



BETTER MARKETS

By Electronic Submission

September 28, 2023

Vincent McGonagle, Director
Division of Market Oversight

Clark Hutchinson, Director
Division of Clearing and Risk

Amanda Olear, Director
Market Participants Division

Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Request for Comment on the Impact of Affiliations of Certain CFTC-Regulated Entities

Dear Mr. McGonagle, Hutchinson, and Ms. Olear:

Better Markets¹ appreciates the opportunity to comment on the request for comment (Request for Comment) concerning the impact of affiliations of certain CFTC-regulated entities requested by staff at the Commodity Futures Trading Commission (“CFTC” or “Commission”).² More specifically, provide comment on potential issues that may arise from affiliations between designated contract markets (DCMs), derivatives clearing organizations (DCOs), swap execution facilities (SEFs), and intermediaries such as futures commission merchants (FCMs) or other market participants, including trading entities.

Importance of Oversight

Under the Commodity Exchange Act (the "Act") and the regulatory framework established by the Commission, DCMs, DCOs, and SEFs bear significant responsibilities for overseeing the behavior of their members and participants. These essential duties encompass ensuring trading integrity, managing risk effectively, and enforcing compliance with market rules. Indeed, the very

¹ Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

² Request for Comment on the Impact of Affiliations of Certain CFTC-Regulated Entities (June 27, 2023), available at <https://www.cftc.gov/media/8826/rfcimpactaffiliations062823/download>.

foundation of our derivatives markets relies on the adept execution of these supervisory functions. Equally vital, DCMs, DCOs, and SEFs play a central role in upholding the financial stability of our broader financial system. This responsibility demands rigorous oversight to avert market disruptions and financial crises.

Challenges and Concerns

However, the dynamic landscape of these markets has ushered in new complexities, one of which is the affiliation between DCMs, DCOs, or SEFs and intermediaries, including futures commission merchants FCMs and other market participants. This affiliation raises many concerns regarding the effective execution of supervisory responsibilities through these intermediaries. The looming specter of conflicts of interest, potential compromises in regulatory impartiality, and compromised oversight due to these affiliations presents formidable challenges. It is imperative that any such affiliations do not compromise the ability of DCMs, DCOs, and SEFs to carry out their regulatory mandates with the requisite efficacy.

Moreover, the affiliations between intermediaries or market participants and DCMs, DCOs, or SEFs can give rise to additional apprehensions. These include concerns about potential anti-competitive behavior, disparities in access to market data and services, and the secure handling of nonpublic information. It is incumbent upon the Commission to ensure that affiliations do not inadvertently foster anti-competitive practices, erode market transparency, or jeopardize the confidentiality of sensitive market data.

Call for a Comprehensive Study

Better Markets holds a general stance against vertical integration within the derivatives markets, citing the inherent risks and potential adverse impacts it may impose on both the market itself and market participants. Vertical integration, involving close affiliations or integration of entities with distinct roles in the market, poses significant challenges to maintaining a level playing field and ensuring the fair and efficient operation of our financial markets. These affiliations can give rise to conflicts of interest, distort competition, and compromise the integrity of regulatory oversight. In addition to the concerns raised regarding affiliations, we underscore the necessity of conducting a comprehensive internal study to meticulously examine the broader implications of vertical integration and the potential consequences it may bring to the stability and fairness of the derivatives markets.³

³ Statement of CFTC Commissioner Christy Goldsmith Romero on Request for Comment on the Impact of Affiliated Entities, available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement062823>

COMMENTS

I. DCO and affiliated FCM

According to the Act, a DCO bears significant responsibilities in the realm of risk management. These responsibilities encompass a broad spectrum, spanning from general risk management practices to specific obligations. These specific obligations encompass key tasks such as establishing and rigorously enforcing margin requirements and maintaining financial resources substantial enough to withstand potential defaults.⁴

Under the Core Principles, certain facets of a DCO's risk management duties revolve around interactions with individual clearing members, necessitating the exercise of discretion. For instance, Core Principle C lays out the mandate for a DCO to establish appropriate admission and ongoing eligibility criteria for its members and participants.⁵ Similarly, Core Principle H requires that a DCO maintain robust mechanisms and resources, essential for effectively monitoring and enforcing compliance with its rules.⁶ This includes having the authority to take disciplinary action against any member or participant violating the DCO's rules.

In specific instances, a DCO exercises discretion, as necessitated by the regulations set forth by the Commission in implementing the Core Principles or as dictated by particular circumstances. For instance, CFTC regulation §39.13(h)(5)(iii) outlines the mandate for the DCO to evaluate and address the risk management policies of its clearing members, with a clear directive to take appropriate action if concerns surface during these evaluations.⁷

While many margin requirements detailed in CFTC regulation §39.13(g) are structured to be objective and uniformly applicable to all clearing members, there may be scenarios where margin-setting is tailored to accommodate specific portfolios.⁸ Furthermore, the DCO may be vested with discretion to elevate margin requirements for a particular clearing member, often driven by apprehensions surrounding that member's financial stability.⁹

The CFTC's Part 39 regulations outline the DCO's responsibilities for monitoring and enforcing clearing members' compliance with DCO rules and managing the associated risks.

Tailoring Margin Requirements

The tailoring of margin requirements to specific portfolios or clearing members within a DCO can be influenced by the DCO's affiliation with an FCM. This affiliation can introduce

⁴ See Request for Information at 1.

⁵ See Request for Information at 2.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

certain risks, including potential conflicts of interest and preferential treatment. To address these concerns, it is essential to consider the following measures:

- **Transparency and Disclosure:** Maintaining transparency regarding the DCO's affiliation with an FCM is crucial because it entails providing all clearing members with clear and comprehensive information about any financial or operational connections between the DCO and the FCM. Such disclosure should encompass insights into the decision-making process behind margin requirements and identifying and managing potential conflicts of interest.
- **Conflict of Interest Policies:** Robust conflict of interest policies are paramount in preventing preferential treatment driven by affiliations. These policies should incorporate clear guidelines that prevent situations where the interests of the FCM take precedence over the broader clearing membership's best interests.
- **Whistleblower Mechanisms:** Establish mechanisms that allow clearing members and employees to report concerns or suspicions related to unfair margin-setting practices or preferential treatment. These mechanisms should be accompanied by strong whistleblower protections, encouraging individuals to come forward with their concerns.

Implementing these steps is crucial to reducing related risks when affiliations with FCMs are involved. This may contribute to preserving the fairness and transparency of margin-setting procedures, benefiting all clearing members and helping to uphold market integrity.

Rule Enforcement

In addition to margin requirements, the discretionary authority held by a DCO in determining whether a specific clearing member warrants investigation, if a particular course of conduct violates the DCO's rules, and the appropriate disciplinary measures to impose can indeed raise potential conflicts of interest, particularly when an affiliated FCM is involved. These conflicts of interest may arise due to the DCO's financial or operational ties with the affiliated FCM, potentially influencing the decision-making process in favor of the FCM's interests. To address these conflicts more effectively, it might be worth considering several important actions:

- **Transparency:** DCOs should prioritize transparency in their affiliations with FCMs. Clear and comprehensive disclosure of any financial or operational links between the DCO and the FCM should be disseminated to all clearing members. This disclosure should encompass insights into investigative and disciplinary decisions and highlight potential conflicts of interest.
- **Conflict of Interest Policies:** Develop and rigorously enforce conflict of interest policies tailored to the specific dynamics of the DCO's affiliation with the FCM. These policies should include clear guidelines for identifying, managing, and preventing conflicts of interest, with explicit prohibitions on preferential treatment.

- **Transparency in Disciplinary Actions:** Maintain transparency in disciplinary actions taken by the DCO. Ensure the rationale for disciplinary decisions is communicated to all affected parties and regulatory authorities. Transparency enhances accountability and helps mitigate concerns related to preferential treatment.
- **Whistleblower Mechanisms:** Establish mechanisms that enable clearing members and employees to report concerns or suspicions related to unfair investigative practices or disciplinary actions. Robust whistleblower protections should be in place to encourage reporting and shield individuals who come forward.

Contagion Risk Management

The risk of contagion stemming from an affiliated entity's failure, whether an FCM or a DCO, is a significant concern that requires careful consideration and proactive risk management. Below, we outline some potential measures that both DCOs and FCMs may consider in providing assurance and effectively managing contagion risk:

- **Contingency Planning:** DCOs and FCMs should develop and maintain comprehensive contingency plans that delineate clear steps to manage and contain contagion risk. These plans should encompass liquidity management, risk mitigation strategies, and communication protocols.
- **Communication and Transparency:** Maintain clear and transparent communication regarding contingency plans and risk management capabilities with customers, counterparties, and clearing members. Regular updates and risk assessments should be provided to address concerns and maintain confidence.
- **Regulatory:** Collaborate closely with the Commission to ensure regulatory oversight and safeguards are in place to address contagion risk. The Commission should consider enhancing risk management and reporting standards for affiliated entities.
- **Stress Testing and Scenario Analysis:** Conduct stress tests and scenario analyses to assess the potential impact of an affiliated entity's failure on the DCO, FCM, and clients. These analyses can identify vulnerabilities and inform risk management strategies.

In addressing contagion risk, the Commission should:

- Evaluate the adequacy of contingency plans and risk management practices for both DCOs and FCMs, ensuring they can effectively manage contagion risk.
- Promote transparency and disclosure requirements to keep stakeholders well-informed about contingency plans and risk management capabilities.
- Collaborate with DCOs and FCMs to establish clear guidelines and standards for managing contagion risk associated with affiliated entities.

Through the adoption of these measures and by nurturing a collaborative regulatory atmosphere, both DCOs and FCMs might offer reassurance regarding their capacity to handle contagion risk. This could potentially support the retention of trust from customers, counterparties, and clearing members, thereby potentially contributing to the overall market stability.

Information

When a DCO is affiliated with an FCM, it can raise concerns about the DCO's ability to obtain information from other clearing members and whether other members might perceive the DCO as something other than market neutral. These concerns can potentially impact information sharing and trust within the clearing community. To mitigate such impacts effectively, several strategies and safeguards can be put in place:

- **Enhanced Information Barriers:** DCOs should establish and enforce robust information barriers within their organizations to ensure that information obtained from clearing members is not shared with affiliated FCMs. This involves strict policies, procedures, and systems to segregate and protect sensitive information.
- **Disclosure:** DCOs should provide clear and comprehensive disclosure to all clearing members about their affiliations with FCMs. This disclosure should outline the mechanisms to prevent information sharing and conflicts of interest.
- **Commission Oversight:** The Commission should actively oversee and verify that DCOs adhere to information-sharing restrictions and maintain market neutrality.
- **Oversight Committees:** DCOs should establish independent oversight committees or boards responsible for ensuring that information-sharing restrictions are strictly followed. These committees should include representatives from various clearing members to provide diverse perspectives.
- **Whistleblower Protections:** DCOs should implement strong whistleblower mechanisms that encourage clearing members and employees to report any concerns or suspicions related to information sharing or preferential treatment. Robust whistleblower protections are essential to foster reporting.
- **Review of Rulebooks:** Periodically review and update DCO rulebooks to ensure that information-sharing restrictions are clear and aligned with regulatory requirements. Rulebooks should explicitly state that information will not be shared with affiliated FCMs.
- **Ethical Walls:** DCOs should establish "ethical walls" or information barriers between the DCO and affiliated FCMs. These barriers should prevent any inappropriate sharing of information or undue influence.

Through the conscientious adoption of these measures, DCOs may seek to showcase their dedication to market neutrality and the effectiveness of information-sharing restrictions in safeguarding the interests of all clearing members. Adopting clear and transparent practices, complemented by regulatory oversight, could be essential in maintaining trust and confidence within the clearing community.

II. DCM/SEF and affiliated intermediary

DCMs and SEFs are pivotal in maintaining market integrity and ensuring compliance with the derivatives marketplace's rules and regulations. Their self-regulatory responsibilities encompass a broad spectrum of critical tasks, including financial surveillance over member FCMs, oversight of compliance with minimum financial requirements, establishment and enforcement of trading rules, market surveillance, and the investigation and implementation of disciplinary actions when rule violations occur.¹⁰

Customer Impact

When a DCM has an affiliated FCM or a SEF has an affiliated Introducing Broker (IB), Commodity Trading Advisor (CTA), or Commodity Pool Operator (CPO), there is a potential for favoritism towards the affiliates' product listings when advising or serving customers, clients, or participants. To mitigate this possibility and ensure fair treatment, several strategies can be employed:

- **Disclosure Requirements:** Mandate clear and comprehensive disclosure by FCMs, IBs, CTAs, and CPOs of their affiliations with DCMs or SEFs. Customers and clients should be informed about these affiliations upfront.
- **Conflicts of Interest Policies:** Require FCMs, IBs, CTAs, and CPOs to establish and enforce robust conflicts of interest policies. These policies should explicitly address situations where affiliates' product listings might be favored and provide clear guidelines for managing such conflicts.
- **Equal Access:** Establish and enforce rules that ensure all products, including those of non-affiliated entities, have equal access to distribution channels and advisory services. Prevent any discriminatory practices in favor of affiliates' products.
- **Customer Best Interest Standard:** Impose a fiduciary duty on FCMs, IBs, CTAs, and CPOs to act in the best interests of their customers and clients. This duty should override any potential bias towards affiliates' products.

¹⁰ See Request for Information at 10

- **Regulatory Oversight:** The Commission should closely monitor compliance with conflicts of interest policies and ensure that customers are not disadvantaged due to affiliations.
- **Reporting Requirements:** Require regular reporting by FCMs, IBs, CTAs, and CPOs to regulatory authorities regarding their interactions with affiliated DCMs or SEFs and any steps to mitigate conflicts of interest.
- **Market Education:** Conduct educational initiatives to inform customers, clients, and participants about their rights and the safeguards in place to protect them from potential favoritism.

Through the incorporation of these measures, DCMs, FCMs, SEFs, IBs, CTAs, and CPOs could potentially reduce the risk of showing a preference for affiliates' product listings and work towards ensuring equitable treatment of customers, clients, and participants, all while acting in their best interests. The presence of regulatory oversight and a commitment to transparency could be pivotal in upholding market integrity and sustaining trust.

CONCLUSION

We hope these comments are helpful.

Sincerely,

A handwritten signature in black ink, appearing to read "Cantrell Dumas". The signature is fluid and cursive, with the first name being the most prominent.

Cantrell Dumas
Director of Derivatives Policy

Better Markets, Inc.
2000 Pennsylvania Avenue, NW
Suite 4008
Washington, DC 20006
(202) 618-6464
cdumas@bettermarkets.org
<http://www.bettermarkets.org>