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March 18, 2024

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

Re: Protection of Clearing Member Funds Held by Derivatives Clearing Organizations (RIN RIN 3038–AF39)

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**") Notice of proposed rulemaking ("**NPR**") on the Protection of Clearing Member Funds Held by Derivatives Clearing Organizations (the "**Consultation**").

We welcome the opportunity to provide our views on this important topic.

This proposal will provide some enhanced protection for clearing member assets, including assets of Futures Commission Merchants ("**FCM**") in the intermediated clearing architecture. With an intermediated clearing architecture, we mean an architecture in which a DCO includes non-affiliated FCMs among its members and in which these FCMs clear on behalf of customers.

Such additional safeguards are positive, in particular the requirements that a Derivatives Clearing Organization ("**DCO**") segregate a DCO-clearing member's "proprietary funds" including guaranty fund contributions; perform a daily reconciliation of the amount of proprietary funds owed to each member with the amount of such funds held in the DCO's depositories; and limit a DCO to investing proprietary funds according to the standard a DCO must follow for investing customer funds.

We understand that the primary reason for the Commission to issue this proposal, however, is to address issues in direct clearing models, where customers, including retail customers, access the DCO directly, without the protections they would usually receive from their FCM. Protection of

the assets of participants clearing in a direct model is addressing merely a part of the issues arising from the creation of a direct clearing model and does not recognize the other important protections a customer gets from clearing via an FCM, nor the broader roles which FCMs play within the clearing infrastructure with regards to governance, default management, and anti-money laundering.

We propose that the Commission finalize the enhanced protection for clearing members assets in connection with an intermediated DCO only, that includes multiple FCMs, unaffiliated with the DCO, as its members. By contrast, with respect to a DCO providing direct clearing without multiple FCMs unaffiliated with the DCO, the Commission should wait to propose enhanced protection for clearing members' assets, once the Commission completes a full assessment of the risks and complications associated with a DCO providing direct clearing. At that point it would be appropriate for the Commission to propose a comprehensive framework to address these risks holistically. This would not only ensure that all relevant risks and concerns are addressed, but would also be valuable for all market participants, including new market entrants with direct clearing models, who need to understand the ultimate framework and responsibilities they will operate under. Otherwise, the current NPR would lend a new, added imprimatur of safety to the dis-intermediated model, which imprimatur of safety is superficial due to this rule not creating a comprehensive safety regime for dis-intermediated CCPs, with many risks arising from such models left unaddressed. In that regard, we are looking forward to the Commission's forthcoming proposals to address potential risks, conflicts and governance issues arising from new market structures, as announced in a recent speech by Chair Behnam.[1]

We also believe that the Commission should not register any more DCOs that utilize a direct clearing model, or allow that these DCOs clear leveraged contracts, before additional protections have been implemented.

[1] https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam43

General Comments

Impact on FCMs

While certain DCOs have adopted their own rules and requirements to segregate clearing members' funds and to be able to return them quickly in case of its default[2], we welcome that the NPR proposes new rules that would require all DCOs to provide FCMs the same protections as for customers.

These rules would not guarantee that clearing member assets would be unaffected in bankruptcy, e.g. if the DCO suffers a catastrophic non-default loss ("**NDL**"), the rules improve the current safeguards, for instance by having checks of the required balances. Still, the risk of getting assets returned in insolvency with a haircut remains. We appreciate that the Commission has limited ability to introduce changes within the framework of the U.S. Bankruptcy Code. In order to mitigate this risk, DCO's capital should be right-sized, to ensure that the DCO has sufficient equity to address possible NDLs without entering insolvency or allocating these losses to clearing members or their clients outside insolvency.

Direct clearing vs intermediated clearing

In the intermediated clearing model, customers are well protected:

- The FCM segregates customer assets from its own assets and operationally from the assets of other customers. For direct clearing models, this protection will be addressed to a certain extent by the NPR.
- The FCM participates in loss mutualisation at the DCO and shields the customer from the default of other clearing members, other than in extreme situations when the CCP needs to invoke recovery plans.
- The FCM pays intraday margin calls for their customers and can provide collateral transformation services to assist the customer with margin calls.
- The FCM assesses the suitability of the products cleared and level of risk and position concentration taken by a customer using the DCO.
- The FCM on-boards customers, including by conducting know-your-customer ("**KYC**") and anti-money-laundering ("**AML**") checks and conducts ongoing AML/KYC checks.
- The FCM provides reporting to the Commission, including data covering customers.
- The FCM provides client disclosures.

[2] See 17 CFR 39.15.

FCMs also protect the clearing ecosystem, by:

- Guaranteeing their clients to the CCP.
- Participation in default management, especially by providing hedges for the defaulter's portfolio and by bidding in an auction.
- Acting as shock absorbers, especially if a client or another clearing member defaults.
- Additional layer of risk prevention – e.g., additional margin where CCP margin is insufficient, holistic view of customer risk across exposures.
- Feedback to the DCO via the risk management committee or other channels -- FCMs, who are professional risk managers, are able to meaningfully contribute to DCO risk management. This can include advice on changes proposed by the DCO, but also due diligence or new product assessments. The crucial contribution of FCMs to DCO risk management is lost in a disintermediated clearing model, where a powerful DCO sits in the middle of a population of small users, which changes the balance of powers in the clearing ecosystem.
- Registered personnel.

However, the NPR only covers asset protection, not the other benefits that customers currently enjoy through their relationship with the FCM in the intermediated model.

This proposal represents an improvement of the asset protection for FCMs, including in the case of customers clearing directly at DCOs, but is at most a partial solution to creating a regulatory framework for direct clearing models. We propose that the Commission conduct a comprehensive assessment of risks in direct clearing models. This analysis should consider the functions FCMs provide for customers and the wider market that would need to be replicated in a direct clearing model. It should be informed by the existing outreach the CFTC has conducted, including the 2022 request for comment on non-intermediated clearing and the 2023 request for comment on conflicts of interest in vertical integration[3]. In that regard, we look forward to the forthcoming proposals by the Commission to address risks, conflicts and governance issues that may arise from new market structures and affiliate relationships.

[3] https://www.cftc.gov/PressRoom/PressReleases/8734-23. ISDA's response to the request for comments can be found here: https://www.isda.org/2023/10/04/isda-response-to-cftc-on-conflicts-of-interest-between-dcos-and-affiliated-clearing-members/ .

We also refer to the "Proposed Rule: Requirements for Designated Contract Markets and Swap Execution Facilities Regarding Governance and the Mitigation of Conflicts of Interest Impacting Market Regulation Functions"[4], which also addresses only part of the issues stemming from affiliated entities serving multiple functions.

ISDA welcomes the additional protections that DCOs would be required to afford to proprietary funds of clearing members. ISDA believes that the following proposed protections modelled after the protections now afforded to customer funds should also apply to proprietary funds: the requirement to segregate a DCO-clearing member's "proprietary funds" including guaranty fund contributions; perform a daily reconciliation of the amount of proprietary funds owned to each member with the amount of such funds held in the DCO's depositories; and limit a DCO to investing proprietary funds according to the standard a DCO must follow for investing customer funds.

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

[4] https://www.cftc.gov/PressRoom/PressReleases/8866-24

Appendix: Response to the Commission's questions

Question 1: Would classification of guaranty fund contributions as proprietary funds inhibit DCOs' current guaranty fund programs? The Commission has proposed to specifically include guaranty fund deposits in the definition of proprietary funds, and does not intend for the inclusion to prevent DCOs from continuing to use guaranty funds as one of their default resources.

As long as regulation does not prohibit the use of the guarantee fund ("**GF**") in case of a member default, we do not see why the inclusion of GF deposits in the definition of proprietary funds, should stop the GF being one of the DCO's default resources (subject to legal review/verification).

As a parallel, initial margin of customers has to be segregated. In case of a client default, these resources can be used by the FCM even though the IM was segregated. We do not see why a similar mechanism cannot be found for GF contributions.

There is a similar question on liquidity management: usually, CCPs keep cash to satisfy their cover-1 / cover-2 liquidity demands, some or all of it as part of margin posted by clearing members and their clients. This would work only if the CCP has access to this cash in times of a default. Segregation of clearing member asset would in this context only work if the value of the assets is segregated, not the actual assets themselves, similar to the Legally Segregated but Operationally Commingled ("**LSOC**") collateral segregation model.

This would allow the CCP to replace cash in the customer's account with non-cash collateral of the defaulter (with suitable haircuts) to ensure the value of the customer account stays above the required amounts.

Question 2: Should the Commission require DCOs to report to the Commission the daily calculations and reconciliations required by proposed § 39.15(g)?

We propose to align the rules for daily reporting between FCMs and DCOs. FCMs do have to report the segregation computation daily[5]. We suggest that the Commission could deploy new technologies in order to detect anomalies in the reports received by FCMs and DCOs.

[5] 17 CFR 1.32

Question 3: Anti-money laundering (AML) and know-your-client (KYC) programs are required for many entities registered with the Commission, including intermediaries such as FCMs. In the context of intermediated DCOs, FCMs perform this critical role of assisting U.S. government agencies in detecting and preventing money laundering. However, in the context of non-intermediated DCOs, in the absence of an FCM, DCOs may be exploited by actors seeking to engage in illegal and illicit activities. How might the Commission ensure AML and KYC compliance for DCOs that offer direct clearing services (a market structure that would not include FCMs or other intermediaries that are typically directed to create Bank Secrecy Act compliance programs)? Should DCOs offering direct-to-customer services to non-eligible contract participants or retail customers be required to comply with AML and KYC requirements?

Regulation should not allow a function as important as AML and KYC checks to "fall between the cracks". A direct -to-customer service needs to have the same AML and KYC requirements at least as robust as FCMs have to follow in the intermediated model. Without this there would be an unlevel playing field and a dangerous regulatory arbitrage between the two models.

It is critical that the Commission work with the Financial Crimes Enforcement Network (FinCEN) of the U.S. Department of the Treasury to implement a framework to address AML and KYC compliance for DCOs that offer direct clearing services as matter of priority in light of the fact that a DCO, unlike an FCM, is not among the financial institutions to which the Bank Secrecy Act applies.

There are two avenues open to the Commission:

- Either allow affiliated FCMs that could provide all protections that customers receive at present. Having one FCM that guarantees all clients to the DCO would however mean that the default resources would all have to be located at the affiliated FCM, as the FCM will be the entity that conducts default management. Using an affiliated FCM also raises significant concerns around conflicts of interest[6]. At minimum the concept of a Self-Regulatory Organization should be reviewed for such entities.
- Or combine the DCO and the FCM into one entity that provides the functions of an FCM and DCO, without the separation of the two entities as required at present. 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 careful analysis and extensive new rulemaking.

In either case, the protections provided by unaffiliated FCMs to the clearing ecosystem (see under "General Comments") would not be available.

[6] These issues are discussed in more detail in ISDA's response to the CFTC's Request for Comments on the Impact of Affiliations of Certain CFTC-Regulated Entities.

As mentioned above, while we are supportive of the protections put forward in this NPR, we propose for the Commission to conduct a comprehensive analysis of the risk and complications of a direct clearing model and propose comprehensive regulation to address identified concerns. This would be most helpful for the whole market, including new entrants who currently do not know what regulatory requirements they will operate under in the future.

Question 4: Should the Commission require any additional written acknowledgments (to those contained in proposed § 39.15(b)(3) or § 39.15(f)(2)(vi) as applicable) from central banks of money center countries in order for a DCO to use them to hold futures customer funds, cleared swaps customer collateral, or proprietary funds?

Requiring any additional written acknowledgements would be likely unworkable if central banks in money center countries would then be exposed to US regulatory oversight.

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 76 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.