August 28, 2023

Submitted via cftc.gov

The Honorable Rostin Behnam
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

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

Dear Chairman Behnam,

I appreciate the opportunity to submit comments concerning the Commodity Futures Trading Commission's ("CFTC" or "Commission") request for information on the impact of affiliations on CFTC-regulated entities ("RFI"). I am an Assistant Professor of Legal Studies at the J. Mack Robinson College of Business at Georgia State University and am a former member of the CFTC's Market Risk Advisory Committee. I submit these comments in my personal capacity.

I. Summary of Comments

Vertical integration in the derivatives markets can be harmful as affiliates' perverse incentives can create anti-competitive market distortions. To address this, the CFTC should:

- Ensure that registered entities are decision-independent from affiliates;
- Prevent or limit registered entities from facilitating affiliates' transactions;
- Effectively supervise registered entities by evaluating policies and decisions to ensure they are not anti-competitive; and
- Decide whether to permit registered entities to operate in firms' closed ecosystems.

II. Comments on the Request for Information

Unless all affected markets affiliated with derivatives transactions—including the markets for brokerage, exchange, and clearing services—are competitive, vertical integration will be harmful. Because each affiliate is incentivized to act for the benefit of the company as a whole and not the affiliate alone, affiliates' perverse incentives can create market distortions that are anti-competitive. Some hypotheticals include:

- A DCO that is a monopoly giving discounts to affiliated FCMs or imposing heightened costs on affiliated FCM's competitors, allowing its affiliates an anti-competitive edge in providing brokerage services;
- A DCO that gives discounts to trades executed on affiliated DCMs;
- An SRO that conducts less-extensive supervision on its affiliated FCMs; and

- An FCM that auto-directs client trades to affiliated DCOs for clearing.

Rules can frequently help prevent the most obvious market distortions, but whenever there is judgment involved on the part of regulated entities' executives and officers, there is the risk that they may (even inadvertently) preference their firms' affiliates. For example, because margin requirements are based on both the instruments being cleared and the portfolios of counterparties,[1] a DCO's risk management officials may put a thumb on the scale of finding a bespoke instrument held by an affiliate or the affiliate's entire portfolio to be less risky than they ought to be.

These concerns are particularly heightened, given the historical lack of competition between derivatives platforms. Although the CFTC listed 16 operational DCMs and 24 operational SEFs as of July 2023,[2] these numbers are illusory because most instruments or classes of instruments trade on only one or two exchanges.[3] This is because there is a tendency toward natural monopoly on exchanges as they "exhibit particularly strong network effects: traders value liquidity in financial markets and this creates a tendency for trading to concentrate on a single exchange" where there are other traders.[4] As the Department of Justice noted more than 15 years ago:

> The introduction of a new contract by one futures exchange frequently prompts another exchange to offer a similar contract, and a battle to garner all the liquidity in the contract ensues. After one exchange wins most of the liquidity in the contract, the other exchange usually exits.[5]

The CFTC must ensure that there are competitive markets for services and engage in effective regulation and supervision of platforms to ensure anticompetitive activities do not occur.

<u>The CFTC should ensure that registered entities are decision-independent from affiliates.</u>

The best way for the CFTC to ensure competition for derivatives market services and address the harms from vertical integration is to prevent affiliates from controlling registered entities. The CFTC most likely cannot prohibit affiliations outright, but it can impose governance restrictions that prevent affiliates from unduly influencing registered entities' decisions.

The CEA provides that the CFTC must affirmatively approve the applications of various registered entities before they may begin operating and may condition such approval on the

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[1] *See* 17 C.F.R. § 39.13(g)(2)(i) ("A derivatives clearing organization shall have initial margin requirements that are commensurate with the risks of each product and portfolio, including any unusual characteristics of, or risks associated with, particular products or portfolios.").
[2] *See* CFTC, *Trading Organizations – Designated Contract Markets (DCM)* (last accessed July 2023); CFTC, *Trading Organizations – Swap Execution Facilities (SEF)* (last accessed July 2022).
[3] Agricultural derivatives tend to trade on CME and ICE; energy futures on NYMEX (a subsidiary of CME) and ICE; metal futures on COMEX (a subsidiary of CME) and ICE; interest rate swaps on CME, Bloomberg, and ICE; foreign exchange swaps on CME and Cboe; and equity indices on CME, ICE, and CBOE. LedgerX only trades crypto derivatives, and Kalshi is an events market.
[4] Estelle Cantillon and Pai-Ling Yin, *Competition between Exchanges: Lessons from the Battle of the Bund* (Jan. 20, 2008).
[5] U.S. Department of Justice, *Comments of the U.S. Department of Justice* at 10 (2007).

ability of the entities to comply with the CEA and the CFTC's regulations thereunder.[6] The CFTC may go beyond the "four-corners" of any application to ensure that a registered entity's holding company or affiliates cannot exercise control over its operations and ensure that the registered entity retains independence to carry out its regulatory obligations.

The authority to approve platforms' registration applications is one that the nation's other markets regulator, the Securities and Exchange Commission (SEC), has used to ensure platforms act in the markets' interests, not its affiliates. Like the CFTC, the SEC also has no legal authority to regulate the activities of registered entities' affiliates (unless, of course, those affiliates are themselves registered entities), but the agency nevertheless examines affiliates' operations. For example, in its order approving the exchange IEX's application for registration, the SEC thoroughly examined the extent to which the exchange's holding company, IEXG, could influence the platform, as well as the extent to which any entity could exercise control over the holding company; the SEC approved the order based in part on a finding that IEXG could not negatively influence the platform's responsibilities under the Securities Exchange Act of 1934 ('34 Act) and regulations thereunder.[7] Among other things, it approved of the facts that "no person, either alone or together with its related persons, may beneficially own more than 40% of any class of capital stock of IEXG;" that "no person, alone or together with its related persons, may vote or cause the voting of more than 20% of the voting power of the then issued and outstanding capital stock of IEXG;" and that "pursuant to the IEX Exchange Operating Agreement, IEXG may not transfer or assign … its ownership interest in IEX Exchange, unless

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[6] *See* 7 U.S.C. § 7a-1(a)(1) (providing that it is "unlawful for a derivatives clearing organization … to perform the functions of a derivatives clearing organization" unless registered); *id*. § 8(a) ("Any person desiring to be designated or registered as a contract market or derivatives transaction execution facility shall make application to the Commission for the designation or registration and accompany the same with a showing that it complies with the conditions set forth in this chapter, and with a sufficient assurance that it will continue to comply with the requirements of this chapter.").

[7] *See In the Matter of the Application of: Investors' Exchange, LLC for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission*, 81 FR 41141, 41146–47 (June 23, 2016):

> Although IEXG is not directly responsible for regulation, its activities with respect to the operation of IEX Exchange must be consistent with, and must not interfere with, the self-regulatory obligations of IEX Exchange. As described above, the provisions applicable to direct and indirect changes in control of IEXG and IEX Exchange, as well as the voting limitation imposed on owners of IEXG who also are IEX Exchange members, are designed to help prevent any owner of IEXG from exercising undue influence or control over the operation of IEX Exchange and to help ensure that IEX Exchange retains a sufficient degree of independence to effectively carry out its regulatory obligations under the Act. In addition, these limitations are designed to address the conflicts of interests that might result from a member of a national securities exchange owning interests in the exchange. As the Commission has noted in the past, a member's ownership interest in an entity that controls an exchange could become so large as to cast doubt on whether the exchange may fairly and objectively exercise its self-regulatory responsibilities with respect to such member. A member that is a controlling shareholder of an exchange could seek to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and conduct surveillance of the member's conduct or diligently enforce the exchange's rules and the federal securities laws with respect to conduct by the member that violates such provisions. As such, the Commission believes that these requirements are designed to minimize the potential that a person or entity can improperly interfere with or restrict the ability of IEX Exchange to effectively carry out its regulatory oversight responsibilities under the Act.

such transfer or assignment is filed with and approved by the Commission."[8] Similar limitations on MEMX's holding company were found beneficial in the SEC's approval of that exchange.[9]

In fact, the CFTC can find permission to examine whether affiliates can influence registered entities in the text of the CEA. That statute imposed on regulated entities core principles to which they must adhere, subject to CFTC regulations. These core principles generally require institutions to "establish and enforce rules to minimize conflicts of interest in the decision-making process"[10] and implement governance fitness standards,[11] and prohibit them from "tak[ing] any action that results in any unreasonable restraint of trade" or "impos[ing] any material anticompetitive burden."[12] Accordingly, the CFTC may act to ensure that conflicts of interest are minimized, registered entity governance standards ensure impartiality, and that entities are not structured in ways that would impose anticompetitive effects. In evaluating entities' applications, the CFTC may, like the SEC, refuse to approve applications that would result in boards of directors that are wholly controlled by affiliates that would benefit by entities engaging in illegal activities or those that would otherwise negatively affect competition on the platform.

It is possible that the CFTC would not want to go down this route; the CEA, unlike the '34 Act, provides that registered entities "shall have reasonable discretion in establishing the manner in which the [entity] complies with the core principles."[13] However, that discretion is constrained by rules the CFTC may write. Accordingly, the CFTC could condition approval of registered entity applications on adhering to certain governance requirements that ensure affiliates cannot influence registered entities' activities.

<u>The CFTC should prevent or limit registered entities from facilitating affiliates' transactions.</u>

The Commission may write regulations that put into effect the CEA's core principles or that, in its judgment, "are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes" of the CEA.[14] It may use these authorities to prohibit affiliates from utilizing registered entities to execute or clear trades, or implement volume caps to ensure that transactions related to affiliates make up only a de minimis share of registered entities' activities. Doing so would ensure competition for derivatives market services and address the harms from vertical integration.

Activity restrictions that prohibit affiliates from touching a single transaction in more than one way would eliminate any vertical integration concerns. For example, were the CFTC to prohibit DCMs from executing and DCOs from clearing any trades entered into by affiliated traders, the end result would be that affiliated traders would either use non-affiliated DCMs and

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[8] *Id*., at 41146.
[9] *See generally In the Matter of the Application of MEMX LLC for Registration as a National Securities Exchange Findings, Opinion, and Order of the Commission*, 85 FR 27451 (May 8, 2020).
[10] 7 U.S.C. § 7a-1(c)(2)(P). *See also id*. § 7(d)(16) (same for DCMs); *id*. § 7b-3(f)(12) (same for SEFs)
[11] *Id*. § 7a-1(c)(2)(O). *See also id*. § 7(d)(15) (same for DCMs).
[12] *Id*. § 7a-1(c)(2)(N). *See also id*. § 7(d)(19) (same for DCMs); *id*. § 7b-3(f)(11) (same for SEFs).
[13] *Id*. § 7. *See also id*. § 7b-3 (same for swap execution facilities); *id*. § 7a-1 (same for derivative clearing organizations).
[14] *Id*. § 12a.

DCOs—thereby increasing demand for competition in DCMs and DCOs—or holding companies would divest themselves of one or more affiliates—removing vertical integration concerns. Similarly, were the CFTC to prohibit DCOs from clearing trades entered into on affiliated DCMs such that trades executed on one firm's DCM would be cleared on another's DCO, vertical integration concerns would similarly be negated. And, of course, were the Commission to prohibit DCMs from executing or DCOs from clearing trades entered into by affiliated FCMs, SDs, or MSPs, there would be no incentive for registered entities to preference their affiliates' transactions.

If the CFTC decides that it does not want to go so far as preventing the executing or clearing of affiliates' transactions, it should consider imposing volume caps or other quantitative limits on registered entities' exposure to (1) a single affiliate and (2) to all affiliates. As a comparison, Section 23A of the Federal Reserve Act limits (with exceptions) member banks' exposure to affiliates to 10% of its capital to one affiliate and 20% to all affiliates.[15] Given that DCMs and DCOs are market platforms whereas Federal Reserve member banks are not, the CFTC should consider this 10%/20% limitation to be *far in excess* of what may be appropriate for its registered entities.

<u>The CFTC should effectively supervise registered entities by evaluating policies and decisions to ensure they are not anti-competitive.</u>

If the CFTC does continue permitting registered entities to handle affiliates transactions, it must have regulations that prevent platforms from preferencing their affiliates and impose knowledge firewalls between affiliates. And effective regulation *requires* effective supervision, with examiners not only ensuring that firms have policies and procedures as required by the CFTC or that those policies and procedures are implemented but also ensuring that those policies and procedures appropriately comply with provisions of the CEA that use judgment-laded language.

CFTC examination staff must be vigilant in ensuring that registered entities' policies do not prejudice non-affiliates. It is not sufficient that entities have policies that purport to be neutral as to affiliates—its policies must *actually* not benefit affiliates. The actions entities take under those policies must also not benefit affiliates. Much as how bank examiners may evaluate whether any particular activity a bank undertakes is a safety and soundness concern before the banking agency issues a regulation declaring it so, examiners with the CFTC's Divisions of Clearing and Risk and Market Oversight can also do so with any of the core principles. For example, the CEA's core principles prohibiting "any action that results in any *unreasonable* restraint of trade" or "impose[s] any *material* anticompetitive burden" allows examiners to determine whether restraints of trade are unreasonable or anticompetitive burdens are material.[16] Although the CEA provides that registered entities have "reasonable discretion in establishing the manner in which the [entity] complies with the core principles,"[17] examiners may evaluate whether any particular rule, practice, or individual act is "reasonable" under the core principles or otherwise complies with the CEA, and issue "matters requiring attention" when they believe

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[15] 12 U.S.C. § 371c.
[16] *Id.* § 7a-1(c)(2)(N). *See also id.* § 7(d)(19) (similar for DCMs); *id.* § 7b-3(f)(11) (similar for SEFs).
[17] *Id.* § 7(d)(1)(B); § 7b-3(f)(1)(B). *See also id.* § 7a-1(c)(2)(A)(ii) (similar for DCOs).

registered entities engage in conduct that is not "reasonable" under the core principle or otherwise violates the CEA. If such a matter requiring attention issued by examiners is not addressed, the CFTC may then bring cease and desist orders to put into effect the examiners' finding.

Accordingly, examination staff must ensure that regulated entities policies and actions do not preference their affiliates, violating the antitrust core principles.

Crypto-Related Scenarios

The RFI raises a number of questions about scenarios that primarily arise in crypto asset markets, including DCOs with a single FCM, affiliated direct-clearing members, and affiliated spot markets. Although the CFTC can attempt to implement rules that prohibit the preferencing of affiliates, it should decide whether to permit registered entities to operate in firms' closed ecosystems. That is, whether to permit (1) DCMs to be limited to executing transactions entered into by affiliated FCMs or unbrokered customers; (2) DCOs to be limited to clearing transactions entered into on affiliates' DCMs; and (3) DCMs and DCOs to be limited executing and clearing derivatives wherein the price of the underlying is based on data provided by an affiliated spot exchange. Because the CFTC cannot regulate or supervise the entire firm, this decision should depend on whether the CFTC thinks it has the capacity to fully supervise registered entities to ensure that markets are fair or whether structural separation is necessary. Affiliated traders must not be able to use inside information or loopholes in rules to profit at the expense of customers.[18]

As explained above, unless the markets for brokerage, exchange, and clearing services are competitive, vertical integration will be harmful. When affiliated with a spot exchange, unless the market for spot-execution and -clearing services are competitive as well, the holding company may have the incentives and means by which it may preference its own transactions. Because the CFTC may not regulate affiliated spot services, the CFTC should not let regulated entities affiliate in this manner.

If the CFTC does decide that it wishes to ensure some form of separation in crypto asset markets, one solution is to impose volume caps on regulated entities, prohibiting more than a certain percentage of transactions entered into on a DCM be with affiliated FCMs, and prohibiting more than a certain percentage of transactions cleared by a DCO to be executed on affiliated DCMs. Volume caps would require that registered entities actively work to expand beyond their holding companies' closed ecosystems.

Conclusion

Vertical integration can be harmful to competition as each affiliate is incentivized to act for the benefit of the company as a whole and not the affiliate alone. Affiliates' perverse incentives can create market distortions that are anti-competitive. The CFTC should act to ensure that such incentives are eliminated or mitigated.

[18] Public information indicates that, despite the insufficient controls intentionally placed on Alameda by FTX International, the firm's U.S. derivatives subsidiary, LedgerX, had no such issues.

Sincerely,

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