

WFE Response to the CFTC’s Notice of Proposed Rulemaking on the Protection of Clearing Member Funds Held by Derivatives Clearing Organizations

Background

Established in 1961, the World Federation of Exchanges (WFE) is the global industry association for exchanges and clearing houses (CCPs). Headquartered in London, it represents over 250 market infrastructure providers, including standalone CCPs that are not part of exchange groups. Of our members, 34% are in Asia-Pacific, 45% in EMEA, and 21% in the Americas.

WFE’s 90 member CCPs and clearing services collectively ensure that risk takers post some $1.3 trillion (equivalent) of resources to back their positions, in the form of initial margin and default fund requirements. WFE exchanges, together with other exchanges feeding into our database, are home to over 50,000 listed companies, and the market capitalisation of these entities is over $100 trillion; around $140 trillion (EOB) in trading annually passes through WFE members (at end 2022).

The WFE is the definitive source for exchange-traded statistics, and publishes over 350 market data indicators. Its free statistics database stretches back more than 40 years and provides information and insight into developments on global exchanges. The WFE works with standard-setters, policy makers, regulators, and government organisations around the world to support and promote the development of fair, transparent, stable and efficient markets. The WFE shares regulatory authorities’ goals of ensuring the safety and soundness of the global financial system.

With extensive experience of developing and enforcing high standards of conduct, the WFE and its members support an orderly, secure, fair, and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence, and economic growth, and we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in a globally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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Response

The WFE welcomes the opportunity to comment on the Proposed Rulemaking issued by the Commodity Futures Trading Commission (CFTC) on the Protection of Clearing Member Funds Held by Derivatives Clearing Organizations (Proposed Rule) and wishes to emphasise both the importance of investor protections and the role that the CFTC plays in this respect by upholding Section 4d of the Commodity Exchange Act (CEA) and Parts 1, 22 and 30 of the Commission’s regulations.

In particular, these rules protect the funds of retail customers who use Futures Commission Merchants (FCMs) to clear trades at Derivatives Clearing Organisations (DCOs) on their behalf. These rules ensure that customer funds are segregated from the FCM's and DCO’s own funds in a depository that acknowledges that such funds belong to the customer and cannot be used by the FCM or DCO for other purposes. DCOs also employ comprehensive practices when it comes to the protection of customers and proprietary funds under the Code of Federal Regulations Title 17 § 39.15. Ultimately, these regulations and practices are designed to protect and ensure the safety of funds and assets belonging to clearing members and their customers, while also minimising the risk of loss or of delay in the access by the DCO to such funds and assets.

The Commission has correctly identified a gap in their regulatory framework that would arise under a clearing model wherein a CCP offers clearing directly for retail market participants without the intermediation of FCMs (i.e., a disintermediated clearing model) and thus, these retail market participants do not receive the regulatory protections that customers of FCMs receive. However, the WFE questions the Commission’s approach which has resulted in a Proposed Rulemaking that is piecemeal and unnecessary for most DCOs.

The Proposed Rule attempts to bridge the gap between the historical prevailing DCO clearing model and the disintermediated clearing model targeted at retail market participants by proposing to implement rules for *all* DCOs (irrespective of which model they use) that are similar to the rules to which FCMs are subject. The Proposed Rule would address DCOs’ treatment of proprietary funds, which would include various categories of funds received by DCOs from clearing members, including clearing member margin and guaranty fund contributions. In particular, the Proposed Rule would require DCOs to segregate proprietary funds from the DCO's own funds and to hold these funds in a depository that acknowledges that the funds belong to the clearing members, not the DCO, and also proposes strict limitations on the use of these funds. As noted above, Proposed Rules are intended to address issues raised by the fact that the funds of retail market participants would be considered proprietary funds at a disintermediated DCO. The Proposed Rule also mandates that DCOs perform a daily reconciliation of proprietary and customer funds held relative to funds owed.

Under the Proposed Rule, DCOs would be able to commingle proprietary funds from multiple clearing members in one account, use proprietary funds as part of the DCO's default waterfall in accordance with its rulebook, and hold these funds (as well as customer funds) at foreign central banks (which can provide various credit and liquidity risk management benefits). While, as described below, the WFE questions whether the Proposed Rule should proceed in its current form, to the extent the Commission does move forward with a final rule, the WFE appreciates these aspects of the proposal, as well as the stipulation that the investment of proprietary funds would be limited to the instruments permitted under the revised Regulation 1.25, subject to the resolution of issues highlighted in the WFE's response to the related, recent consultation on the CFTC’s Proposed Rulemaking Regarding Investment of Customer Funds by FCMs and DCOs.[[1]](#footnote-2)

However, we find that the proposed restrictions on the use of proprietary funds, as defined in proposed Regulations 39.15(f)(3)(ii) and 39.15(f)(4), are excessively restrictive and inconsistent with current industry practice. In particular, the Proposed Rule might be interpreted to curtail current industry best-practices which permit the deployment of a guaranty fund in specific scenarios. For example, some DCOs may be permitted under their rules to use the guaranty fund to address bank or investment counterparty failures and borrow against the guaranty fund under certain defined circumstances (such as clearing member defaults or suspensions of clearing members). Such a narrow conception of the permissible uses of proprietary funds that include guaranty funds could unduly restrict DCOs in their efforts not just to manage defaults but also promote systemic stability by taking action to prepare for or avert such defaults. A more effective approach would be to grant DCOs the appropriate flexibility to use proprietary funds in alignment with their rules, to which all clearing members (sophisticated, regulated entities in the case of traditional, intermediated DCOs) have agreed as a condition of membership. Rather than specifying permissible categories of use, this approach acknowledges the transparent nature of DCOs' rulebooks and the regulatory scrutiny applied to such rules. This would offer adequate visibility for members and regulators regarding the potential use of proprietary funds without unnecessarily restricting the ability of DCOs to navigate stress situations for the benefit of the broader market.

Beyond the urgent need for the change described above, the WFE is troubled by the Commission’s general approach regarding the Proposed Rule. In particular, the Commission attempts, in part, to propose requirements that address concerns with the disintermediated clearing model targeted at retail customers, which implies that such a model should be permitted. By focusing on this one aspect, the Commission fails to fully consider other applicable legal protections and risk management functions performed by FCMs in regards to customers that are not mirrored in a disintermediated clearing model targeted at retail market participants.

Intermediated clearing is the most widely accepted and utilised model, despite any formal guidance to the otherwise. And while we recognise that some DCOs support the traditional FCM clearing model and may also have some non-FCM clearing members, this practice is subject to strict participation requirements that apply, irrespective of the type of clearing member, and that these non-FCM clearing members are well-capitalised, highly sophisticated firms with the requisite risk management expertise. The same cannot be said for a disintermediated clearing model targeted at retail market participants.

In conclusion, the WFE urges the Commission to take more time to consider the whole spectrum of issues raised by disintermediated clearing models. The WFE is troubled by the Commission’s piecemeal approach to rulemaking in this Proposed Rule that allows for a significant change to market structure by effectively permitting a disintermediated clearing model targeting retail market participants. A misleading public perception of safety could be created if the Commission is deemed to have validated this type of disintermediated clearing model by approving a limited set of rules on funds protection without publicly recognising the other significant risk management protection gaps which remain.

1. WFE Response: CFTC’s Proposed Rulemaking Regarding Investment of Customer Funds by FCMs and DCOs, https://www.world-exchanges.org/news/articles/wfe-response-cftcs-proposed-rulemaking-regarding-investment-customer-funds-futures-commission-merchants-and-derivatives-clearing-organisations [↑](#footnote-ref-2)