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

Via CFTC Comments Portal: https://comments.cftc.gov

Re: Comment on Notice of Proposed Rulemaking Regarding Protection of Clearing Member Funds Held by Derivatives Clearing Organizations; RIN 3038-AF39

Dear Mr. Kirkpatrick:

Nodal Clear, LLC ("Nodal Clear" or "Nodal") appreciates the opportunity to respond to the Commodity Futures Trading Commission's ("CFTC" or "Commission") Notice of Proposed Rulemaking regarding the protection of clearing member funds held by derivatives clearing organizations ("DCOs") (the "NOPR" or the "Proposed Rule").[1] As background, Nodal Clear is a registered DCO and the clearing house for Nodal Exchange, LLC ("Nodal Exchange") and Coinbase Derivatives Exchange, which are both CFTC designated contract markets ("DCMs").[2] Nodal Clear is a wholly owned subsidiary of Nodal Exchange, itself wholly owned by the European Energy Exchange AG ("EEX"). Nodal Clear is a "Subpart C" DCO, having elected to comply with the requirements applicable to DCOs that have been designated systemically important ("SIDCOs") by the Financial Stability Oversight Council. The NOPR refers to a "prevailing" or "traditional" clearing model (hereinafter, "Prevailing Model") whereby a DCO's clearing members are futures commission merchants ("FCMs").[3] Nodal Clear uses this model.

Nodal Clear respectfully submits the following comments regarding the NOPR.

## I. <u>General Comments</u>

Nodal Clear recognizes the protection of both customer and clearing member funds as a core DCO responsibility and supports the Commission's ongoing efforts to review and enhance rules

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[1] *Protection of Clearing Member Funds Held by Derivatives Clearing Organizations,* 89 Fed. Reg. 286 (Jan. 3, 2024).

[2] Coinbase Derivatives Exchange is a registered DCM under LMX Labs LLC.

[3] Proposed Rule at 287.

regarding the protection of clearing member funds held by DCOs. Nodal particularly supports enhanced rules for DCOs that clear directly for market participants (including market participants who are natural persons) without the intermediation of FCMs, which is the non-Prevailing Model of clearing (hereinafter, "Direct Access").[4] However, if adopted as proposed, the Proposed Rule requirements would apply to *all* DCOs regardless of whether those DCOs use the Prevailing Model or the Direct Access model.[5] Under the Prevailing Model, FCMs already provide a comprehensive regime used to safeguard funds belonging to customers pursuant to the Commodity Exchange Act and the CFTC's existing regulations, as reiterated throughout the preamble to the NOPR.[6] For Prevailing Model DCOs, the requirements in the Proposed Rule are duplicative of protections that already exist to safeguard customer funds and would thereby impose additional and resource intensive costs on DCOs utilizing the Prevailing Model with little added benefit.

Under the Prevailing Model, DCOs and FCMs operate under a robust risk mitigation regime. For example, FCMs provide a second layer of oversight and risk management that supplements regular Commission examinations, ultimately making Prevailing Model DCOs stronger and more resilient. For example, FCMs—that are independent and are almost always not affiliated with any DCO—challenge DCOs to improve their risk management practices, including cybersecurity and counterparty risk, by regularly engaging with DCOs through feedback, board committees, and at Nodal, its risk advisory committee.[7] If a DCO makes a change to its risk practices, the FCMs inquire about the justification for the change and may provide direct feedback that the DCO will consider. FCMs may also collect additional initial margin from their customers when they disagree with the risk practices of a DCO to mitigate their perceived risk. In contrast to retail market participants, FCMs have staff and resources equipped to evaluate and navigate Prevailing Model DCO rules, risk practices, and cybersecurity measures. FCMs are well positioned to perform these evaluations, as they are often clearing members of multiple DCOs and have the benefit of understanding risk management regimes for a wide array of cleared products. FCMs also represent large groups of customers, giving FCMs leverage to challenge DCO practices.

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[4] Proposed Rule at 287. Our reference to the Direct Access model in this letter focuses on fully-collateralized DCOs that allow retail market participants to clear directly with the DCO without FCM intermediation. There may be other concerns, not addressed herein, with other types of Direct Access DCOs (i.e., those that permit margined positions). Those issues are beyond the scope of these comments.

[5] Although some DCOs using the Prevailing Model may also have some non-FCM clearing members, these non-FCM clearing members are well-capitalized, highly sophisticated firms with risk management expertise. For example, Nodal only has one non-FCM clearing member, which is a well-capitalized multinational bank.

[6] *See, e.g.,* Proposed Rule at 287 ("At the most general level, the customer protection regime requires FCMs to segregate customer funds from their own funds, deposit customer funds under an account name that clearly identifies them as customer funds, and obtain a written acknowledgment from each depository that holds customer funds.") (citations omitted).

[7] Nodal created its own risk advisory committee some years ago to engage with and solicit FCMs opinions and feedback regarding risk management practices. By July 2024, all DCOs must have a risk management advisory committee. *See Governance Requirements for Derivatives Clearing Organizations*, 88 Fed. Reg. 44675 (July 13, 2023).



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Nodal recommends that rather than adopting the Proposed Rule, the CFTC considers undertaking a thorough comparative analysis of the Direct Access model relative to the Prevailing Model. The Direct Access model is new and untested, while the protections present in the Prevailing Model have been validated through decades of stress events and enhanced by Commission oversight and regulation.

The comparative analysis could be used to understand any inherent strengths the Prevailing Model has with respect to risk mitigation that may be lacking in the Direct Access model. The Commission may also want to consider whether customers of the Direct Access DCOs may believe that such entities have the same or similar protections as a Prevailing Model DCO, and whether disclosure of that risk profile might be necessary for Direct Access DCO customers. If necessary, the CFTC should consider specifically addressing risks of the Direct Access model in a proposed rulemaking. In sum, the CFTC should withdraw the Proposed Rule and consider reissuing a revised NOPR targeted to addressing risks of Direct Access DCO customer fund protection and other relevant concerns.

We recommend that, if the Commission does reissue a more targeted NOPR, that any revised rules should designate a different name and distinct registration category for a Direct Access DCO, which is a fundamentally different form of clearing from the Prevailing Model. Distinct naming and registration would also allow for targeted regulation that better fits each respective DCO model. A different name and distinct registration category for Direct Access DCOs may also help to clarify that Direct Access DCOs do not provide the same protections as Prevailing Model DCOs, and would also help distinguish the distinct categories of DCO should an issue arise at a Direct Access DCO related solely to its clearing model.

As we note herein, the Proposed Rule, if adopted, would impose duplicative requirements and unnecessary costs on Prevailing Model DCOs, which inherently have low risk profiles under existing regulations. However, should the Commission choose to not withdraw and/or reissue a revised NOPR, and instead adopt the Proposed Rule in substantively the same form, Nodal Clear provides the following comments highlighting its specific concerns and observations regarding specific proposed rule changes in the NOPR.

## II. Comments on Specific Provisions

### A. Proposed Regulation § 39.15(g), Daily Reconciliation Reports

The Commission is proposing Regulation 39.15(g), which would require a DCO to conduct a reconciliation for each type of segregated account (customer funds, cleared swaps customer collateral, and proprietary funds) the DCO holds for its clearing members by noon of each business day. The reconciliation would consist of calculating the amount of the relevant funds owed to each clearing member as well as reconciling the total amount of the funds aggregated across all clearing members with the amount of each respective type of funds (customer funds, cleared swaps customer collateral, and proprietary funds) held in separate accounts across all



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depositories.[8] It would also require the DCO to immediately report any discrepancy in the relevant calculations or reconciliations that "reveal[] that the DCO did not, at the close of the previous business day, maintain in separate segregated accounts" funds in an amount sufficient in the aggregate to cover the total value of funds owed to all clearing members.[9]

Like other requirements in the NOPR, this proposal is based on existing FCM requirements—specifically, it is based on CFTC Regulation 1.32 for reporting of segregated account computation and details for holding futures customer funds.[10] Nodal reiterates that the CFTC should not impose duplicative requirements on Prevailing Model DCOs given the existing risk mitigation regime described in our general comments above.

However, should the Commission decide to adopt the Proposed Rule in substantially similar form, Nodal proposes that the daily reconciliation for clearing member funds be completed by the end of the day rather than by noon. The extra time would allow DCOs the flexibility to produce more accurate and better-quality reports even during times of competing regulatory responsibilities, and any discrepancy would still be immediately reported to the Commission that day under proposed Regulations 39.15(g)(5) and 39.19(c)(4)(xxvi).

### 1. Reconciliation Timeframe

The Commission should consider that there may be times where technical issues could delay the completion of the reconciliation process past the noon deadline. Therefore, the Commission should allow for flexibility on timing of the process by requiring that reconciliations are completed by the end of the day. Such flexibility may also help ensure the accuracy and quality of reconciliation reports. Assuming a 9:00 AM start to the business day, the noon deadline would only allow for 3 hours to complete the reconciliation. This short window may increase the likelihood of errors or compromise the quality of the reconciliation and may cause unnecessary discrepancy reports to be filed.[11] The primary function of the reconciliation process is the identification and resolution of discrepancies. If a discrepancy needs to be investigated, or the reconciling personnel are otherwise occupied, rushing to meet the noon deadline may be detrimental to the quality of the reconciliation and undermine the underlying goal of this proposal.

Because the noon deadline, if adopted, would create challenges that include possible technical issues that could delay the reports and issues in the quality of reports when they need to be completed in a constrained timeframe, we recommend extending the reconciliation deadline to the end of the day.

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[8] Proposed Rule at 291.

[9] *Id.*

[10] *Id*.

[11] Proposed Rule, Proposed CFTC Regulation 39.19(c)(4)(xxvi).



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### 2. Support for Reporting Only in Case of a Reconciliation Discrepancy

With regards to the proposed requirement that a DCO immediately report to the Commission any discrepancies in a calculation or reconciliation, Nodal supports that there should not be a requirement to report unless there is a discrepancy.[12] This would match analogous requirements for registrants such as swap dealers and major swap participants that are only required to report to the CFTC certain discrepancies that arose when performing portfolio reconciliation.[13] The requirement to report only in the case of a discrepancy supports goals of the proposed regulation –*i.e.*, to monitor funds held by DCOs and identify and report any discrepancies to the CFTC.

### B. Proposed Regulation 39.15(e)(3), Permitted Investments

The Commission is proposing Regulation 39.15(e)(3), which would subject the investment of clearing member proprietary funds to the limitations described in existing Commission Regulation 1.25 (applicable to FCMs).[14] Permitted investments under Commission Regulation 1.25 "include, among other investments, general obligations of the U.S. government, general obligations of any U.S. state or municipality, certificates of deposit, and interests in money market funds" subject to terms, conditions, and requirements depending on the type of permitted investment.[15]

Nodal supports rules that enhance the protection of clearing member funds and how they are utilized and invested; however, proposed Regulation 39.15(e)(3) would constrain the investment capacity for smaller DCOs and potentially result in greater risk of loss for proprietary funds. Therefore, Nodal requests that the Commission not adopt proposed Regulation 39.15(e)(3).

DCOs, such as Nodal, that do not have the ability to deposit funds on an overnight basis at a Federal Reserve Bank have few options for holding clearing member funds overnight while meeting Commission liquidity requirements. These DCOs can either leave the proprietary cash initial margin posted to them at a deposit bank or invest that cash via short term reverse repurchase agreements. The latter is superior from a credit risk standpoint because the DCO can receive highly liquid U.S. government securities as collateral via the reverse repurchase agreement transaction, whereas cash left at a deposit bank is uncollateralized and protected by limited Federal Deposit Insurance Corporation insurance.

While reverse repurchase agreements are a valuable investment vehicle for DCOs, many DCOs may not have access to a sufficient set of reverse repurchase agreement counterparties with which they can trade. This limited access is potentially attributable to reverse repurchase agreement counterparties requiring sizable activity from the relationship. The smaller DCOs who do not have a broad selection of counterparties may struggle to invest all the clearing member

[12] *See* Proposed Regulations 39.15(g)(5) and 39.19(c)(4)(xxvi).

[13] *See, e.g.,* 17 C.F.R. 23.502(c) (reporting related to portfolio reconciliation).

[14] Proposed Rule at 289.

[15] *Id.*



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proprietary funds held and still comply with the 25% counterparty concentration limit spelled out in Regulation 1.25(b)(3)(v). This inability to comply with the concentration limit would result in smaller DCOs being forced to leave more proprietary cash at settlement banks, thereby increasing credit risk for proprietary cash relative to the status quo.

DCOs that cannot deposit funds into a Federal Reserve Bank are already disadvantaged compared to those that can, such as SIDCOs.[16] Regulation 1.25(b)(3)(v) and its 25% counterparty concentration limit already increases credit risk for smaller DCOs with respect to the investment of customer funds, and if proposed Regulation 39.15(e)(3) is adopted, it would extend this issue to proprietary funds. Requiring the restrictions on investments of proprietary funds from Regulation 1.25, including a 25% counterparty concentration limit, would further disadvantage smaller DCOs, increase the credit risk for proprietary funds, and would work contrary to the aims of proposed Regulation 39.15(e)(1), which is to invest funds in instruments with minimal credit, market, and liquidity risks. Proposed Regulation 39.15(e)(1) would increase credit risk among smaller DCOs instead of reducing it and therefore should not be adopted by the Commission.

### C. Proposed Regulations 39.15(f)(3)(ii) and 39.15(f)(4), Restrictions on the Use of Proprietary Funds

The Commission is proposing Regulation 39.15(f)(3)(ii), which provides, in part, that a DCO is not permitted to commingle proprietary funds with the DCO's own funds or customer funds. Similarly, proposed Regulation 39.15(f)(4) would require that a DCO (and any depository holding proprietary funds) not hold, use, or dispose of proprietary funds except as belonging to the clearing member that deposited the proprietary funds.

This proposal is based on existing FCM requirements—specifically, it is based on CFTC Regulation 1.20 covering segregation of customer funds.[17] Nodal reiterates that the CFTC should not impose duplicative requirements on Prevailing Model DCOs given the existing risk mitigation regime described throughout our comments.

However, should the Commission decide to adopt the regulations proposed in the NOPR, it should not adopt proposed Regulations 39.15(f)(3)(ii) and 39.15(f)(4). The proposed restrictions on the utilization of proprietary funds, as provided in proposed Regulations 39.15(f)(3)(ii) and 39.15(f)(4), are incompatible with prevailing industry practices. Specifically, proposed Regulations 39.15(f)(3)(ii) and 39.15(f)(4) could be interpreted as limiting current industry practices that authorize the utilization of a guaranty fund in specific circumstances. We

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[16] As the Commission is seeking to strengthen DCO safeguards for the protection of clearing member funds via rules designed to minimize credit risk, market risk, and liquidity risk, it should be noted that the most effective and efficient way to minimize these risks would be to permit all DCOs to deposit clearing member funds at the Federal Reserve Banks. The Commission itself acknowledged in this NOPR that "central banks are often the safest place to deposit customer funds…." Proposed Rule at 289. Accordingly, the Commission should continue to advocate for Federal Reserve Bank deposit access for all DCOs holding clearing member funds, so those funds are held in the safest place.

[17] Proposed Rule at 291.



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understand certain DCOs may be authorized under their rules to use the guaranty fund in anticipation of a default or to manage a settlement bank failure. Restricting the permitted uses of proprietary funds, including guaranty funds, could impair existing DCO practices designed to manage defaults and certain non-default losses. The Commission should allow DCOs to continue to use proprietary funds in a manner consistent with its rules. Continuing to allow a DCO that option provides sufficient transparency for clearing members and the Commission regarding the potential utilization of proprietary funds without unnecessarily impeding a DCO's ability to navigate stress events. Accordingly, the Commission should not adopt proposed Regulations 39.15(f)(3)(ii) and 39.15(f)(4).

### D. Considerations for Time to Implement Proposed Regulations

For DCOs to properly implement requirements from the Proposed Rule, they will be required to alter and/or reallocate existing operational, technical, and personnel resources should the Proposed Rule be adopted in its current form. Nodal requests the Commission to afford considerable time for DCOs to conform with the new requirements.

For example, daily reconciliations required by proposed CFTC Regulation 39.15(g) that are to be completed by noon every day would require a large shift in time and duty prioritization for the applicable teams at a DCO to complete the reconciliation by the deadline. This will also likely require DCOs to build up their teams to a point where they have personnel that can be solely focused on this requirement each morning, and hiring additional qualified personnel may take considerable time.

Additionally, proposed Regulation 39.15(g)(4)(i) provides that "[e]ach of the DCO's calculations and reconciliations would need to be approved by a person who did not prepare the initial calculation or the related reconciliation, and who does not report to the person who prepared them."[18] Because this provision requires a "person" to approve calculations and reconciliations, DCOs lose the option to use automated software to accomplish this requirement. That consequently adds more burden on smaller DCOs to hire and/or train appropriate personnel as necessary. The Regulation, if adopted, should allow for the use of automated software to aid in the completion of daily reconciliation.

As another example, proposed CFTC Regulation 39.15(f)(2) requires "a DCO to obtain from any depository holding proprietary funds a written acknowledgment that the funds belong to the DCO's clearing members and cannot be used by the DCO for any other purpose." This proposal will require DCOs' existing documentation with depositories to be amended. Also, in practice, the requirement will impact how that documentation reflects account titles, addresses notification procedures for changes, and the language used in proprietary fund letters. Amending such documentation will require close and usually time-consuming work with each of the DCO's depositories.

[18] Proposed Rule at 289.



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For Prevailing Model DCOs, these additional costs have little to no added benefit as the existing risk mitigation regime for DCOs and FCMs in the Prevailing Model are appropriately robust. However, if the Commission adopts the Proposed Rule, it should thoughtfully consider the time that it will take for DCOs to conform with the new requirements and allow at least a year or longer for DCOs to become compliant. Nodal also recommends that the Commission revise the word "person" in proposed Regulation 39.15(g)(4)(i) to add more flexibility concerning preparing required calculations or reconciliations.

## III. Conclusion

Notwithstanding the primary concerns Nodal has described herein, existing CFTC requirements already provide a comprehensive regime for Prevailing Model DCOs and their clearing members to protect and mitigate risks associated with holding customer funds. While Nodal supports the CFTC's efforts to enhance rules to cover gaps that may exist for Direct Access DCOs, the CFTC should reconsider whether Prevailing Model DCOs should be included in the instant proposal. FCMs provide a multifaceted and additional layer of protection for customers under the Prevailing Model. Therefore, Nodal recommends that the Commission withdraw the Proposed Rule and consider whether it is more appropriate to issue a targeted rule for Direct Access DCOs.

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Nodal Clear appreciates the opportunity to comment on the NOPR. If you have any questions regarding these comments, please do not hesitate to contact the undersigned.

Respectfully submitted,

/s/ Ken McCracken

Ken McCracken
General Counsel

/s/ Cody Alvarez

Cody Alvarez
Chief Compliance Officer &
Corporate Counsel



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