Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581.

March 18, 2024

17 CFR Part 39
RIN 3038–AF39 Protection of Clearing Member Funds Held by Derivatives Clearing Organizations[1]
Notice of proposed rulemaking ("NPR")

Submitted electronically

Dear Mr. Kirkpatrick,

The Institute for Agriculture and Trade Policy ("IATP")[2] appreciates the opportunity to comment on this NPR and is grateful for the Commission's comment deadline extension. IATP last wrote to the Commission about fully automated clearing and position liquidation without intermediation by Futures Commission Merchants ("FCMs") in our May 11, 2022, letter, regarding the "FTX Request for Amended DCO [Derivatives Clearing Organization] Registration Order Derivatives Clearing Organization" ("FTX Request").[3]

IATP criticized the FTX Request for several reasons, including that such a consequential change to market structure should not be undertaken as an amendment to an existing DCO registration. Instead, we recommended that the Commission begin a formal rulemaking process with the title of "Regulation Automated Clearing and Position Liquidation" to put that rulemaking in the broader context of automated and decentralized finance. After reviewing the FTX application, we doubted that it would be possible to fully automate Anti-Money Laundering (AML) and Know Your Customer (KYC) requirements for the FTX platform's 1.2 million "registered users," i.e. customers.[4] Citing these and other reasons, we urged the Commission to disapprove the FTX Request.

[1] https://www.cftc.gov/sites/default/files/2024/01/2023-28767a.pdf
[2] IATP is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minnesota, with offices in Washington, D.C. and Berlin, Germany. IATP participated in the Commodity Markets Oversight Coalition (CMOC) from 2009 to 2015, and the Derivatives Task Force of Americans for Financial Reform since 2010. IATP is an Associate Member of the Commission's Technology Advisory Council.
[3] https://comments.cftc.gov/PublicComments/CommentList.aspx?id=7254
[4] *Op cit.*, p. 4.

Learning from history or not

The background to this NPR is historically truncated. The Commission proposes to retroactively make its past approvals of DCOs without FCM intermediation consistent with Core Principle F:

> The Commission's initial focus in implementing Core Principle F was on the custody and safeguarding of customer funds, consistent with section 4d of the CEA [Commodity Exchange Act]. This approach was largely responsive to the historical prevailing model in which all or nearly all clearing members of a DCO are FCMs. However, the Commission has since granted registration to a number of DCOs that clear directly for market participants without the intermediation of FCMs, including, in most cases, market participants who are natural persons (i.e., individuals).[footnote18] Additionally, many DCOs that use the traditional FCM clearing model have at least some non FCM clearing members. (Federal Register (FR), Vol. 89, No. 2, p. 286)

There is no mention in the NPR of the history of direct-to-retail clearing of cryptocurrency transactions nor an analysis of the Commission's reasons for having approved applications for DCOs that make retail customers into clearing risk takers. Only in Commissioner Kristin Johnson's concurrence[5] and Commissioner Christy Goldsmith Romero's dissent do we get summaries of the historical context of this NPR.

Per Commissioner Goldsmith Romero's dissent[6], IATP does not understand why the NPR was developed before following a Financial Stability Oversight Council (FSOC) recommendation, in its October 2022 "Digital Asset Financial Stability Risks and Regulation" report. The Commission and other FSOC members should assess the impact of direct-to-retail cryptocurrency trading and clearing on customer protections, market integrity, financial stability, and given, the use of cryptocurrencies to fund terrorist operations, national security. As applied to the CFTC, this FSOC recommendation would require consideration of rulemaking beyond whether to accommodate the digital asset industry demand for regulatory amendments to make its direct-to-retail clearing model consistent with customer protections under Core Principle F. There are applications pending for Commission approval of direct-to-retail DCO registrations. However, there is no public interest reason why the Commission should hasten to draft, revise and approve the NPR, when the consequences of direct-to-retail clearing failure are so grave, not only for customers unprotected in the event of a DCO bankruptcy, but for financial stability in derivatives markets if the direct-to-clearing model is expanded to cover all commodity assets, not just digital assets.

IATP strongly supports Commissioner Goldsmith Romero's dissent. We urge the Commission to withdraw the proposed rule and repropose it only if several conditions are met. First, the Commission must carry out the assessment recommended in the FSOC report. It must conduct other necessary legal, technological and economic analysis, e.g. to determine whether it is technologically feasible for DCOs to automate AML and KYC risk management controls fully and safely for millions of retail customers of cryptocurrencies. For example, on

[5] Appendix 3—Statement of Commissioner Kristin N. Johnson, FR, pp. 301-304.

[6] Appendix 4 – Dissenting Statement of Commissioner Christy Goldsmith Romero, pp. 304-306.

January 8, the Technology Advisory Committee's subcommittee Digital Assets and Blockchain Technology released a report on decentralized finance with recommendations on interagency technology assessment and agency reviews of existing regulations.[7] The TAC subcommittee on Emerging and Evolving Technologies is studying inter alia whether artificial intelligence models can perform AML and KYC functions accurately and safely. Why would the Commission finalize this NPR before understanding whether the disintermediated clearing model can be implemented technologically and with comprehensive customer protections and a clear risk management accountability structure? This NPR should not be finalized in 2024 as if it were one more box to be ticked off to fulfill the Commission's 2024 regulatory agenda.

When the Commission approved the application of Ledger X in 2017 to become the first DCO to directly clear retail cryptocurrency transactions, it did so for the purpose of supporting financial "innovation." The Commission did not consider the impact of disintermediated clearing of retail cryptocurrency transactions on the custody and safeguarding of customer funds under conditions of market stress that imperiled the solvency of a DCO. Furthermore, as FTX CEO Sam Bankman Fried testified to the Senate agriculture committee on February 9, 2022, "That [LedgerX] license was later amended in 2019 to permit the clearing of futures contracts on all commodity classes and not just digital assets."[8] (our emphasis) The prospect of direct-to-retail trading and clearing of transactions in all commodity classes instigated IATP's comment to the Commission on the FTX Request.

IATP does not know if the pending applications for direct-to-retail clearing apply only to the trading of digital assets or whether the applications also envision direct-to-retail clearing of all commodity assets. Nor does IATP know if these applications require automated liquidations of positions of the retail customer to cover losses in the retail client's account, per the FTX Request. The segregation of customer funds from DCO funds would be momentary if the direct retail-to-clearing model requires such automated liquidation to fully collateralize client losses. Does direct-retail to-client clearing apply or could it apply in the future to all commodity assets? Does that clearing model requires automated liquidation of client positions to satisfy the current definition of "fully collateralized position"[9] in 17 CFR Part 39? The Commission should review the entirety of Part 39 to determine how direct-to-retail clearing affects clearing recordkeeping, reporting and market integrity.

Direct-to-retail clearing is not simply a model of clearing enabled by smartphones, automated trading and automated clearing. Nor can possible harms resulting from direct-to-retail clearing be remedied solely by a segregation of funds amendment to Part 39. CFTC customer protection rules, recordkeeping and reporting requirements apply to Self-Regulatory Organizations, retail foreign exchange dealers and market intermediaries, all of whom are

[7] https://www.cftc.gov/About/AdvisoryCommittees/TAC

[8] Sam Bankman Fried, Written testimony for "Examining Digital Assets - Risks, Regulation, and Innovation." Hearing Before the U.S. Senate Committee on Agriculture, Nutrition and Forestry," p. 3. https://www.agriculture.senate.gov/imo/media/doc/Testimony_Bankman-Fried_0209202211.pdf

[9] "Fully collateralized position means a contract cleared by a derivatives clearing organization that requires the derivatives clearing organization 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."

responsible for protecting retail customers.[10] Direct-to-retail clearing changes the normative structure of clearing. Prior to considering any application for DCO direct retail-to-clearing, the Commission should review its customer protection rules to determine if the model is consistent with the normative objectives of the customer protection rules.

LedgerX withdrew its FTX's parent's Request for Commission approval of its direct to clearing and automated margining model[11] when FTX became a subject of investigation for fraud and other crimes. FTX US has sold LedgerX for $50 million to pay some of the debtors in the prolonged FTX bankruptcy proceedings.[12] But the operational and technological risks of fully automated clearing remain. As Professor Hillary Allen has contended,

> "DeFi [Decentralized Finance] has evolved such that users have to trust in some combination of ISPs [Internet Service Providers], core software developers, miners, wallets, exchanges, stablecoin issuers, oracles, providers of client APIs [Application Programming Interfaces] used to access distributed ledgers, and concentrated owners of governance tokens. [footnote 12] In short, DeFi does not so much disintermediate finance as replace trust in regulated banks with trust in new intermediaries who are often unidentified and unregulated.[13]

Trust in capital markets is built from the consistent and effective operation of many components. For decades, customer trust in the clearing of derivatives transactions has begun with customer protection required by the Commission of FCMs and other market intermediaries. Reassigning trust to a new group of intermediaries requires more than the proposed mandatory segregation of retail customer funds from DCO funds, a prudential provision that IATP supports. In the remainder of this short letter, IATP responds first to the questions embedded in the NPR and then proposes topics for inquiry that the Commission should undertake before it considers whether to retroactively validate earlier Commission decisions to approve direct-to-retail DCOs.

Responses to NPR questions

Should the Commission require DCOs to report to the Commission the daily calculations and reconciliations required by proposed § 39.15(g)? (FR., p. 292)

[10] "Customer Protection Rules," https://www.ecfr.gov/current/title-17/chapter-I/part-166

[11] Lydia Beyoud, "FTX Withdraws Big Plan to Overhaul how Crypto Derivatives Trade," November 11, 2022, Bloomberg.

[12] Tracy Wang, "FTX's LedgerX Derivatives Exchange Sold to Miami Holdings International in Bankruptcy Auction," Coin Desk, May 8, 2023 and Randall Chase, "Appeals Court reverses district judge's ruling, orders appointment of independent examiner in FTX bankruptcy," Associated Press, January 22, 2024.

[13] Hilary J. Allen, DeFi: Shadow Banking 2.0?, 64 Wm. & Mary L. Rev. 919 (2023), p. 924. https://scholarship.law.wm.edu/wmlr/vol64/iss4/2

Commissioner Johnson's statement of concurrence provides both useful information for evaluating this NPR and requests for comments that commenters should heed. She writes, for example,

> The Commission exercises direct oversight with respect to DCOs, meaning DCOs are not supervised by self regulatory organizations (SRO) or designated self-regulatory organizations (DSRO). The Commission performs the examination functions. DCOs may benefit from a similar oversight as FCMs, which involves a regular reporting of reconciliation and not just the reporting of discrepancies. (FR, p. 304)

If the Commission votes to finalize the NPR, against IATP's advice, there are at least two issues embedded in Commissioner Johnson's statement about daily reconciliation. The first issue is the Commission's budgetary, personnel and infrastructure capacity to evaluate the accuracy and comprehensiveness of the DCO reported daily reconciliations and discrepancies. Former CFTC Commissioner Dan Berkovitz's congressional testimony on a pending cryptocurrency bill, advised Members that any expansion of the CFTC's authority to regulate cryptocurrencies must be accompanied by congressional appropriations sufficient to effectively implement and enforce new authorities:

> The CFTC should be provided with a dedicated source of funding for the regulation and oversight of the non-security digital asset spot market. Current CFTC resources are not sufficient to undertake this additional responsibility without compromising the CFTC's ability to oversee the traditional commodity markets.[14]

In the best-case scenario, Congress would follow Commissioner Berkovitz's advice by authorizing the Commission to become a self-financing agency. For example, the Commission could levy proportional fees on DCOs for examining their daily reconciliation reports, with higher fees for analysis of reconciliation discrepancies. However, to judge by the history of congressional appropriations for the Commission, Congress will continue to underfund the Commission as it adds new mandates to its mission, including the retail automated trading and clearing by millions of retail cryptocurrency customers.

A second issue embedded in Commissioner Johnson's statement concerns the granularity of analysis required to evaluate daily reconciliation reports and to investigate the source of persistent discrepancies. The NPR proposes,

> A reconciliation deficit in a particular account type in one currency may be offset by a surplus in that same account type in another currency, based on publicly available exchange rates, with the surplus subject to haircuts reasonably determined by the derivatives clearing organization, consistently applied. (FR, p. 299)

[14] "The Future of Digital Assets: Measuring the Regulatory Gaps in the Digital Assets Markets," Statement of Dan M. Berkovitz before the Committee on Agriculture, U.S. House of Representatives, June 6, 2023, p. 2. https://docs.house.gov/meetings/AG/AG00/20230606/116051/HHRG-118-AG00-Wstate-BerkovitzD-20230606.pdf

The NPR would allow DCOs to offset deficits in an account type denominated in one cryptocurrency with a surplus in another cryptocurrency. Which exchange rate would be used for offsetting? A stablecoin exchange rate? A U.S. dollar denominated exchange rate? A fiat currency denominated exchange rate used in a foreign central bank located in a Commission defined "money center country" where the DCO could deposit its funds under the terms of the NPR? Would the reconciliation methodology report how the DCO reasonably determined its "haircuts" of the surplus currency? Could a cryptocurrency deficit in an account type be offset by a fiat currency? Answers to these and like questions should be provided in the NPR preamble and the text of the rule itself, if the Commission decides to finalize this DCO rule.

How might the Commission ensure AML and KYC compliance for DCOs that offer direct clearing services (a market structure that would not include FCMs or other intermediaries that are typically directed to create Bank Secrecy Act compliance programs)? Should DCOs offering direct-to-customer services to non-eligible contract participants or retail customers be required to comply with AML and KYC requirements? (FR, p. 292)

Commissioner Goldsmith Romero notes in her dissent, "anti-money laundering controls sit with the FCM, and clearinghouses have no AML requirements. AML is a critical guardrail for national security and customer protection." (FR, p. 304) Because AML controls are mission critical for federal financial regulators and because clearinghouses have no AML requirements, the nearly full automation of AML and KYC protections in disintermediated clearing the Commission require the Commission to undertake require a separate AML rulemaking that would begin with a Request for Information about the state of technology for developing regulatory bots to replace many of the Commission's regulatory functions. Commissioner Johnson writes, "Following consultation with the U.S. Department of Treasury, the Commission may need to engage in a formal rulemaking that imposes AML requirements on DCOs."(FR, p. 303) The consultation with the Department is crucial because the Department of Treasury has more resources than has the Commission to detect and investigate money laundering. Furthermore, the Treasury has a dedicated mission to combat foreign and domestic money laundering. The Commission should avail itself of the Treasury AML risk assessment techniques.[15]

The Commission should not allow disintermediated clearing for non-contract participants, at least not before DCOs have demonstrated the efficacy of their AML regulatory bots, and have in place, as part of a DCO AML rule, a clear accountability structure and risk management plan to protect customers when the bots fail to do so. The LedgerX contract with retail customers required them to attest that the source of their funds to purchase cryptocurrency position did not originate with money laundering. Such attestation is surely only step one in the prevention of KYC and AML. The DCO's management and governing body must assume ultimate responsibility for implementing AML and KYC controls and assume liability when these controls fail to protect their customers.

[15] "Money Laundering," U.S. Department of Treasury, https://home.treasury.gov/policy-issues/terrorism-and-illicit-finance/money-laundering

Should the Commission require any additional written acknowledgments (to those contained in proposed § 39.15(b)(3) or § 39.15(f)(2)(vi) as applicable) from central banks of money center countries in order for a DCO to use them to hold futures customer funds, cleared swaps customer collateral, or proprietary funds?

IATP does not have an opinion about present written acknowledgements for bank custody of customer funds and hence does know how revisions to the written acknowledgements can better protect customer funds. However, we do have a couple questions about custody of funds denominated in cryptocurrencies, particularly when banks in foreign "money center countries" are the custodians of customer funds and DCO proprietary funds. Do these banks have to already have central bank digital currencies to receive and serve as custodians of funds denominated in different crypto currencies? For money centers without central bank digital currencies, are the DCO's crypto funds converted into the respective fiat currencies of the "money center countries" before they are deposited and subsequently invested?

Five topics for further consideration in the NPR

1. Regarding the applicability of the Regulatory Flexibility Act to the NPR

The Commission has previously determined that DCOs are not small entities for the purpose of the RFA.[footnote 57] Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed regulations will not have a significant economic impact on a substantial number of small entities. (FR, p. 292)

Commissioner Goldsmith Romero dissent stated that "CFTC staff said that the proposed rule was an attempt to provide parallel protections to those individuals who we would normally consider to be "customers," but who now are "members." But it fails to provide parallel protections to retail participants. The proposed rule attempts to port over to this direct-to-retail model one protection (segregation of funds, which I support) without the other protections, or checks and balances present in an intermediated model with an FCM. (FR, p. 304) Under the disintermediated clearing model, retails customers become de facto clearing "members," but without the financial resources of the FCMs that are clearing members in the traditional clearing model. Most retail customers are surely small entities, so the regulatory and economic impact of the NPR on them cannot be dismissed, as the Commission proposes to do here. The Commission should determine what economic impacts the NPR might have on the retail customers that the NPR transforms legally into clearing members.

2. Benefits By eliminating any uses for proprietary funds other than on behalf of clearing members, the proposed rule would help ensure that the funds are readily available if needed either by the clearing member directly, or for a permitted use by the DCO. The clarifications providing that an FCM's funds may be used by a DCO to cover the FCM's customers' losses, or as part of a clearing member-funded, mutualized guaranty fund, ensures that the rule would not hamper DCOs' existing risk management programs. (FR, p. 296)

Since disintermediation obviates the role of traditional FCMs, the DCO's automated liquidation of retail customer positions to cover retail customer losses is beneficial for the DCO. However, the Commission should assess whether and how the NPR is beneficial for the retail customer who will not know when and in what quantity and/or currency her position

is being liquidated to ensure the solvency of the DCO. One question to evaluate is not whether the rule would hamper the DCO's existing risk management program, but how the DCO's operational and technological risks would change with the adoption of the disintermediated clearing model, particularly under highly stressful market conditions. For example, if an AI directed risk control began to hallucinate during the automated liquidation process, how would the DCO's risk management program respond to protect customer positions and funds?

3. Additionally, by requiring the daily calculation and reconciliation to be approved by an independent employee, the proposed rule would help prevent a single bad actor at a DCO from misusing futures customer funds, cleared swaps customer collateral, or proprietary funds, and from concealing that misuse. The requirement to report any discrepancies to the Commission would help ensure that the Commission is immediately made aware of potentially missing funds, and that it can work with the DCO to resolve the matter. (FR, p. 297)

Daily calculation and reconciliation of DCO funds is a sound and prudent practice to prevent misuse of funds. But which employee in a DCO is sufficiently independent and knowledgeable to verify the accuracy and comprehensiveness of these calculations and reconciliation before approving and reporting them to the Commission? Will all registered DCOs report the daily reconciliations in a uniform format that CFTC examination staff and infrastructure can readily evaluate, if the independent employee(s) overlooks a discrepancy? There is a lack of DCO accountability structure in the disintermediated model regarding reporting of reconciliation and discrepancies that must remedied in the rule, if it is to be finalized.

4. Proposed Amendment to § 39.15(h) a. Summary of Changes The proposed rule would exempt foreign DCOs from the requirements of proposed § 39.15(e)(3), (f), and (g)(3) because in the event of an insolvency, the clearing member funds held by a foreign DCO would not be subject to U.S. bankruptcy law.71 (FR. P. 297)

Commissioner Goldsmith Romero's dissent states, "This rule also does not require disclosures to inform retail participants that they are giving up customer protections and bankruptcy customer priority, instead taking the status of "clearing members," similar to the roles and duties that normally falls to an FCM such as a large bank." (FR, p. 304) This absence of DCO disclosure requirements in the disintermediated clearing model must be remedied if the Commission decides to finalize the rule. If foreign DCOs become insolvent and U.S. retail customers of the DCO have lost their customer protections and customer bankruptcy priority in the disintermediated clearing model, only the most well-resourced retail customer could attempt to seek redress under foreign bankruptcy law. Does the Commission have any proposals to negotiate measures with foreign regulators that would enable the uninformed the U.S. retail investor, who has lost both customer protections and bankruptcy priority, to seek redress?

5. The Commission should propose to FSOC a study about the environmental sustainability, particularly regarding energy and water use, of the technologies employed in disintermediated clearing and decentralized finance in general. What are the consequences for financial stability, if one or more of these technologies become environmentality unsustainable to some degree at a projected point in time? The electrical energy used to

"mine" cryptocurrencies is a matter of U.S. government study and concern.[16] Less discussed by the public is the energy and water use in manufacturing graphic processing units and the electrical energy required to operate generative artificial intelligence models[17], including those modified by CFTC registrants for trading and clearing. There are, of course, technological fixes proposed to remedy these environmental sustainability issues. However, FSOC should not assume that the fixes will work effectively at the scale, cost and at the take-off time anticipated by their promoters. If the use of generative AI applications becomes more prevalent in the derivatives industry, FSOC may wish to study how projected electrical energy capacity and use will affect those applications.

Conclusion

IATP hopes that these comments will help persuade the Commission that the NPR has not been researched and deliberated sufficiently for it to proceed to finalization. If the Commission proceeds to finalize the NPR, these comments and questions may help to improve the final rule.

Respectfully submitted,

Steve Suppan
Senior Policy Analyst

[16] E.g., "Tracking electricity consumption from U.S. cryptocurrency mining," U.S. Energy Information Agency, February 1, 2014. https://www.eia.gov/todayinenergy/detail.php?id=61364#:~:text=Electricity%20demand%20associated%20with%20U.S.,2.3%25%20of%20U.S.%20electricity%20consumption.

[17] E.g., Kate Crawford, "AI's environmental costs are soaring –and mostly secret," *Nature*, February 20, 2024. https://www.nature.com/articles/d41586-024-00478-x