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,

Americans for Financial Reform Education Fund and Demand Progress Education Fund appreciate the opportunity to comment on this notice of proposed rulemaking.

Overall, we are concerned that the rule as proposed fails to adequately address customer protection risks and other risks that would likely be amplified for market participants should the Commission allow for the more widespread use of a direct-to-retail market structure that does away with the traditional role that Futures Commission Merchants (FCMs) typically provide under the Commodities Exchange Act. While the aspects of this rule that seek to address bankruptcy protections for customer or market participants are important, they address only one facet of customer protection and are not sufficient on their own to address the additional customer and market risks posed by this trading model.

Lack of adequate customer protections

We share many of the concerns about customer protection that Commissioners Romero and Johnson raised in their statements regarding the proposed rule.[2]

In particular, the direct-to-retail market structure outlined in this NPR effectively removes FCMs from the traditional market model that typically applies to CFTC-regulated markets and entities. That model relies on an interrelationship between FCMs, Derivatives Clearing Organizations (DCOs) and customers that is used to manage, distribute, and mitigate risks. In that model, investors rely on FCMs, or alternatively broker-dealers, for various aspects of customer protection. For example, FCMs and broker dealers are sometimes able to insulate their customers from swings in markets that result in margin calls and the liquidations of trader positions. Additionally, FCMs provide a measure of customer protection regarding issues such as conflicts of interest, suitability, best execution, disclosures, and other measures.

However, under this rule, retail participants would no longer be considered FCM customers, but would be "members" of Derivatives Clearing Organizations. This effectively means that retail

[1] https://www.cftc.gov/sites/default/files/2024/01/2023-28767a.pdf
[2] Appendix 3—Statement of Commissioner Kristin N. Johnson, FR, pp. 301-304; Appendix 4 – Dissenting Statement of Commissioner Christy Goldsmith Romero, pp. 304-306.

customers engaging with the services provided approved under this direct-to-retail model would no longer have the same customer protections provided under the current model by FCMs. Instead, they would be considered market participants themselves, interacting more directly with DCOs or similar actors, exposing them more directly to market volatility.

Broadly speaking, members of DCOs have traditionally been large, sophisticated, well-resourced investors or investment firms. The notion that a retail customer of a crypto service provider, who is in many cases quite literally an individual opening an application on their phone to trade crypto assets, should now be considered by default to be investors in that same class – with comparable levels of sophistication, risk appetite, and ability to sustain losses due to market swings – seems risky and ill-advised. Additionally, as noted by Commissioner Romero in her dissent, we agree it's unclear if retail customers would be aware of how this change in status with respect to other market participants would affect them.

These potential risks are likely to be exacerbated by the fact that the Commodities Exchange Act provides no formal definition for a retail customer/investor. This lack of definition has been mitigated somewhat within the traditional market structure by the roles that FCMs have played, but under this proposed direct-to-retail model, this lack of definition leaves customers more exposed.

Increased market stability risks

Automated trading, especially in crypto markets, has the potential to amplify market stability risks, especially since crypto markets continue to suffer from frequent instances of market manipulation. For example, since trading activity on crypto platforms, including those relying on automated trading facilities, can occur twenty-four hours a day, seven days a week, there is a larger period wherein market manipulation or volatility events can occur. Paradoxically, since there is less trading activity on these 24/7 platforms outside of conventional business hours, there can also be periods where fewer market participants are trading, which creates stretches of illiquidity. Such periods can trigger destabilizing events, which can trigger automated margin calls, at a time precisely when many traders are offline, and not monitoring their positions, increasing their exposure to margin calls they may be less able or prepared to cover. Market actors can also exploit these conditions to trigger margin call liquidations against competitors.

With a traditional FCM model, FCMs can act as buffers during liquidation events, mutualizing the losses amongst more than one FCM clearing member. Without an FCM, DCOs are directly exposed to the credit and credit risk of market participants, and vice versa. The DTC model is supposed to be able to account for this risk by using automation to conduct real-time updates (or near real-time) of margin risks for its platform users, and by requiring its members to post required margins for their positions. But, given the crypto market's record of volatility and manipulation, these standards seem like a low bar to set and are not a substitute for the traditional buffer FCMs can provide (and even the traditional model remains vulnerable to similar patterns).

Lastly, while we acknowledge and appreciate the extension of the deadline to submit comments on this proposed rule, we remain concerned that the process to evaluate and finalize this rule nonetheless appears incomplete and is moving forward despite significant unanswered questions. As Members of this Commission noted in their statements with respect to the proposed rule[3], in October 2022 the Financial Stability Oversight Council recommended that the Commission undertake an assessment of what impacts vertically integrated market structures (such as those allowed under this proposed rule) might have on conflicts of interest and market volatility.[4] That assessment has not been conducted, but the agency has moved ahead, even approving petitions for direct-to-retail market structures prior to notice of this rule.

We believe these actions are premature, and overlooking the potential of conflicts of interests present within this model ignores lessons from the recent failures within the digital asset marketplace – notably the collapse of FTX, a major proponent of the direct-to-retail model whose Ledger X petition before this Commission created significant concerns even prior to the platform's failure in 2022.[5]

We urge the Commission to delay moving forward with the rule as proposed until these risks can be better understood and more adequately addressed. Ultimately, we ask the Commission to consider whether a direct-to-retail model is consistent with the Commission's principles and responsibilities under the Commodities Exchange Act. We urge the Commission not to move forward, but if the Commission does establish more formal rules allowing direct-to-retail models, it should swiftly develop (in concert with other policymakers as appropriate) a clear and robust definition of retail customer or investor under the Commodities Exchange Act.

Thank you for your time and for your consideration of this comment.

-Mark Hays

Senior Policy Analyst

Americans for Financial Reform Education Fund/Demand Progress Education Fund

markhays@ourfinancialsecurity.org

---

[3] Appendix 3—Statement of Commissioner Kristin N. Johnson, FR, pp. 301-304; Appendix 4 – Dissenting Statement of Commissioner Christy Goldsmith Romero, pp. 304-306.

[4] https://home.treasury.gov/news/press-releases/jy1171

[5] https://www.coindesk.com/policy/2022/11/08/ftxs-push-for-us-crypto-clearing-left-in-suspense-by-binance-deal/