational reliability, and access to liquidity[56]).

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Thank you for your consideration of these comments. If the Commission or any member of the staff have any questions regarding the matters discussed herein or need any additional information, please contact Allison Lurton, General Counsel and Chief Legal Officer, FIA, at alurton@fia.org or 202.772.3057.

Respectfully submitted,

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56 See CFTC Regulation 1.11(e)(3)(A) (same requirement applicable to FCMs).