

July 13, 2023

# CFTC Requests Comment Regarding Impact of Affiliations on Regulated Entities

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## Release Solicits Feedback on the Effects of Affiliation Amongst DCOs, DCMs, SEFs, CFTC-Regulated Intermediaries and Trading Entities.

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### SUMMARY

On June 27, 2023, the staff (the “Staff”) of the Commodity Futures Trading Commission (“CFTC” or “Commission”) issued a request for comment on potential issues that may arise when CFTC-regulated entities, including derivatives clearing organizations (“DCOs”), designated contract markets (“DCMs”) and swap execution facilities (“SEFs”), are affiliated with other market participants they are tasked with supervising, including regulated market intermediaries such as futures commission merchants (“FCMs”) or trading entities. Noting that affiliations between such entities “raise[] questions” regarding, among other things, the carrying out of supervisory responsibilities, potential anti-competitive effects and compliance with financial resources requirements, the Staff hopes to better understand these issues and seeks input regarding “possible mitigating measures.”

Comments in response to the request are due by August 28, 2023.

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### BACKGROUND

The Commodity Exchange Act and the CFTC’s regulations subject DCOs, DCMs and SEFs to a wide range of risk management requirements, and also obligate them to supervise the conduct of their members and participants. These members include FCMs and other trading entities.

For example, a DCO’s supervisory responsibilities include reviewing its clearing members’ risk management policies and procedures, setting margin requirements, monitoring and enforcing rule compliance, and disciplining members for rule violations. Under the Commission’s principles-based

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regulatory approach, a DCO generally has significant discretion in carrying out these risk management responsibilities, and the Staff's questions in the request<sup>1</sup> suggest that the CFTC is concerned that discretion may be exercised to the advantage of a DCO's affiliates.

Similarly, as a self-regulatory organization, a DCM is required to adopt, among other things, financial and reporting requirements for its FCM members and maintain a financial surveillance oversight program to ensure compliance with those requirements. Both DCMs and SEFs are required to set rules governing access to and trading on their platforms and monitor trading and rule compliance. For a SEF, certain of these obligations may also extend to introducing brokers ("IBs"), commodity trading advisors ("CTAs") and commodity pool operators ("CPOs"). The request suggests that the Staff may be concerned that affiliations between DCMs and SEFs, on the one hand, and FCMs and trading entities, on the other, could make examinations, monitoring and enforcement less effective and harm competition.

The request ultimately suggests that affiliations between DCOs, DCMs or SEFs and the entities they are required to oversee raise a host of concerns regarding the adequacy of the Commission's existing regulatory framework.<sup>2</sup>

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### REQUEST FOR COMMENT

The request includes 37 specific questions—some with multiple sub-questions—split into three categories. This section provides illustrative examples of the questions posed in each category:

- 1. DCO and Affiliated FCM:** Given the requirement for a DCM to set rules applicable to its FCM members and to monitor and enforce compliance with those rules, the request asks:
  - How a DCO's affiliation with an FCM may affect its use of discretion in setting margin requirements and making default determinations;
  - Whether a DCO's affiliation with an FCM may impact its decision whether to investigate and discipline that FCM;
  - How a DCO should perform its risk management and mitigation responsibilities, generally, given the potential conflicts of interest with an affiliated FCM;
  - Whether a DCO with an affiliated FCM can provide assurance that it possesses the ability to manage contagion risk in the context of a "run" on the FCM;
  - Whether additional financial resources should be required to mitigate risk in the context of affiliated entities;
  - What effect resource and information sharing between a DCO and an affiliated FCM may have on a DCO's ability to obtain information from non-affiliated clearing members;
  - Whether certain mitigants, including with respect to disclosure, conduct restrictions or trading caps, could be effective; and
  - Whether other affiliations, including with market makers and spot markets, should be considered.<sup>3</sup>

**2. Designated Self-Regulatory Organization (“DSRO”) and Affiliated FCM:** In order to better understand the potential implications of affiliations between a DCM that is a DSRO<sup>4</sup> and an FCM, the request asks:

- Whether a DSRO can effectively conduct examinations of an affiliated FCM, whether there could be impacts to non-affiliated FCMs and whether there are ways to mitigate these concerns (including a prohibition on a DCM acting as the DSRO for its affiliated FCM);
- Whether a DSRO should be required to adopt appropriate firewalls or other procedures to prevent an affiliated FCM’s staff from accessing information gathered in the course of a DSRO’s financial surveillance of other FCMs; and
- Whether there are ways to mitigate risk in connection with conflicts of interest that may arise from an SRO being the DSRO of an affiliated FCM.<sup>5</sup>

**3. DCM/SEF and Affiliated Intermediary:** The request finally asks questions in the context of affiliations between a DCM or SEF and market intermediaries, including FCMs, IBs, CTAs and CPOs, including:

- Whether the current regulatory regime, which imposes an obligation on DCMs to monitor the financial condition of member FCMs and to monitor the positions of the customers of member FCMs, adequately addresses situations where the DCM and FCM are affiliated entities;
- Whether risk management requirements might mitigate conflicts of interest that may arise from the obligation of the DCM to monitor the financial condition and positions of an affiliated FCM and the positions of the customers of an affiliated FCM;
- How a DCM can minimize conflicts of interest while performing its surveillance of its own markets with respect to an affiliated FCM that intermediates transactions, executes proprietary trades, or carries accounts for customers executing trades on the DCM;
- Whether affiliations will result in market integrity concerns, including a DCM’s or SEF’s ability to prevent manipulation, price distortion and other market disruptions;
- Whether there are potential competition or impartial access concerns if a DCM has an affiliated FCM, or if an SEF has an affiliated IB, CTA or CPO;
- Whether limits should be imposed on DCMs and SEFs sharing resources with affiliated market participants;
- Whether existing regulatory requirements effectively address the potential for a DCM or SEF to favor an affiliated market participant and its customers with respect to trade execution;
- Whether and how the CFTC should consider contagion risk, *i.e.*, where problems at an affiliated market participant could spread to the DCM or SEF, or vice versa;
- Whether certain mitigants, including with respect to disclosure and conduct restrictions, could be effective; and
- Whether other affiliations, including with market makers and spot markets, should be considered.<sup>6</sup>

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## IMPLICATIONS

The request’s focus on risks associated with affiliations between market participants and market infrastructure providers is indicative of financial market regulators’ heightened focus on vertical integration

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concerns. For example, several digital asset platforms offer direct access models that integrate several market functions, including trading platforms, clearing entities and intermediaries. These arrangements have been the focus of several recently issued reports from multinational regulatory bodies.<sup>7</sup> Some firms in the traditional financial sector have also begun to explore such vertically integrated models,<sup>8</sup> which, together, may be prompting regulators to scrutinize whether existing regulations are sufficient to manage risks associated with a broader trend toward affiliations in both the traditional and digital asset markets. Furthermore, although the request does not actually propose any changes to CFTC rules, it could signal an appetite for rule changes in the future, and CFTC-regulated entities and market participants should be prepared for the possibility that the CFTC or their DSRO may raise questions regarding these topics in the context of examinations and other reviews.

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### ENDNOTES

- <sup>1</sup> Commodity Futures Trading Commission, Request for Comment on the *Impact of Affiliations on Certain CFTC-Regulated Entities* (June 27, 2023), available at <https://www.cftc.gov/PressRoom/PressReleases/8734-23>.
- <sup>2</sup> *Id.* at 1.
- <sup>3</sup> *Id.* at 3–6.
- <sup>4</sup> The National Futures Association (“NFA”) is also a DSRO.
- <sup>5</sup> Request at 9–10.
- <sup>6</sup> *Id.* at 11–16.
- <sup>7</sup> *E.g.*, Financial Stability Oversight Council, Report on Digital Asset Financial Stability Risks and Regulation (2022), available at <https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf> (discussing, among other things, vertical integration by crypto-asset firms); OICU-IOSCO, Policy Recommendations for Crypto and Digital Asset Markets: Consultation Report (May 2023), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD734.pdf> (providing recommendations to securities and derivatives regulators, including with respect to conflicts of interest arising from vertical integration of activities and functions in the crypto-asset markets).
- <sup>8</sup> *E.g.*, Alexander Osipovich, Wall Street Journal, *Futures Giant CME Considers Brokerage, Taking Cue from Crypto Rival FTX* (September 30, 2022), available at <https://www.wsj.com/articles/futures-giant-cme-considers-brokerage-taking-cue-from-crypto-rival-ftx-11664592510>.

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