

Clemson University

Allowing Approved Introducing Brokers Direct Submission of Derivatives Contracts to Foreign
Boards of Trade on Behalf of U.S. Clients

In Support of Foreign Boards of Trade Proposal by the Commodity Futures Trading Commission

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1. Introduction

The Commodity Futures Trading Commission (CFTC or Commission) proposes an amendment to Part 48 of the Commission's regulations, which was created in effect of section 738 of the Dodd-Frank Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act, often shortened to the Dodd-Frank Act, came about as a result of the Great Recession and enacted a near-total overhaul of the United States' financial regulatory system. One key aspect of this reform was its changes to the Commodity Exchange Act, a 1936 Act which established federal regulation of all commodities and futures trading via organized exchanges (not dissimilar to retail brokerage exchanges). The essential effect of these changes is that they allowed the CFTC to oversee regulation of the swaps market, which now has a notional value estimated at over \$400 trillion. In this way, the Dodd-Frank act allowed the Commission to exert greater control over the derivatives market as a whole by allowing them to begin regulating a new asset class. In a keynote address by Scott D. O'Malia, at the 2014 Bank of Canada International Economic Analysis Workshop on Financialization of Commodity Markets, the former Commissioner claimed that the "two fundamental goals of the Dodd-Frank Act were to increase the transparency and integrity of the swaps markets" (O'Malia). Now, the CFTC is attempting to revise sections of Part 48 as it feels that it has had adequate time to note regulatory inefficiencies. These revisions are titled "Foreign Boards of Trade" and were proposed March 1st, 2024. They are largely focused around the manner in which introducing brokers (IB) should be allowed to submit orders for commodity derivative contracts directly to a foreign board of trade's (FBOT's) trading system on behalf of U.S. customers.

2. Working Definitions & Impacted Parties

A few working definitions are required prior to comment on the Commission's Foreign Boards of Trade proposal. An introducing broker should be considered a representative on the customer side, or front-end, of derivative contract orders because they are responsible for client services. IB's essentially facilitate the transaction by connecting clientele to the financial service provider which (likely) handles the execution, clearing, and settlement of payments in a transaction—in the context of this proposal, the term given to the securities dealers who are responsible for executing a customer's trade, as well as holding their cash and securities, is that of Futures Commission Merchant (FCM). Other, similar entities that execute derivatives trades in FBOTs are commodity pool operators (CPOs), and commodity trading advisors (CTAs), though they are less impacted by this proposal. In general, these forms of entity are referred to as the "clearing broker." IB's typically receive a commission for referring clients to these securities dealers, which is linked to the trading activity of a client's account. For this paper, FBOT's are organized exchanges, or marketplaces, where commodities are sold outside of the U.S. and its territories. The most immediately familiar marketplace to the average reader is the New York Stock Exchange (NYSE) on Wall Street—the visual of traders and brokers shouting trade orders at each other is useful to understanding the work being performed by FBOT's, but it is important to note that the majority of these transactions are now performed online using brokerage software—especially in international trades. It is equally important to note that the NYSE is not a derivatives marketplace (New York *Stock* Exchange); the largest derivatives marketplace domestically is the Chicago Mercantile Exchange (CME), which consists of four primary exchanges operated by the CME Group, and the second largest is the Intercontinental Exchange (ICE) which is headquartered in Atlanta, Georgia.

3. Basic Profit Structure of Derivatives

A basic understanding of derivatives and how traders profit from trading them is necessary to comprehend the proposed regulatory changes. Derivatives are a financial instrument which *derive* their value from the expectations for future performance of an underlying asset. For example, a put option on oil futures would increase in value when the market believes that the difference between oil's future value and present value is growing. This means that the value of oil itself may be decreasing, while the call option's value is increasing, because the owner of the put option is able to sell their position at a predetermined price even if the market value of oil is substantially lower. The profit for the trader is the amount they agreed to sell the position for, less the current market value of the underlying asset—that is, profitability increases at the same rate as does the difference between the two prices (barring leverage infusion). It is this form of security, as well as a variety of other forms of derivative contracts with similar profit structures, that the CMTC is tasked with overseeing.

4. Proposed Regulatory Changes

The changes proposed in Foreign Boards of Trade are most consequential to §48.4, but also include stipulations affecting §48.6, §48.8, and §48.9. As of right now, §48.4 limits the types of trade intermediaries that are eligible to directly access FBOTs trade-matching software for entering orders on customer's behalf to FCMs, CPOs, and CTAs. The Commission proposes that all IBs registered with regulatory agencies should be added to the list of approved intermediaries. This would allow all of the 920 IBs registered with the National Futures Association (NFA) to enter client trades directly into the trade-matching software of FBOTs. The proposed change to §48.6 is relatively straightforward: the Commission would like to delete this section as it describes a discontinued approval procedure relying on staff no-action letters. §48.8 is, more or

less, an extension of the changes proposed in §48.4. This subsection provides the conditions that an entity must meet in order to be approved for direct access to trade-matching interfaces of FBOTs. The proposed policy adjustments in this section are largely focused on updating language to include IBs alongside FCMs, CPOs, and CTAs, though there is also a request to include the phrase “registered as such” in §48.8(a)(4)(ii) to clarify that these entities must be approved by regulators before utilizing foreign order-matching software. The changes proposed in §48.9 largely focus on changing the necessary procedure for FBOTs themselves to request revocation of Commission approval. In this way, a trade board would be made capable of requesting that CFTC-approved entities halt trading on their exchanges.

5. Comments

Because it is believed that only §48.4 contains consequential regulatory changes, and that the proposed changes to other subsections merely serve to reconcile its alterations, this paper will seek to respond to requests for comment on §48.4 only. The first request for comment focuses on unintended consequences from allowing IBs to submit trade requests directly to FBOTs. The first and most important effect of this change is increased order flow. As noted, the NFA is tasked with registering IBs, and has approved 920 unique entities to fill the client-side of order matching (as of the time of writing). These IBs promote market efficiency by connecting clients with institutions capable of handling their trades; in this way, orders that were previously unable to be filled due to a distinct lack of regulatory framework will be executable. There are a wide array of arbitrage strategies, namely high frequency statistical arbitrage, in which profitability increases alongside order flow imbalances (Wang et al. 523). Order flow imbalances will only be exacerbated in the direction of market movement when allowing a new form of entity to submit orders to trade-matching systems; given that IBs would represent 26.7753% of

eligible trade executors should this proposal be approved, it is expected that there will be a similar increase in order flow to FBOT's software ("Membership").

Because IBs generally serve private clients, retail traders, and other small accounts incapable of directly accessing FBOTs due to insufficient trade volume, it is predicted that order flow will increase at a proportionally smaller rate than does the number of approved entities. This, combined with the heightened application of volume-dependent arbitrage, suggests that there will be a large influx of American capital into overseas derivatives markets. This is not expected to result in inflation, as the funds used in trades will most likely be pulled from domestic commodity exchanges to pursue more favorable trades abroad rather than from freshly infused liquidity. The most glaring negative effect is predicted to be an outflow of capital from U.S. accounts into foreign markets. While it is extremely unlikely that this would lead to a liquidity squeeze, there is a large amount of literature on the negative effects of financial outflows in capital markets. However, it is believed that the net proceeds of the trades matched and executed by FBOTs will be transferred back to client's domestic accounts, and, ultimately, any realized gains will return to the pockets of U.S. consumers. In this way, the inadvertent consequences of this proposal are forecasted to result in negligible effects on domestic derivatives markets and available capital, respectively. The only meaningful effect is to the geographical location in which trades are executed, as traders may utilize FBOTs without changing the nature of their orders. Thus, the proposed changes to §48.4 are recommended to be enacted.

The Commission seeks comment on a second proposed modification to requirement §48.4, which focuses on the manner in which registered FCMs must act as the clearing firm for IBs transactions. This is a logical step because IBs facilitate only the front-end of

transactions—that is, these firms will be required to find a carrying broker in a FBOT as they do domestically. While it may be inefficient to allow only FCMs registered with the CFTC to execute these trades, given that foreign clearing brokers likely have preexisting market synergies, this method of trade pooling minimizes the financial risk associated with lack of regulation. It may be true that marginal profits will be lost due to the limitation of eligible clearing brokers, but it is noted that this framework is modeled on domestic trade-matching requirements for IBs. In this way, foregone marginal profits simply represent a deadweight loss, or a natural consequence of introducing the proposed regulatory changes. It is perplexing, however, that the Commission does not provide leniency for self-clearing firms. The CFTC seeks comment on whether firms approved for direct-clearing by an FBOT itself will utilize IBs to submit orders to the same FBOT. The key consideration for this change is whether or not a firm will submit orders via IBs for execution by FCMs despite being approved to submit orders directly to market makers. It is recommended that the Commission does not require these entities to utilize the services of IBs, but also not prevent them from doing so. This framework promotes market efficiency by allowing direct-clearing brokers to utilize IB facilitation capabilities only when the expected cost is less than the expected cost of submitting trades to order-matching software themselves. It is believed that providing this option will allow for the private reconciliation of regulatory inefficiencies.

A final piece of noteworthy regulatory change is found in the Foreign Boards of Trade proposal. This change focuses on requiring all transactions facilitated by IBs to be guaranteed by an FCM, without extending this condition to previously exempt FCMs. The Commission believes that permitting firms that are exempt from FCM registration to execute trades on behalf of an IB in an FBOT would violate the anti-money laundering requirements of the Bank Secrecy

Act. This request appears to rely on jargon in order to develop the illusion of complexity. If all other forms of entity must register with the CFTC in order to submit transactions to FBOT order-matching services, it is logical that this condition would extend to FCMs. In other words, if IBs have to register with the Commission in order to submit client transactions to foreign derivatives exchanges, it would be foolish not to require the clearing broker to do the same. As such, if non-registered firms believe that registering will create positive net present value, they will proceed to register in order to receive commissions on IB-dependent transactions. Thus, the market will function as a natural experiment in regards to the effects of introducing the proposed changes: unregistered clearing brokers will continue to operate as they did before changes were enacted, while registered FCMs will experience the effects of guaranteeing trades submitted by IBs. It is crucial that unregistered clearing agents are not required to guarantee IB transactions because it allows regulators to compare the effectiveness of their changes in real time using a treatment and control group.

6. Conclusion

It is believed that the Commission should enact the changes contained in its' Foreign Boards of Trade proposal. The CFTC sought comment on §48.4, §48.6, §48.8, and §48.9, but it is believed that only §48.4 will have consequential effects on the market itself. The remaining changes are largely aimed at updating language to be in compliance with changes to §48.4, which would allow introducing brokers to submit transactions to FBOTs on behalf of U.S. clientele. The expected consequences of regulatory changes to §48.4 are increased order flow and increased volume of associated trading strategies, the allowance of self-clearing firms to access IBs when efficient, and a natural experiment to determine the effects of these changes on

FCMs specifically. These changes are believed to promote market efficiency while expanding the scope of entities regulated by the CFTC and NFA, respectively.

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Note: I've attached the background info for the entire rule proposal & comment requests for §48.4 only. I thought this was more helpful than attaching the actual first page of the proposal.

I. Background

Under part 48 of the Commission's regulations, an FBOT must be registered with the Commission in order to provide its members or other participants located in the United States with direct access to its electronic trading and order matching system.⁽²⁾ Part 48 is authorized by section 738 of the Dodd-Frank Act, which amended section 4(b) of the Commodity Exchange Act (CEA), to provide that the Commission may adopt rules and regulations requiring FBOTs that wish to provide U.S. persons with direct access to register with the Commission.³ Prior to enactment of the part 48 FBOT registration procedures in 2011, FBOTs relied on no-action letters that were requested by the FBOT and granted by Commission staff in order to provide direct access to U.S. persons.⁽⁴⁾

Part 48 provides the procedures, requirements, and conditions to be met by FBOTs that seek to provide their members and other participants in the U.S. with direct access to the FBOT's trade matching system. The regulations set forth, among other things, procedures an FBOT must follow in applying for registration, requirements that an FBOT must meet in order to obtain registration, conditions that an FBOT must satisfy on a continuing basis upon obtaining registration, and provisions for the termination of registration.

The Commission has not amended part 48 since it was first promulgated in 2011. Based on the Commission's experience engaging with registered FBOTs and applying part 48 over the ensuing years, the Commission is proposing certain amendments to the regulation. The proposed amendments are limited in scope and would not change the overall registration structure or framework of part 48. Rather, the proposal would amend §48.4 to broaden the types of intermediaries eligible for direct access for submission of customer orders to the FBOT to include IBs registered with the Commission as such and located in the United States.⁽⁵⁾ An IB is generally defined as an individual or organization that solicits or accepts orders to buy or sell futures contracts, commodity options, retail off-exchange forex or commodity contracts, or swaps, but does not accept money or other assets from customers to support these orders.⁽⁶⁾ Currently, §48.4 only includes certain futures commission merchants (FCMs), commodity pool operators (CPOs), and commodity trading advisors (CTAs) as intermediaries that are eligible for entering orders on behalf of customers or commodity pools (in the case of CPOs) via direct access on a registered FBOT.

In addition, the proposed amendments would amend §48.9 to provide registered FBOTs with a procedure to request revocation of their FBOT registration. Further, the Commission proposes to delete §48.6, which provides for an alternate registration procedure for FBOTs acting under the preexisting staff no-action letter process, because such no-action letter process and no-action letters are no longer in effect.

Request for Comment

The Commission requests comments on all aspects of the proposal to amend §48.4(b) to permit registered FBOTs to provide direct access to eligible IBs to enter orders directly into the FBOT's trading and order matching system on behalf of customers, provided that all trades effected through submission of U.S. customer orders are guaranteed by a registered FCM or a firm exempt from FCM registration pursuant to §30.10. In particular, the Commission requests comment on the following questions.

- (1) Would extending direct access eligibility to eligible IBs for the purpose of submitting customer orders potentially result in any unintended consequences? Is there any reason the Commission should not amend §48.4 to extend direct access eligibility to eligible IBs for the purpose of submitting customer orders? Are there other issues the Commission should address in order to ensure that FBOTs providing direct access to IBs under proposed §48.4(b)(4) does not harm U.S. markets or increase risk to the U.S. economy?
- (2) The proposed regulation would require that an FCM registered with the Commission as such or a firm exempt from such registration pursuant to §30.10 act as a clearing firm and guarantee, without limitation, all trades of the IB effected through submission of orders for U.S. customers to the trading system.
 - (a) Is this condition appropriate? Why or why not?
 - (b) Does "act as a clearing firm and guarantee, without limitation, all trades of the introducing broker" effectively translate to and encapsulate the various comparable foreign regimes and market structures of FBOTs and their clearing organizations? Are there relevant considerations relating to the clearing and guarantee of IB trades that differ from that of CPO and CTA trades?
 - (c) How could this condition impact trades submitted by an IB on behalf of a self-clearing firm? Do direct clearing members of FBOT clearing organizations use IBs to submit their orders to FBOTs? If so, does this proposed condition raise any operational issues, additional costs, or other issues for such direct clearing members (e.g., relating to portfolio margining, risk management, or other)?
- (3) Should the Commission instead require all U.S. customer trades entered by an IB via direct access on a registered FBOT to be guaranteed by a registered FCM (but not extend the condition to firms exempt from FCM registration under §30.10 to carry such trades)? Would permitting firms exempt from FCM registration under §30.10 to carry U.S. customer trades entered by an IB via direct access on a registered FBOT raise any issues with anti-money laundering (AML) requirements under the Bank Secrecy Act and Commission regulations? What would be the effects of requiring such trades to be carried exclusively by clearing members that are registered with the Commission as FCMs?
- (4) Are there additional registration requirements under §48.7 that the Commission should consider for FBOTs that provide direct access to IBs under proposed §48.4(b)(4)?
- (5) In addition to the information that FBOTs provide to the Commission on an ongoing basis under §48.8, is there additional information that the Commission should receive from FBOTs that provide direct access to IBs under proposed §48.4(b)(4), and if so, why? For example, is there additional information that FBOTs could provide to assist the Commission in identifying, evaluating, and addressing situations that may adversely impact consumers, IBs, market participants, and financial markets? Further, please describe whether this information should be provided on a periodic basis (i.e., quarterly or monthly), or event-driven basis (i.e., after a disciplinary action).