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September 28, 2023

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St. N.W.
Washington, DC 20581

Re: Request for Comment on the Impact of Affiliations of Certain CFTC-Regulated Entities

Dear Mr. Kirkpatrick:

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to submit these comments on the Commodity Futures Trading Commission's (the "**Commission**") staff request for comments on the impact of affiliations of certain CFTC-regulated entities (the "**Consultation**").

Our response focuses on questions 1 – 19 regarding the relationship between a Derivatives Clearing Organization ("**DCO**") and an affiliated clearing member ("**CM**") and does not cover the role of DCOs as Self-Regulatory Organizations. As most of the issues covered in the Consultation are applicable to both Futures Commission Merchants ("**FCM**") and Swap Dealers clearing their house business, we will use the term CM in the response, unless a particular consideration applies only to a particular subgroup.

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General Comments

The potential conflicts of interest and mitigants covered in the first part of the Consultation cover two distinct situations:

- A DCO is affiliated with one of many CMs[1]: This setting poses a conflict of interest, which however can be managed through a range of mitigants. The Commission needs to ensure that the bar is set suitably high and that there is robust regulatory enforcement if such mitigants, like information barriers, are not adhered to, in line with other parts of the financial industry.

  Some ISDA members disagree that mitigants (see below) would address the potential risks and believe that the CFTC should not permit affiliated CMs in this situation.

- A DCO with only one FCM which is affiliated to the DCO: Such a set-up (see question 11) would enable direct clearing of customer business by the combination of DCO and FCM but opens up a host of questions that need to be analyzed in detail. We provide some thoughts on these questions under question 11.

Existing Commission regulations do not sufficiently address the potential for conflicts of interest where a DCO has SRO supervisory authority over an affiliated intermediary. Some members believe that the mitigants proposed in the RFC may not adequately address the conflicts of interest inherent in a DCO's relationship with an affiliated intermediary.

Assuming the Commission does not prohibit affiliation between a DCO and one or more CMs, we would prefer the CFTC to provide new principles-based rules to address these conflicts, with granular guidance on potential ways to satisfy the principles, where appropriate. We do not propose "one-size-fits-all" rules, but where conflicts of interest arise from affiliation, whether due to acquisitions by existing registrants, or by new entrants into this regulatory space, fundamental mitigants, such as governance controls and separation of roles are crucial. This is especially true where there is sensitive data or a concern that there may not be a level playing field for all similarly registered entities. It should be pointed out that the current regulatory landscape is an ecosystem of checks and balances that should not be undervalued or discarded without careful consideration.

We also want to point out that any additional financial resources established to address conflicts of interests, or to reduce the likelihood of conflicts, need to be clearly positioned at either the DCO or the FCM so they are dependable and cannot be double-counted.

[1] A special case is a mutualized DCO, i.e. a DCO owned by its CMs. Despite the affiliation, conflicts of interests are less pronounced since no single CM has overall control.

Mitigants

As we lay out in details under the Commission's questions, if a DCO has an affiliated CM, conflicts of interest will arise in instances where the DCO has discretion in the application of its rulebook, such as setting margin requirements, tailoring margin to special portfolios, calibrating margin add-ons, especially for large positions (concentration margin, stress loss margin, credit margin), credit review, managing a default event, liquidating a portfolio and rule enforcement.

Where conflicts of interest cannot be removed, we propose that conflicts from affiliated CMs could be mitigated by a combination of the below mitigants. Some members are however concerned that these mitigants would not address the risk of affiliation fully.

<u>Information barriers</u>

- Implement robust information barriers between the DCO and affiliated CM. These have been applied successfully for decades in other parts of the financial services sector where conflicts may arise, and are supported by a long history of case law.

<u>Transparency/disclosure</u>

- The DCO provides documentation on decisions affecting their affiliated CM with regular review by the Commission of such decisions.
- Maintain transparent rules and processes so that the DCO will be held accountable if it does not uniformly apply those rules across the CMs.
- Thorough disclosures by the affiliated DCO and CM around potential conflicts of interest caused by their affiliation, including to other clearing members.

<u>Governance/supervision</u>

- Enhanced governance around use of discretion:
    - Focus on independent decision-making, potentially including a requirement that key decisions which could be impacted by a perceived or actual conflict of interest be made by a majority independent board or board committee.
    - Increased involvement of DCO's risk management committee ("**RMC**") in cases which affect the affiliated CM. The more independent the RMC is and the more likely the DCO to follow its decisions, the more effective this mitigant would be. Reprimand or retaliation against RMC members that vote against the affiliated CM needs to be prevented.
- Enhanced supervisory focus by the Commission on decisions affecting affiliated entities.[2]

[2] The DCO as Self-Regulatory Organization would be too conflicted to play this role.

- Potential requirement for explicit regulatory approval for use of discretion by the DCO impacting the affiliated CM (e.g., in default/recovery/resolution).
- Establish a forum for stakeholders to bring complaints if they feel that discretion has been misused.

Resources

- Increase the tranche of DCO equity in the default waterfall, so called 'skin-in-the game' ("**SITG**"), or incorporate a segmented section of SITG that applies in the case of losses associated with the affiliated CM.
- Require robust capital and liquidity resources at the affiliated CM as proposed in the Consultation, to reduce the likelihood of the affiliated CM falling into financial stress, assuming these situations are the most obvious opportunities for the DCO to employ discretion. There should be dedicated separate capitalization and liquidity resources for each registered entity with no double-counting allowed. While strong financial resources will reduce the likelihood of situations requiring discretion, we need to prevent the application of pressure by the parent of the DCO not to take any action against the CM that could put the larger CM's resources at risk.
- As conflicts of interest become more significant with the size of the affiliated CM, caps on the size of such affiliated CMs might also be helpful.

Rules

- DCO setting more prescriptive rules for affiliated CMs, even though additional prescription might restrict the required level of flexibility in managing unforeseen risks. Such increased prescriptiveness needs to be carefully balanced against the flexibility required for prudent risk management.

Other

- There should be a principle that the DCO treats all members equally, regardless of affiliation. For example, if a DCO declines to allow one CM to participate in a rebate program, then the DCO's affiliate CM should not be allowed to participate either. We are aware that many of the mitigants proposed in this section would treat the affiliated CM differently than other CMs. This mitigant, however, would address the specific situation of an affiliated CM, which is different from other CMs.
- Reputational risk for the DCO may provide a natural mitigant, especially if the DCO has an established business. Reputation will be the most incentivizing to the DCO if the affiliated CM is small in relation to the size of the DCO's capital and profit.
- As technology evolves, it may give rise to new mitigants, e.g., smart contracts that could reduce the reliance on discretionary actions by the DCO.

ISDA

This response covers the positions of our members on the buy-side and sell-side. The paper does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views.

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ISDA appreciates the opportunity to submit these comments on the Commission's Consultation.

If ISDA can be of any help in this process, we hope that you will not hesitate to contact ISDA's Head of Clearing, Ulrich Karl, at telephone number +44 20 3808 9720 or at UKarl@isda.org.

Sincerely,

Ulrich Karl
Head of Clearing

Appendix: Response to the Commission's questions

We combined responses to questions 1 to 4, see below under question 4.

Question 1. §39.13(g), Margin. Margin requirements are generally based on parameters that are applied uniformly to all clearing members, without the exercise of discretion vis-à-vis individual clearing members. However, some margin-setting may be tailored to specific portfolios (and, thus, to specific clearing members) and there may be some discretion specific to individual clearing members. Are there ways in which such tailoring may be affected by a DCO's affiliation with an FCM? If so, how can this risk effectively be mitigated?

We combined responses to questions 1 to 4, see below under question 4.

Question 2. §39.16, Default rules and procedures. A DCO has discretion to determine whether a clearing member is in default (and this discretion is particularly present for defaults other than payment defaults, e.g., undercapitalization). Moreover, in liquidating the positions of a defaulting clearing member, the DCO has discretion to determine how to do so; different actions may relatively benefit the positions of certain clearing members (including, the affiliate) while disfavoring the positions of other clearing members. Is this a relevant concern if a DCO has an affiliated FCM? If so, how can this issue effectively be mitigated?

We combined responses to questions 1 to 4, see below under question 4.

Question 3. §39.17, Rule enforcement. A DCO has discretion in determining whether a particular clearing member should be investigated, whether a particular course of conduct violates the DCO's rules, and, if so, what discipline is appropriate. If a DCO has an affiliated FCM, will this give rise to potential conflicts? If so, how can they effectively be mitigated?

We combined responses to questions 1 to 4, see below under question 4.

Question 4. General risk management. How will a DCO perform the remaining responsibilities set out above with an affiliated FCM, given the potential conflict of interests? We note that Core Principle P of the Act 11 and §39.25 requires the DCO to "establish and enforce rules to minimize conflicts of interest in the decision-making process," of the DCO.

In general, situations where the DCO has discretion in the application of its rules to an affiliate could give rise to a conflict of interest.

In the case of margin, the DCO could use its discretion to apply a lower margin requirement for the affiliated CM. If the affiliated CM is an FCM, such lower margin requirement could be passed on by the affiliated FCM towards its clients, in order to achieve a competitive advantage over other, non-affiliated FCMs. This could not only weaken other FCMs commercially, but also the DCO itself and other CMs, as any default of the affiliated CM might be more costly due to insufficient margin at the DCO.

The DCO might also be disincentivized from using higher margin requirements or margin calls to address issues at other CMs if the affiliated CM is in a similar situation and the DCO wants to avoid punitive measures being applied to the affiliated CM.

In relation to large position margin calibration (concentration margin add-on, stress loss margin add-on, etc.), the DCO may calibrate margin levels to reduce/eliminate the impact on the affiliate CM, increasing the risk of losses to other CM.

Most DCOs use internal credit rating models that include high levels of subjectivity and discretion. The result of a lower credit rating could result in higher margin, lower intra-day extension of credit (more frequent intra-day calls or higher liquidity need at a CM), lower (soft) position limits, etc. The DCO's credit staff may assign a higher rating to an affiliate, shielding the affiliate from negative repercussions, and/or may assign a lower rating to competitors, increasing costs.

In relation to default management, there are two concerns:

While DCO rulebooks are clear on what constitutes a default, the DCO might delay the default of its affiliated CM and thereby make the default more costly. Should the default be more costly than the DCO's capital contribution to the default waterfall, through the so-called "skin-in-the-game" ("**SITG**"), such a delay might be at the expense of non-defaulted, non-affiliated CMs through using their guaranty fund contributions. On top of this, the liquidation of the affiliated CM's positions could be more costly to other clearing members. For instance, the affiliated CM's positions could be closed out at a price higher than necessary (so the non-defaulting/non-affiliated FCMs would have to pay more), or by invoking partial tear-ups at an earlier stage.

Secondly, if a non-affiliated CM defaults, the affiliated CM might be advantaged during the hedging process or the liquidation/auction process. During default management, the DCO usually has discretion about its hedging counterparty and on who to invite to bid in the auction. Either of this could be directed to the affiliated CM if attractive, or away from the affiliated CM if not attractive.

Key mitigant across all of these conflicts of interests are separation of functions and information barriers. For issues around margin and default management, two complementary mitigants could be effective:

- One the one hand the DCO could have extremely prescriptive margin rules to minimize the need for judgment calls in relation to the affiliated CM. As flexibility is important in risk management, such increased prescriptiveness needs to be balanced against the impact of lost flexibility.
- On the other hand, the affiliated CM should have robust resources (capital and liquidity) to make situations where DCO risk managers would have to employ discretion extremely unlikely.

An additional mitigant would be a requirement that the DCO not treat its affiliate CM with any more latitude than it treats every other CM. The DCO should be required to document and be able to evidence to the Commission that the affiliated CM is treated equally to its other CMs.

Conflicts of interest around conduct compliance cannot be solved by additional resources at the affiliated CM (alone), or by asking the affiliated CM to act in an exemplary way, since all CMs should be held to the same high standard.

Such conflicts however could be addressed by mitigants already mentioned, especially separation of functions and information barriers.

The situation is different depending on the type of affiliation: if CMs are not only clearing members of the DCO, but also have financial participation in the DCO (e.g., a mutualized structure or minority ownership stakes), then the DCO would be affiliated to all CM, but in this particular case competing CM have the common interest of a well-functioning DCO. In addition, in this circumstance, the DCO would not have majority control of any individual CM and vice-versa, meaning that the conflicts of interest are less acute.

Question 5. Contagion risk to DCO. One risk to the DCO may be that clearing members and/or clients lose confidence in the DCO and consequently start a "run" (e.g., through rapidly closing positions and withdrawing margin) because of a failure or perception of an imminent failure of an affiliated FCM. How can a DCO with an affiliated clearing member provide assurance that it possesses the ability to manage contagion risk in this context? How should the Commission consider and address contagion risk in this context?

We combined responses to questions 5 and 6, see below under question 6.

Question 6. Contagion risk to FCM. An analogous risk to the affiliated FCM may be that customers or other counterparties lose confidence in the FCM and consequently start a "run" (e.g., through rapidly closing positions and withdrawing margin or through refusing to extend normal credit) because of a failure of an affiliated DCO. How can an FCM with an affiliated DCO provide assurance that it possesses the ability to manage contagion risk in this context? How should the Commission consider and address contagion risk in this context?

We agree that there is the risk of contagion between an affiliated CM and DCO. The degree of risk of contagion depends on the share of the affiliated CM of the DCO's market, and on the size of the FCM in relation to the DCO's size, for example the size of the CM compared to the DCO's capital, liquidity resources etc., among other factors. If the affiliated CM is reasonably small, issues at this CM would not likely cause a "run" on the affiliated DCO and vice versa.

We believe that in the situation introduced in question 6, a run on the affiliated CM driven by issues at the DCO, concerns about a failure or potential failure at the DCO, which will affect the whole membership of the DCO, will overshadow concerns about the affiliated CM.

To mitigate this contagion risk, at a minimum both the DCO and its affiliated CM would have to plan for this risk, including reserving more capital, SITG and liquidity resources. The recovery plan of the DCO would need to include any contagion risks at the affiliated CM. Increased resources for the CM's recovery and recapitalization to reduce reliance on the parent entity should also be considered. As with all confidence problems, making these plans transparent to other CMs or the wider market could be very helpful.

While clear plans and increased resources would make issues that could lead to concerns of market participants less likely, once there are concerns, contagion risk will be very difficult to manage.

As the risk of contagion increases with the share of the affiliated CM in the DCO's clearing volumes, a limit on the size of an affiliate might also be a suitable solution.

Question 7. Financial/liquidity resources. The financial or liquidity resources of the DCO and affiliated FCM may need to be tapped effectively simultaneously in the case of FCM or DCO weakness/failure. Does this raise a significant concern? How could the relationship between a DCO and an affiliated FCM be structured to reduce this concern?

One potential mitigant for this risk might be a requirement for a DCO with an affiliated FCM to have additional financial resources, for example, sufficient supplementary default and liquidity resources to cover (under stress conditions) the default of the affiliate in addition to the DCO's current Cover 1 or Cover 2 requirements pursuant to, as appropriate, §39.11(a)(1)/§39.33(a) and §39.11(e)(1)(ii) /§39.33(c).

As mentioned in the responses to the questions above, one key mitigant to conflicts of interests between DCO and affiliated CMs will be robust resources (capital and liquidity) at the affiliated CM, to reduce the likelihood of any situation where discretion is used and conflicts of interests arise. Additional financial resources at the DCO could also help, for instance to mitigate contagion risks (see questions 5 and 6). Those supplementary resources should be funded by the DCO/CM rather than by the rest of the membership.

If multiple entities in a group rely on parental guarantees, said funding needs to be segregated to ensure availability. Unaffiliated CMs should not have higher costs because of the affiliated CM.

The DCO and affiliated CM should be separately capitalized, and have separate sources of funding, so that either may survive the other depending on the circumstance. The other clearing members should not be at increased financial risk because the DCO has an affiliate CM. Note that the affiliate CM could be a member of more than its affiliate DCO and should not be allowed to pose more of a risk to the industry than any other CM.

Wherever these additional resources are kept, these resources should be counted once, not twice, for each purpose, and be separate so as to avoid simultaneous tapping. There is still a risk of contagion if resources beyond pre-funded dedicated resources need to be utilized, e.g. additional assessments when the pre-funded guaranty fund is depleted. This could then hit the DCO's resources.

Clear information barriers and organizational separation between the DCO and its affiliated CM will also be important.

a. To what extent would this approach effectively mitigate conflict issues?

Additional resources at the DCO might reduce conflicts of interests somewhat, but might also drive additional conflicts of interest, for instance in relation to the design of stress scenarios. While it might not be guaranteed that additional resources at the affiliated CM would ensure this CM will not get into a situation where the CM does require discretion, additional resources at the CM would not drive additional conflicts in relation to stress scenarios as suggested above.

We also note that a larger guarantee fund would pose costs to other CM.

b. Might there be conflicts in designing and conducting stress testing to determine the amount of resources required?

See above.

c. Should there be restrictions on how a DCO could source any additional default resources? For example, should any supplemental resources be sourced solely from the DCO and its affiliate, or should it be permissible for the supplemental resources to be sourced from non-affiliated clearing members?

If the DCO would not be allowed to mutualize losses from the default of its affiliated CM, conflicts of interests would reduce significantly. DCOs should have the same reputational risk as bank holding companies have with their subsidiaries, and stand behind these entities.

A solution to this could be to require meaningful additional skin-in-the-game for defaults that involve the affiliated CM.

Question 8. Information. If a DCO is affiliated with an FCM, what might be the impact on the DCO's ability, in its role as a risk manager, to obtain information from other clearing members? Might other members be less willing to provide information if they view the DCO as something other than as market neutral?

How can such impacts effectively be mitigated? Are the information sharing restrictions that DCOs typically have in their rulebooks sufficient to provide confidence to other members that they will not share information about those other clearing members with any affiliated FCMs?

While there is a danger on information of non-affiliated members being shared with the affiliated CM, this is a situation for which information barriers were designed. These barriers work well in other contexts, for instance between the clearing and the trading business of a CM.

Such barriers need to be clearly documented, supervised, and enforced against, where necessary.

This should include not only information barriers, but also separation of duties, and something along the lines of CFTC regulations §1.71 on clearing conflicts prohibitions.

Another mitigant would be reputational risk: the reputational consequences for the DCO if it were to violate informational barriers could be extreme. A DCO is a regulator of its members and can compel them to provide itself with proprietary information (e.g., the identities of their clients). If it were determined that a DCO shared such information with its affiliated CM, this would pose a huge risk to the DCO's franchise. We are however also concerned that a risk to the DCOs franchise is not only a risk for the DCO, but could also evolve into a risk to its stability, and to the stability of the market it serves.

Question 9. Resource sharing. What limits, if any, should there be on DCOs sharing resources (personnel, technology, etc.) with affiliated FCMs? Are there conceptual differences between the sharing of personnel between a DCO and DCM that has historically occurred, on the one hand, and the sharing of personnel between a DCO and an FCM, on the other? Might overlap of personnel exacerbate the concerns raised in Question 8 above with respect to clearing members providing information to a DCO with an affiliated FCM in its role as a risk manager? Might some required separation of duties mitigate these difficulties?

Whether resource sharing would be permissible or not depends on what resources are shared.

It is difficult to see how sharing of staff would be compatible with appropriate information barriers, whereas sharing of other resources might pose less of a problem.

Sharing resources could also pose competition concerns if the affiliated CM could achieve cost savings or better access to the DCO's systems compared to other CMs.

a. To the extent that DCO and FCM personnel are separate, are there "ethical walls" or other information barriers that might be appropriate? To make such information barriers effective, would there be a need for personnel to be located in separate physical space?

One key mitigant to conflicts of interests between a DCO and an affiliated CM are information barriers. Information barriers are not possible if personnel is shared. There are also different goals and incentives: DCOs and DCMs have the functioning of a whole market as their primary focus, whereas for a CM its own functioning comes first (of course impacted by the functioning of the markets).

Also, the DCM or DCO should not be permitted to share information obtained from non-affiliated CMs for the benefit of their affiliate CM. Clearing members share a lot of confidential proprietary information that should not be passed along to create a competitive advantage for the affiliate CM.

For effective information barriers, staff should be located in separate physical spaces with strict access control. There also needs to be separate reporting lines or even separate legal entities. This would be in line with how CMs implement information barriers between their trading and clearing businesses.

The robustness of information barriers between a DCO and an affiliated CM would be directly related to the consequences for the DCO for failure to respect such barriers. A securities firm regulated by the SEC establishes information barriers because the consequences for its violation of the relevant securities laws would be severe, and could include civil and criminal liability, regulatory fines and the potential that the firm could not continue to engage in a full-service business model. It is unclear what the penalty would be for a DCO that failed to abide by restrictions on sharing of information with an affiliated CM. There is also a question as to who would be tasked with monitoring the DCO's compliance. We do think information barriers are a good mitigant, but only to the extent there is a robust regulatory framework behind such mechanisms.

b. Are there certain areas, or instances, where the sharing of personnel, technology, etc. would provide benefits to the marketplace (e.g. cost efficiencies, reduced complexity), that would outweigh potential concerns?

Other than a case where a small DCO can reduce its cost by sharing resources with its affiliated CM, it is very difficult to envisage cases where resource sharing between DCO and affiliated CM will provide benefits to the whole market. As we mention elsewhere, conflicts of interest become worse the larger the affiliated CM is in comparison to the non-affiliated CMs. Therefore, such savings would likely not be significant enough to provide benefits to the whole marketplace. This is especially so as only resources like data centers or buildings can be shared, not personnel. It might be better for the DCO to look at services that provide cost efficiencies or reduced complexity for all CMs, not only for the affiliated CM.

c. Are there particular functional areas that present more or less potential for conflicts, e.g., sales, operations, IT development, risk management, treasury, credit management?

All these areas have their own potential for conflicts, and are difficult to compare. As mentioned above, sharing of business functions (other than data centers) would not be consistent with appropriate information barriers and should be avoided. On the other hand, the sharing of data centers, buildings, building management or other services not directly linked to clearing, like fleet management, central purchasing might not cause concerns.

Question 10. Competitive effects. Are there competitive implications of allowing a DCO to affiliate with an FCM? Are there specific effects of this affiliation which may be detrimental? Would any effects be helpful to competition? Are there effective mitigants?

We do not see how any affiliation of one CM to the DCO will be helpful for competition. There are a number of mitigants available that might limit the impact of an affiliated CM on other CMs and the marketplace (see above and under questions 13-15). A lot will depend on the size of the affiliated CM compared to other CMs, its business, its resources, and documentation of its relationship to the DCO, including potentially more prescriptive rules in relation to the CM. All of this would require close supervision and could be aided by increased transparency to other CMs.

If not appropriately mitigated, conflicts of interest (or even perceived conflicts of interest) could have an anti-competitive effect, as they could discourage other CMs from clearing at that DCO if they think they are being, or will be, treated unfairly.

We are also concerned that the establishment of an affiliated FCM could already affect competition: other CMs could, through their clearing fees, indirectly fund a competitor.

Question 11. Organizational Structure – Single FCM. Are there concerns raised if a DCO operates with a single affiliated FCM clearing member (and has no other clearing members)? What concerns are raised if there is a single affiliated FCM and other non-affiliated, non-FCM clearing members? In either of those circumstances, are the concerns unique to the fact that the single FCM is an affiliate of the DCO? What concerns are raised if a DCO has an affiliated FCM, and one or more non-affiliated FCMs, and the affiliated FCM is responsible for the bulk of the volume at the DCO?

A DCO with only one FCM which is affiliated, raises a different set of issues. We discuss some complications and issues arising from such a structure below, but would ask for further study and consultations by the Commission before allowing such a structure.

The DCO will not have the benefit of a large number of clearing members. These benefits provided by clearing members include:

- Participation in the governance of the DCO, providing a different set of points of views to be considered on key issues of risk management.
- FCMs guarantee their clients to the DCO, providing risk absorbency in the system and reducing risk at the level of the DCO.
- Participation in mutualization, meaning that there would be a smaller and less diversified pool of resources available to cover losses in the case of a default.
- Operational support of customers, including paying intraday margin on behalf of these customers.
- Assessment of the suitability of the products cleared and risk taken by a customer using the DCO, which is subject to challenge by the CMs.
- Onboarding of customers, including know-your-customer ("**KYC**") and anti-money-laundering ("**AML**") checks.
- Participation in default management, especially by providing hedges for the defaulter's portfolio and by bidding in an auction.
- Having many well capitalized CMs at a CCP that guarantee clients and participate in mutualization and recovery.

Such a DCO would have to overcome a considerable set of issues.

The affiliated FCM would have to set up processes for due diligence on potentially many customers. Even if the DCO is not concerned about credit risk, for example because its margin model and default management processes are geared to quickly close out customers that cannot provide margin anymore, the affiliated FCM would still have to do KYC, AML, and suitability checks.

The DCO would have to provide suitable resources to compensate for the loss of mutualization and the shock-absorber function of CMs. Also, there would not be a large number of FCMs, which, in the classic clearing model, guarantee clients to the DCO.

The one affiliated FCM would protect the DCO from default risk of its customers (by definition all of the customers of the DCO/FCM construct). This means that default management would not be performed by the DCO, but by the single FCM. The FCM would require considerable capital and liquid resources for this eventuality and would pose a single point of failure.

As there is only one FCM and no mutualization, and the FCM in this situation would be less diversified, these FCM resources would also need to include an equivalent to the DCO's default fund, which would have to be sized appropriately. It is unlikely that a cover-2 standard would be sufficient if there are many direct customers. More work would be required to establish how to size and structure the resources required for a FCM clearing for all customers of the DCO.

It would be unclear who would provide market liquidity to close out portfolios of failing customers. As the (one) FCM would technically shield the DCO from customer losses, it would fall to the FCM to deal with customer default management. It would not be prudent if this FCM were to take the market risk of defaulted customers, absent any roster of other FCMs that could take over the function of the single FCM. In the futures world, DCOs do not (solely) rely on clearing members, but often sell portfolios of defaulted clearing members to clients. This solution would also be open to the single FCM. In this case, this FCM needs a "bench" of bidders that would be assembled ex-ante. The bench of bidders would have to participate in operational fire drills. Firms on this bench would have to be suitably diversified and have sufficient capacity to buy portfolios of a number of large customers.

The considerations above assumed that the regulatory structure will not be changed – the only difference to the classic FCM setup would be that there is only one FCM. This structure would already imply changes, for instance the requirement for resources at the FCM that replace the default fund, or a bench of bidders managed by the FCM.

Another arrangement could be to combine the DCO and the FCM into one entity that provides the functions of FCM and DCO, without the separation. This could streamline default management processes, but care would be needed that all protections that the current structure provides for customers, other market participants, the wider market and financial stability would still be available, which would require extensive new rulemaking.

On financial stability, another consideration would be a recovery or resolution situation. Under the current clearing model, there would be many CM that could be called for additional resources, or that would be allocated losses by tools like variation margin gains haircutting (VMGH). Most of these resources would not be available in a direct clearing model. VMGH would still be available[3], but in a direct clearing context would fall to 100% on clients.

Therefore, the DCO would have to reserve significant (prepositioned) resources to cater for the loss of cash calls and of other tools and resources. Should resources not be sufficient, ultimately losses in a crisis situation could fall on clients or the taxpayer.

Question 12. Other cross-affiliate risks. Other than the risks mentioned above, are there other examples of cross-affiliate risk if a DCO has an affiliated FCM – areas where risks at the first would be uniquely correlated with the risks of the second? Are there additional risk management requirements that could effectively mitigate both the presence, and the severity, of these risks?

Should resources be shared, these shared resources could form a vector for risks into both DCO and affiliated CM. This could be, for instance, cyber risks if DCO and CM share data centers, or operational risk or fraud stemming from shared personnel.

Question 13. Mitigants – disclosure. Are there additional disclosures that, if required in cases of an affiliate relationship between a DCO and FCM, would help mitigate the concerns discussed in the questions above?

As these conflicts of interests can be managed, but not removed, more disclosure and transparency would be extremely helpful to make the market comfortable.

Towards the clearing members, additional transparency could cover a description of the measures taken to manage the conflicts, especially in areas that affect risk of the CM or potential unequal treatment (margin, default management, competition). The existence of an affiliated CM, and a detailed description of the nature of the affiliation, should be disclosed by both the DCO and the CM.

We also believe that the relationship between the DCO and its affiliated CM should be closely supervised by the Commission, from the measures to mitigate conflicts of interest, policies and procedures applicable to the affiliated CM and resources earmarked to mitigate conflicts of interest or mitigate the likelihood that these conflicts materialize.

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[3] VMGH would only be available if the FCM and the DCO is merged into one entity, or the FCM includes VMGH in its clearing documentation. The latter would remove considerable protections that clients have in the current clearing model, especially if VMGH could be enacted if the FCM otherwise would get into financial difficulties, opposite to recovery arrangements in the current clearing model where VMGH can only applied by the DCO.

Question 14. Mitigants – conduct restrictions. Are there requirements or restrictions that, if instituted, would effectively ensure that affiliated FCMs interact on an "arms-length" basis with DCOs such that affiliated FCMs would be treated in a manner equivalent to non-affiliated FCMs (e.g., incentives available to affiliates are equivalently available to non-affiliates; information available to the affiliate is equivalently available to non-affiliates)? Are there documentation requirements that would contribute to achieving this goal?

While it is difficult to erase the knowledge that the CM is affiliated from a DCO staff's minds, there are a lot of mitigants and measures that can be taken. We mentioned information barriers, documentation and transparency (amongst others) in response to the questions above.

Appropriately managed information barriers would lead to an "arms-length" basis that allows the affiliated CM to be treated in line with other CMs.

These measures cannot mitigate completely some concerns (see question 1,2 and 3), but can go a long way towards this. A general principle should be that the affiliated CM does not receive any benefits, including financial benefits, influence, or information that other CMs do not receive.

An analysis of conflicts of interest, mitigants and any other factors that would lead to the affiliated CM being treated differently than other CMs would be very helpful to provide comfort to the market.

Question 15. Mitigants – volume caps. Would the concerns discussed above be mitigated by a cap on the volume (expressed as a percentage) of clearing at the DCO that can be made through an affiliated FCM? What practical issues would be raised by enforcing such caps?

Given that conflicts of interest issues increase with the relative size of the affiliated CM, some kind of caps could be considered. These caps could for instance be on volume, risk, number of clients.

These caps should however be implemented in a way that does not restrict the ability of the affiliated CM to manage its risk. For instance, volume caps should therefore not stop the affiliated CM from entering into hedging transactions.

Question 16. Affiliated trader. If a DCO is affiliated with a market maker or other trader that settles through the DCO, does that raise concerns? If so, what mitigants would be effective?

The FCM that clears trades of the affiliated market maker would guarantee the one affiliated counterparty to the other affiliated entity, which does not make much sense. Such a constellation needs to be disclosed to the FCM so it is aware of additional risks stemming from this setup.

Also, the DCO might aim to clear large volumes, which would motivate the affiliated market maker or trader to trade more volume only for the volume's sake.

Question 17. Affiliate spot market. If a DCO is affiliated with a spot market, does that raise concerns? If so, what mitigants would be effective?

DCOs are often affiliated with exchanges, and some of these exchanges can be spot markets. This alone should not raise concerns. The combination of a DCO and spot market alone should not pose conflicts of interest. In general, the spot market should be of a sufficient size that the prices observed in this spot market can reliably be used for clearing purposes, for instance for the determination of variation margin calls.

Should an affiliated CM come into play, there might be conflicts of interest, as for instance the determination of end-of day prices could directly affect the profit/loss of the affiliated CM.

In terms of mitigants, information barriers and segregation of functions will be most effective. Staff that determines end-of-day prices or any other input into the DCO's variation margin calculation should be independent from the affiliated CM and not have any information about the positions of the affiliated CM. This way, staff at the DCO and the spot market operator would not even know how to advantage the affiliated CM.

This also covers question 34.

Question 18. Affiliated direct clearing members. How would the responses to the questions above differ, if at all, if the DCO is affiliated with a non-FCM direct clearing member instead of an FCM clearing member?

As mentioned at the outset of this response, nearly all concerns with affiliated FCMs are also valid for affiliated non-FCM direct clearing members and vice versa, for instance margin, default management or information sharing.

Question 19. Affiliated DCO and DCM. How would the responses to the questions differ, if at all, if the FCM is affiliated with a DCM as well as a DCO?

DCO and DCM are already often affiliated, which does not cause issues we are aware of. Please see also under question 17.

In this setup, if a CM is affiliated, there might be a conflict of interest if the prices determined by the DCM could influence the profit or loss of the affiliated CM. There could also be another concern: if the DCM either decides that a market is unorderly and the decision benefits the CM, or decides not to declare an unorderly market if this helps the affiliated CM with positions affected by an unorderly market.

For mitigants, please see our response to question 17: if staff at the DCO and DCM do not know whether and how decisions affect the affiliated CM, conflicts of interest do not arise in the first place.

This also covers question 34.

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Appendix: About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.