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Office of the Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: CFTC Staff Request for Comments on the Impact of Affiliation of Certain CFTC-Regulated Entities, CFTC Release No. 8734-23, June 28, 2023

Ladies and Gentlemen:

I want to strongly commend the staffs of the Divisions of Market Oversight, Clearing and Risk and Market Participants (the “**Divisions**”) of the Commodity Futures Trading Commission (“**CFTC**” or “**Commission**”) for requesting comments regarding the affiliation of certain CFTC-regulated entities. Affiliations among CFTC-regulated entities clearly represent a major regulatory policy issue and may intensify conflicts of interest and misalignment of incentives in market structure, having a potential profound impact on the accessibility of open and competitive cleared derivatives markets and the macro-prudential health of our clearing system. The Divisions’ Request for Comments (“**RFC**”) squarely raises important questions about the permissibility of a designated contract market (“**DCM**”, or exchanges)/derivatives clearing organization (“**DCO**”, or clearinghouses) to act as a futures commission merchant (“**FCM**”). However, and perhaps more importantly, the RFC brings to the forefront the longstanding concerns with the existing DCM/DCO vertical structure and the conflicts inherent in the model.

I have been honored and privileged of having had the opportunity to work in this great industry for over 45+ years. I am currently a Professor Emeritus and the Chair of the Ronald H. Filler Institute on Financial Services Law at New York Law School (“**NYLS**”) and have taught a law school course on Futures Law/Derivatives Law at four different U.S. law schools, beginning in 1977, just two years after the CFTC opened its doors.¹ I have also had the great opportunity to serve on numerous industry boards and advisory committees over these past 45+ years, relating to

¹ I am a Visiting Professor at the College of Law at the University of Illinois where I am teaching this same course in the current Fall 2023 semester along with a course on Financial Services Seminar. I have also taught, among others, courses on Securities Law, Regulation of Broker-Dealers and Futures Commission Merchants and Regulatory Policy at other law schools. This latter course involved educating my students not on what the various financial services laws and regulations are but the how and why so many such laws and regulations have been adopted here in the U.S.

DCOs, DCMs, swap execution facilities (“SEF”), and the FCM community. This particular RFC by the Divisions has special interest to me.²

Background

DCOs, together with FCMs, play an extremely critical role in the financial integrity and stability of the derivatives industry. In particular, DCOs establish the risk management framework that is so critically important, not just to protect our derivatives markets but to encourage end users to feel they are safe when they trade on the U.S. derivatives markets. DCOs not only act as the seller to the buyer, or the buyer to the seller, on every transaction, but, by their very nature, they ensure that all parties perform their financial obligations and provide the requisite financial integrity and safeguards for the U.S. derivatives markets. Market participants are required to post margin, and FCMs act as the guarantor on behalf of all of their underlying customers.³ In addition, while FCMs generally provide most of the financial resources backstopping the DCO in the event of a default, it is the DCO’s job to minimize the risk that those resources are ever used. FCMs thus play a critical role regarding customer protections as evidenced by the various CFTC regulations that apply to FCMs, but, equally as important, by acting as the clearing member firms on all of the major DCOs here in the U.S.

To me, the greatest indicator of the importance of DCOs and FCMs and the role they play in the U.S. derivatives industry, took place on October 19, 1987, the so-called Black Monday. On this day, the U.S. stock market declined by approximately 22% in a single day, the largest single day percentage loss in U.S. stock market history. Not one FCM filed for bankruptcy that day, whereas several broker-dealers did.⁴ There have been several other major market moves since October 1987 that have also proved the resilience of DCOs, DCMs, and FCMs, and the important and critical role that they all play here in the U.S.⁵ Some similar major market price moves that have occurred since then have involved, for example, natural gas and other energy products due to storms and other market events. Not one FCM has ever filed for bankruptcy, to my knowledge, due solely to major price changes in the cleared portfolios of their clients in recent history.

² I have been engaged as an expert by a law firm, but the views expressed herein are wholly my own.

³ See *ADM Investor Services Inc. v. Collins*, 515 F.3d 753 (7th Cir. 2008), for an excellent analysis of the role that margin plays in the futures industry, and the role played by clearing members in providing this guarantee.

⁴ I will not forget that day. The Friday before October 16, 1987, the stock market declined by some 6% to 7% if I recalled. I was hosting the Commodities Law Institute in Chicago that day with hundreds of industry professionals in attendance. We all thought that was a major one-day decline; the next business day proved us all wrong.

⁵ When Lehman Brothers filed for bankruptcy in September 2008, I was teaching at NYLS but got a call from my prior boss there to help them get through that week. I spent that entire week at my former firm. Within five-business days, all \$10 billion of customer funds that were held in its Customer Segregated Account were either transferred to other FCMs or returned back to the customers without a single dollar lost. I spent that entire week working with the CFTC and the CME Clearinghouse and keeping them informed throughout each and every day that week as to what was taking place regarding the futures customers positions and funds. The two major FCM bankruptcies that followed -- MF Global in October 2011 and Peregrine Financial Group in June 2012 -- were not related to funds held at the DCO.

With these thoughts on my mind, I applaud the Divisions' calling for public attention on the potential impact of affiliation among registered entities, and on the current market structure. Moreover, the affiliation between DCMs and DCOs under common control is another potential issue for the Commission to consider for review.

Simply put, the addition of an FCM to the already affiliated DCMs/DCOs raises even more serious concerns and has the potential to result in a combined enterprise that may adversely affect the entire cleared derivatives markets' regulatory structure. Please don't get me wrong; I am a big fan of innovation. However, I urge the CFTC to proceed cautiously if it decides to take any action that could impact, in any way, the financial integrity of the U.S. derivatives industry. Additionally, the derivatives markets have seen a wave of consolidation among market participants who have brought to market products of more complexity and variety. As reflected in statements from CFTC Commissioners Goldsmith Romero and Mersinger, such market evolution should lead the CFTC to taking a fresh look at the existing market structure and consider whether it best serves its purpose for market participants and end users.⁶ I strongly agree with them and believe the timing is right for the Commission to consider to undertake such a rulemaking, or a review.

From a market structure perspective, as discussed below, the affiliation between and among DCMs, DCOs, and FCMs has the potential to threaten or impede competition, and, as such, raises serious anticompetitive concerns that the Commission must address. The negative impact of this affiliation on competition is multifold.

Self-Regulatory Organizations ("SROs")

It would be helpful to explain the context in which the competitive concerns arise: it is the complex web of incentives, relationships, and regulatory powers of DCMs and DCOs. Even without affiliation of an FCM, the DCM/DCO model wields power over the most fundamental market decisions such as: (1) whether to offer a new product for trading and on what terms, (2) whether to accept a particular product for clearing, (3) margin, position limits, settlement, and other life-cycle terms with respect to a cleared product, (4) whether to admit a new trading member/market maker on the DCM's platform, or a new clearing member on the DCO's platform, (5) the manner in which market participants access the DCM/DCO's platforms, and (6) the continued market and financial surveillance of all market participants.

Most notably, it is important to recognize that DCMs and DCOs have powers to make determinations with respect to the above, effectively unchecked, in a unilateral manner and binding on the entire market, as a result of their rule-making and enforcement powers as SROs. The current system places important duties and obligations on SROs. For these critical duties and obligations

⁶ See Statement of CFTC Commissioner Christy Goldsmith Romero, dated June 28 2023, where she requested that the Commission to engage in a comprehensive study regarding the risks and consequences of an integrated market structure. See also Statement of CFTC Commissioner Summer Mersinger, dated June 28, 2023, where she explained that it is incumbent upon the CFTC to consider developments in the markets the agency regulates and whether those developments necessitate any changes to the CFTC's regulations and noted the RFC is an opportunity for the public to inform and shape how the CFTC will manage common ownership and control of regulated entities in our markets going forward.

to continue to apply, there must be additional measures taken to avoid any apparent or actual conflicts of interest.

Anti-Competitive Advantage

Against this backdrop of unilateral “standard-setting” powers, it would be reasonable to expect, given the fact that DCMs/DCOs are publicly traded companies in today’s world, the existence of strong and actionable incentives, on the part of the management of a DCM/DCO group, to maximize the market share and hence profit generation of its DCMs through the control of its affiliated DCO. After all, most exchange-traded products are required to be cleared, and an affiliated DCM/DCO has significant powers that might impact the entry barrier of new DCM or other trading venue competitors through the control of the affiliated DCO.

Such powers *could potentially*, for example, make the clearing of competitor DCMs’ products more difficult or costly (e.g., limiting the exchange-facing web interface setup), if not outright prohibitive.

Conversely, to increase its market share, an affiliated DCM/DCO *could potentially*, for example, utilize its rule-making power and risk management discretion to lower margin levels, waive/reduce execution and clearing fees, and/or create other incentive programs, in a selective, discriminatory manner against different products, market segments, and/or market participants. These types of actions could prevent the migration of open interest and liquidity to a competing DCM/exchange, and thus could possibly impede or suppress the development of more efficient but rival products at competing venues. This took place in the early 2000s when the Chicago Board of Trade (“CBOT”), facing competition on its interest rate products from a new start-up DCM, EUREX US, reduced its exchange fee for electronically traded CBOT products from \$1.25 per contract to \$.30 per contract the night before EUREX US was to commence trading. Changing its fee arrangements the night before was a smart business move by the CBOT but, when you couple it with an integrated market structure, it literally prevented EUREX US from competing in the U.S.

The integration of an FCM could also potentially place the combined DCM/DCO group, operating as an SRO, in a direct competitive position versus other FCMs, intermediaries and market players in futures product distribution. An SRO that operates its own FCM or intermediary has an apparent natural advantage over competing FCMs or intermediaries that the SRO regulates. Query: is this type of conflict of interest conducive to the development of open and competitive markets in the U.S. derivatives industry?

The lack of competition that results from the affiliated DCM/DCO structure has potentially broader impacts for market participants in the futures markets as there is no competition to drive incentives for technology upgrades and customer service that you would find in more competitive markets. This is unique to the futures markets, where there is only one DCM for a given product; it does not exist, for example, in the swaps market or with respect to other exchange-traded and centrally cleared markets such as equities and security options. Further, given that futures

contracts are typically traded on a single DCM, the DCM/DCO is the single point of potential failure for the vertically integrated model.

Additionally, it would be important to recognize that given the current degree of concentration of DCOs, rival and new entrant DCMs (or exchanges seeking to be designated as DCMs) face a lack of substitute DCOs in the supply chain, further impeding product improvement and innovation by new or competing market players. Indeed, the lack of DCOs, that are not controlled by an affiliated DCM or exchange, may also threaten to foreclose a rival's access to a DCO on competitive terms, serving to substantially lessen competition and undermine open access.

Fairness in Oversight of Competitor FCMs

In addition to the anticompetition impact of an integrated DCM/DCO, further integration of the FCM could also give rise to particular concerns over the DCM/DCO, in their SRO capacity, possessing confidential and competitively sensitive information of non-affiliated intermediaries. Under the current SRO structure, DCMs and DCOs have broad audit, examination, and enforcement powers over market participants, and function as the first-tier regulator of U.S. cleared derivatives markets.

How a for-profit SRO group handles competitor information and exercises its regulatory discretion are areas of great concern. There is a lack of robust due process and appeal channels to address concerns of regulated entities with SRO interpretations, examination or investigation findings, or enforcement actions. If not addressed appropriately, a structure that allows an SRO to operate a combined DCM/DCO/FCM may significantly undermine public confidence over the fairness and integrity of the SRO model and the regulatory design supporting this model.

Systemic Risk Concerns

In addition to raising the above concerns, such affiliations could also have profoundly adverse impacts on the risk management of cleared products.

DCOs control many facets of the guaranty default fund, and each clearing member FCM is subject to the manner in which the DCOs set and monitor the guaranty default fund and margin levels. While the DCO's guaranty default fund is calibrated to avoid catastrophe, the FCMs bear the risk *and could* lose the use of funds with respect to the large amounts required to be contributed by clearing members. This structure provides few incentives to prevent a for-profit DCO from lowering margin or otherwise relax risk management standards to gain market share for itself and its affiliated DCM and FCM. The combined DCO/DCM/FCM group would stand to reap all benefits while substantially all of the risk consequences are syndicated to market participants. I fear that the concentration of risk management responsibility, regulatory authority, and commercial interests could possibly be a ticking time bomb in the event of one substantive loss at the guaranty default fund layer.

A recent example to consider is the default of an individual trader at Nasdaq Clearing on its Nordic Exchange in 2018. The trading losses depleted approximately \$133,000,000 of the clearinghouse's guaranty fund, demonstrating that the margin collected from the defaulting trader was grossly inadequate.⁷ We can also look to the recent situation with the nickel markets on the London Metals Exchange ("LME") where the LME cancelled trades in order to prevent its affiliated clearinghouse from having to exercise its default management plan. Query, what if this were to happen at a U.S. DCO where an FCM was affiliated with the DCM and DCO?

Moreover, as other commenters have noted, the incentives of a DCO to use its discretion to delay defaulting an affiliated FCM could possibly warrant particular consideration. As manifested during the COVID market stresses, DCOs held "the keys to the castle" when faced with the crucial question of when they would call the default.⁸ Such a delay in defaulting the DCO's affiliated FCM could create pressures on the DCO to search for alternative means to contain losses or mitigate the drain on the DCO's liquidity, jeopardizing the safety and availability of margin funds of other FCMs and their clients held by the DCO. If the DCO does declare the default of its affiliated FCM, it is conceivable that such an event could trigger a collapse in market participants' confidence in the DCO itself, resulting in a run on the DCO. It may be unrealistic to expect the markets to distinguish the DCO as a separate credit from its affiliated FCM and the rest of the DCO family of entities.⁹

The risk management concerns of an affiliated FCM and DCO could possibly be further exacerbated when you consider that FCMs are obligated to bid in DCO default management auctions and the potential for forced allocations in the event of a failed DCO default management auction. The affiliation of the FCM and DCO thus raises serious concerns on how a for-profit DCO might run those auctions and forced allocations with respect to its affiliate. Further, the independence of default management resources (as compared to comingling) would be blurred. The FCM's capital, on the one hand, and the DCO's skin-in-the-game requirement, on the other hand, are an important risk management tools which could possibly be weakened in the case of affiliated FCMs and DCOs.

Statutory Soundness

As the Divisions properly pointed out in the RFC, the Commodity Exchange Act (the "Act") and Part 39 of the CFTC's regulations play a critical role in regulating the U.S. derivatives markets. Among the DCO Core Principles set forth in the Act, DCO Core Principle C(i)(I) requires a DCO to establish appropriate admission standards and continuing eligibility standards for clearing members whereas DCO Core Principle H requires a DCO to establish proper resources and to discipline a clearing member for its violations. CFTC Regulation 39.13(h)(5) requires the DCO to review the risk management procedures, practices, and policies of each clearing member

⁷ The trader had made a large bet on the power market but a major price spike led to it greatly exceeding the margin risk level established by that exchange.

⁸ See Transcript, Staff Roundtable on Nonintermediation, May 25, 2022.

⁹ This occurred during the 2008 global financial crisis when there was some concerns that firms located outside the U.S. might have an impact on the U.S. markets and firms.

and to take the appropriate actions against a clearing member to address any concerns found from a review. Part 39 of the CFTC's regulations also lists a variety of regulations requiring the DCO to monitor, and therefore enforce, a clearing member's compliance with the DCO's rules and to manage the risk of its clearing members.¹⁰

Requirements directly applicable to competition concerns arising from the affiliation between registered entities are the core principles promulgated under the Act and the CFTC's regulations with respect to registered entities. Section 5(d)(19) of the Act and CFTC Regulation 38.1000, and Section 5b(c)(2)(N) of the Act and CFTC Regulation 39.23, prohibit the DCM/DCO from adopting any rule or taking any action that results in any unreasonable restraint of trade or impose any material anticompetitive burden unless necessary or appropriate to achieve the purpose of the Act.

It should also be noted that the continuous compliance with these requirements (and for that matter, each DCM and DCO Core Principle under the Act) is a condition to "be designated, and maintain a designation" in the case of DCMs, and to "be registered and to maintain registration" in the case of DCOs.¹¹ It would follow that, to provide an effective and credible deterrent to the natural anticompetition incentives created by this affiliation, a DCM or DCO that fails to comply with these requirements should be subject to rigorous supervisory review as to its continued qualification to maintain the license to operate a DCM or DCO.

I believe there is strong public interest regarding the antitrust laws, as provided under Section 15(b) of the Act. Now is the right time for the CFTC and the Divisions to consider an in-depth review of the existing DCM/DCO affiliation and SRO models, to ensure that our market structure uses the least anticompetitive means of achieving the objectives of the Act.¹²

General Recommendations

I believe that the concerns set forth above establish a reasonable basis for the Commission to consider to review the vertical integration model before proceeding with rulemaking to allow additional affiliated entities. However, if the Divisions and the Commission should decide to proceed regarding this FCM affiliation issue, there are certain recommendations that I believe are critical to future adoption of the FCM affiliation model.

As discussed above, the DCM and DCO Core Principles, that have been in place since the Commodity Futures Modernization Act of 2000 ("CFMA"), have played a critical role regarding the U.S. market structure. Query: how would any such affiliation, especially if the affiliate is an FCM, impact these Core Principles? The proverbial "what if" questions will only lead to greater discussions and more questions. If the Commission elects to allow any such affiliations, then I would strongly recommend that the Commission consider requiring new core principles, or even

¹⁰ See CFTC Regulations 39.12(a)(4); 39.12(a)(6); 39.13(g); 39.13(h)(1); 39.13(h)(5); 39.13(h)(6); 39.16; and 39.17.

¹¹ 7 U.S.C. 7(d)(A); 7 U.S.C. 7a-1(c)(2)(A).

¹² 7 U.S.C. 19(b).

new regulations, that apply to the DCM or DCO that is affiliated with an FCM. The below reflect some general recommendations.

1. Independent SRO Public Directors Should be Vested with Audit, Investigatory, Disciplinary, and Risk Decision Authority

Important governance structures must exist to promote fairness and integrity of any SRO in the U.S. derivatives markets. To this end, composition of the SRO board of directors is key to maintaining this fairness. In my opinion, as a starting point, I recommend that any SRO that is affiliated with an FCM must have a majority (51% or more) of public representatives on the SRO's board of directors versus the current guidance of 35% for DCMs.

As the Commission knows, audits by a SRO require much discretion. When I was at Lehman Brothers, I was part of the small group there that handled financial and other customer and market surveillance audits by the CBOT, the designated SRO ("DSRO") for Lehman Brothers at that time. I also served then on the Clearing House Advisory Committee at the Chicago Mercantile Exchange ("CME"), which reviewed the audit reports of all of the CME's clearing members by the CME audit team. Independent oversight is critical to this important function. Therefore, a second recommendation is that public directors be responsible for oversight of the SRO's audit function, which is, as always, subject to CFTC oversight.

Equally as important, DCOs must exercise discretion as to determining when to increase the margin required by its clearing members, and whether to require additional funds to be added to the guaranty default fund in the time of major market moves. An affiliation with an FCM may create the appearance of the SRO not acting in the best interests of the industry. Public directors should also independently approve the amount of deposit into the guaranty default fund by the affiliated FCM, and make risk management decisions regarding stress testing and other market risk analyses.

Finally, in my opinion, public directors, and only the public directors, must be responsible for supervising all market surveillance and compliance activities at the DCM, making investigation decisions, and determining whether any sanctions should be imposed and, if so, what sanctions. Similarly, the Chief Compliance Officer of both the DCM and the DCO should report and be held accountable to the public directors.

2. Oversight of Members by DSRO-Affiliated FCMs

The respective DCM may not act as the DSRO for the affiliated FCM. Such affiliation creates irreconcilable conflicts of interest. Moreover, the CFTC should carefully consider the current model, including whether to allow the DCM which has an affiliated FCM to even serve as a DSRO, pursuant to the Joint Audit Committee arrangement, for another FCM given the confidential information that each DSRO obtains about the other FCMs from such audits. One possible model would only allow the National Futures Association ("NFA") to serve as the DSRO for all FCMs, even clearing member firms, if a DCM becomes affiliated with a FCM.

3. Affiliated FCMs Should be Subject to Stringent Capital and Liquidity Requirements

As noted above and in the Divisions' RFC, a DCO has an affirmative duty to ensure that each of its clearing member firms have the requisite net capital and risk management procedures in place so that a single customer, or even a group of customers, do not trade in any manner that could result in a major default and thus impact the non-defaulting customers of that FCM and the industry at large. In connection with its audits of that clearing member, the SRO must thoroughly examine all such customer positions to ascertain the underlying risks and the potential risks that such a major default might occur by playing the "what-if" game, that is, by shocking the positions through an analysis as to what extent volatility or disruptions might have on the respective FCM's net capital and ability to continue to do business. Such analysis by the SRO is both objective and subjective in nature. Therefore another recommendation, given the conflicts of interest set forth above, is that the CFTC should require minimum objective financial standards on any such FCM affiliation. For example, an FCM affiliated with a DCO or a DCM must have adjusted net capital, as defined in CFTC Regulation 1.17, of two or three times that of other, unaffiliated FCMs.


FCMs are required by CFTC Regulations to post "residual interest" in their "customer segregated account" at the respective custodian bank. When I was at Lehman Brothers, I often monitored this residual interest amount and/or often required a greater amount to be deposited depending on market conditions and transfers of customer accounts from another FCM. If the CFTC allows a DCO or a DCM to be affiliated with a FCM, then that FCM should be subject to enhanced residual interest standards, such as a particular percentage of the total amount of the customer assets held in the FCM's "customer segregated account," the "secured amount account," and the "cleared swap account." This minimum percentage should be higher than the range of residual interest amounts customarily maintained by non-affiliated FCMs.

Similarly, FCMs are required by each DCO to deposit and then maintain a certain amount in the guaranty default fund at that DCO. The guaranty default fund plays a critical role in protecting the underlying market and the end users who trade in that market. Accordingly, I also recommend that the CFTC consider requiring an FCM affiliated with a DCO or a DCM to deposit a certain minimum amount in the respective guaranty default fund, and such guaranty default fund should support loss mutualization before unaffiliated FCMs in the DCO's default waterfall.

Conclusion

Self-regulation is the heart and soul of the U.S. derivatives industry. However, it must be robust and without any apparent or actual conflicts of interest. As noted herein, it is important, in my opinion, that the CFTC seriously consider applying a detailed objective model if it decides to approve a DCO or a DCM to become affiliated with an FCM and also consider reviewing the concentration, competition, and risk management issues under the existing DCM/DCO market structure.

Very truly yours,



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