BETTER MARKETS

By Electronic Submission

February 13, 2023

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

Re: Reporting and Information Requirements for Derivatives Clearing Organizations (RIN 3038-AF12)

Dear Mr. Kirkpatrick:

Better Markets[1] appreciates the opportunity to comment on the proposed rule[2] ("Proposed Rule" or "Release") issued by the Commodity Futures Trading Commission ("CFTC" or "Commission"), which would amend certain reporting and information regulations applicable to derivatives clearing organizations ("DCOs").

DCOs are entrusted with a crucially important role in the derivatives marketplace, which is still emerging from the effects of the financial crisis and adapting to the reforms implemented under the Dodd-Frank Act. DCO reporting to the CFTC is the cornerstone of the CFTC's ability to regulate derivatives clearing. With this information, the CFTC can more effectively oversee and guard against the potential accumulation of systemic risk in these market utilities, which have seen explosive growth over the last 20 years. The Proposed Rule offers some positive improvements in the reporting requirements, but it should be strengthened in a number of respects, as discussed below.

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Reporting and Information Requirements for Derivatives Clearing Organizations; 87 Fed. Reg. 76698 (Dec. 13, 2022).

BACKGROUND

The 2008 financial crisis ("2008 Financial Crisis") was catastrophic for our financial markets, our economy, and tens of millions of American families. In monetary terms, it destroyed more than $20 trillion in GDP.[3] Moreover, on top of the damage caused by the deep recession, as much as $29 trillion was lent, spent, pledged, committed, loaned, guaranteed, and otherwise used or made available to bail out the financial system during the crisis. Among the major causes of the 2008 Financial Crisis were the unregulated derivatives markets.

In response, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which included comprehensive and critical reforms to the oversight of the derivative markets.[4] Specifically, Title VII of the Dodd-Frank Act amended the CEA to establish a comprehensive statutory framework to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Imposing clearing and trade execution requirements on standardized derivative products; (2) creating rigorous recordkeeping and real-time reporting regimes; and (3) enhancing the CFTC's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the CFTC's oversight.

Reporting requirements were an important component of the improvements governing the swaps markets. They critically give regulators the necessary insight into the condition of the markets and market participants, allowing them to address weaknesses and problems and head off potentially catastrophic failures.

Recent events have only intensified the need for a robust DCO reporting regime. Two trends in particular prove the point, including the rapid rise and collapse of the cryptocurrency markets, on which a number of derivatives products are based, and the ever-present threat of cybersecurity breaches such as the one recently reported at ION Cleared Derivatives.

Testifying before the U.S. Senate Committee on Homeland Security and Governmental Affairs, the Director of the agency charged with managing and mitigating cybersecurity risks to critical infrastructure, the Cybersecurity and Infrastructure Security Agency ("CISA"), stated that the U.S. is facing "unprecedented risk from cyberattacks undertaken by both nation-state adversaries and criminals."[5] The financial industry and its participants are prime targets of cyberattacks and data breaches, and those risks are increasing. In fact, the average cost to a financial company of a cyberattack is 40% higher than the average cost to companies in other

---

[3] *See* Better Markets, *The Cost of the Crisis: $20 Trillion and Counting* (2015), https://www.bettermarkets.org/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis_1.pdf.

[4] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[5] *National Cybersecurity Strategy: Protection of Federal and Critical Infrastructure Systems: Hearing Before the S. Committee on Homeland Security & Governmental Affairs*, 117th Cong. (2021) (statement of Jen Easterly, Director, Cybersecurity and Infrastructure Security Agency).

sectors.[6] As the financial industry is a natural target for cyberattacks, the Financial Stability Oversight Council ("FSOC") has increasingly discussed cyberattacks as a threat to the stability of the U.S. financial system in their annual reports to Congress, stating "incidents have the potential to impact tens or even hundreds of millions of Americans and result in financial losses of billions of dollars due to disruptions in operations, theft, and recovery costs."[7]

The rise in the sheer number of cyberattacks and their growing sophistication has led many to acknowledge cybersecurity threats as one of the top risks facing the financial sector. In the World Economic Forum's Global Risks Perception Survey, respondents cited cyberattacks and data fraud or theft as two of the top five global risks. This is in stark contrast with the results from the same survey conducted ten years earlier, which mentioned neither cyberattacks nor data fraud among the top five global risks.[8] After the survey was conducted in 2019, the COVID-19 pandemic and the changes to the modern workplace that have come as a result of the pandemic have only exacerbated the risk of cyberattacks. Malware and ransomware attacks in 2020 increased by 358% and 435%, respectively from the previous year.[9] The increase in remote work has made the financial industry more vulnerable to cyberattacks through the increased use of teleworking strategies, including virtual meeting applications and virtual private networks.[10] Research has found that data breaches where remote work was a factor in the breach increased the total cost of a breach by $1.07 million on average.[11] This raises the level of vigilance that all companies must maintain in connection with cybersecurity vulnerabilities and further demonstrates the growing risk cybersecurity poses to DCOs.

To improve cybersecurity resiliency in the financial sector, FSOC recommended that regulators monitor cybersecurity risks at financial institutions and improve information sharing as it relates to cyberattack incident reporting.[12] This is one reason why the enhanced reporting obligations set forth in the Proposed Rule are so important, including specifically removing the "materiality" and "targeted" tests governing a DCOs obligation to immediately notify the CFTC of any security incident or threat.

This risk of digital assets is another increasingly important threat to DCOs' stability and financial health. Digital assets have proven over and over to be extremely volatile. Just over the last several months, this asset class has experienced an extraordinarily rapid and steep decline, triggering massive investor losses, a string of bankruptcies in the industry, and the freezing of activity in digital asset exchanges. If these assets were more connected to the broader financial

---

6 ANDREW P. SCOTT AND PAUL TIERNO, CONG. RSCH. SERV., IF11717, INTRODUCTION TO FINANCIAL SERVICES: FINANCIAL CYBERSECURITY (Jan. 13, 2022), https://crsreports.congress.gov/product/pdf/IF/IF11717.

7 FSOC, *supra* note 13 at 168. FSOC goes on to highlight three channels through which financial stability could be threatened: disruption of a key financial service or utility with little or no substitute; compromised integrity of market data; and loss of consumer or investor confidence in markets that affects the safety and liquidity of assets.

8 World Economic Forum, The Global Risks Report 8 (2019), https://www3.weforum.org/docs/WEF_Global_Risks_Report_2019.pdf.

9 *Id.* at 9.

10 Financial Stability Oversight Council, Annual Report 62 (2021).

11 IBM, Cost of a Data Breach Report 13 (2021), https://www.ibm.com/downloads/cas/OJDVQGRY.

12 *Id.* at 170.

system, such as through disintermediated clearing, they certainly would have posed a significant threat to our entire financial stability. One can only imagine the calamity the FTX collapse would have caused in the clearing space if it had been allowed to move forward with its disintermediated clearing model. Therefore, the CFTC needs to remain vigilant and forward-looking in its approach to establishing regulations, especially those related to reporting, that will cover new threats and new financial products.

It is important that the CFTC appropriately fortify its DCO reporting requirements in this Proposed Rule. The stakes are higher than ever. Reporting requirements for DCOs are set forth in part 39 of the CFTC's regulations. In January 2020, the CFTC amended many of the provisions in part 39 to enhance certain risk management and reporting obligations and simplify processes for registration and reporting.[13] Through the Proposed Rule, the CFTC is seeking to address certain issues and concerns that were unresolved in the January 2020 rulemaking.

I. THE PROPOSED RULE APPROPRIATELY STRENGTHENS REPORTING REGARDING RISK CHARACTERISTICS OF PRODUCTS TO BE COMMINGLED THAT ARE UNUSUAL IN RELATION TO OTHER PRODUCTS THE DCO CLEARS FOR PARTICULAR CUSTOMERS.

CFTC Regulation 39.15(b)(2) sets forth the requirements a DCO must follow to obtain CFTC approval to commingle customer positions and associated funds from two or more of three separate account classes in either a futures or cleared swaps customer account.[14] The Proposed Rule would strengthen the existing requirements by requiring a DCO to provide not only an analysis of the risk characteristics of the products but also an analysis of any risk characteristics of products to be commingled that are ***unusual in relation*** to the other products the DCO clears, as well as how it plans to manage any identified risks.[15]

Better Markets supports this aspect of the Proposed Rule because adding the phrase "unusual in relation" to the regulation will allow the CFTC and the public to better understand any increased risk posed to the DCO or its customers by the commingling of products that otherwise would be held in separate accounts. Furthermore, this additional requirement will better enable the CFTC to understand the DCO's ability to manage those risks.

However, the CFTC needs to go a step further with its "unusual in relation to" analysis requirement and specify that the reporting should contain analyses that cover products with margining, liquidity, default management, pricing, and volatility characteristics that differ from those currently cleared by the DCO. This discussion is critical in the ever-changing derivatives markets, where new derivatives products are constantly being introduced. The CFTC must be forward-looking in its approach to receiving as much information as possible from a DCO's "unusual in relation to" analysis to determine whether to allow a DCO to commingle products in a single customer account.

---

13 Derivatives Clearing Organization General Provisions and Core Principles, 85 FR 4800 (Jan. 27, 2020).
14 17 CFR 39.15(b)(2)
15 87 Fed. Reg. 76,698

II. REMOVING "MATERIALLY" AND "TARGETED" AS LIMITING FACTORS IN THE REPORTING OBLIGATION IN REGULATION 39.18 IS THE CORRECT APPROACH TO ENSURE COMPREHENSIVE REPORTING.

Regulation 39.18(g)(1) requires that a DCO promptly notify staff of the Division of Clearing and Risk ("DCR") of any hardware or software malfunction, security incident, or ***targeted*** threat that ***materially*** impairs, or creates a significant likelihood of material impairment of, automated system operation, reliability, security, or capacity.[16] The Proposed Rule would amend § 39.18(g)(1) to remove "materiality" as a standard for DCOs to determine whether any hardware or software malfunction or operator error impairs or creates impairment for its automated systems.[17] Furthermore, the Proposed Rule would adopt a new § 39.18(g)(2) that removes "targeted" as a standard for triggering the obligation of a DCO to inform the DCR of any security incident or threat that compromises or could compromise the information relied upon by the DCO.[18] And finally, the Proposed Rule would include a requirement in the new § 39.18(g)(2) that DCOs must report to the Commission if any services, data, or information provided by a third party that the DCO relies upon in satisfying its responsibilities is impaired by incident or threat. All of these reforms are clearly appropriate and necessary, as discussed below.

A. Hardware or software malfunctions and cybersecurity incidents or threats cannot reliably be categorized as material or non-material.

Better Markets commends the CFTC for removing materiality as a trigger for requiring a DCO to provide notice to the CFTC of an incident. As correctly explained in the Release, "a software malfunction that impairs the operation of an automated system can be material, even if the malfunction does not have any effect on the metrics or thresholds often used to determine materiality, such as the number of trades affected by the malfunction, the dollar value of those trades, or the length of a delay in processing and clearing those trades."[19]

Additionally, since there is no bright-line materiality test, DCOs have used different materiality thresholds that have resulted in inconsistent reporting across DCOs.[20] The Release notes that "there have also been instances where [DCR] learned of a malfunction, incident, or threat that had not been reported, even though [DCR] staff readily concluded, upon subsequently learning of the malfunction, incident, or threat, that it was material and that the DCO should have notified [DCR]."[21] Better Markets believes that the CFTC, and DCOs as well, will benefit from having a clear, bright-line test that requires DCOs to report each hardware or software malfunction, or operator error, and each security incident and threat, as opposed to attempting to determine whether a particular malfunction, incident, or threat qualifies as material.

---

16 17 CFR 39.18(g)(1)
17 *See* 87 Fed. Reg. at 76,700
18 *Id.*
19 *See* 87 Fed. Reg. at 76,701
20 *Id.*
21 *Id.*

Along similar lines, Better Markets commends the CFTC for including operator error as an additional subject of required reporting. As stated in the Proposed Rulemaking, the CFTC believes "operator error can cause the same or similar issues that can result from hardware or software malfunctions."[22] A fat finger error can create a significant likelihood of impairment of the operation, reliability, security, or capacity of an automated system. Therefore, we support the CFTC's proposal to require a DCO to notify it when operator error causes, or creates a significant likelihood of, impairment of the operation, reliability, security, or capacity of the DCO's automated systems.

B. <u>Reporting of any threat, not just ''targeted'' ones, will ensure that the CFTC receives notice of a broader range of cyberattacks and cyberthreats.</u>

As noted above, based on FSOC's recommendation, the CFTC must monitor cybersecurity risks at DCOs and improve information sharing as it relates to cyberattack incident reporting. The CFTC is taking a positive step by removing "targeted" as a metric for reporting cyber threats. This will ensure that the CFTC receives notice of all cyberattacks and cyberthreats. Non-targeted cyber attacks can be just as destructive as targeted attacks. As explained in the Release, taking out "targeted" may enhance the ability of the CFTC "to inform other DCOs of emerging cyberthreats and for the Commission to better assess possible emerging threats across DCOs."[23] We have seen the crippling effects a major cyberattack or data breach can have on a company. It is extremely important that the CFTC receive all notices of any cyberattack, regardless of whether it was "targeted" or not.

C. <u>Third-party information, data, or services that are relied upon by a DCO should be reported to the CFTC by the DCO if such information has been impaired due to an incident or threat at the third-party vendor.</u>

Better Markets also commends the CFTC for including "third-party information, services, or data, relied upon by the DCO in discharging its responsibilities" as information that must be the subject of a report if such data has been impaired due to incidents or threats.[24] This holds true for the recent cybersecurity incident involving Ion Cleared Derivatives, which caused a problem in the processing of trades and resulted in significant settlement delays. Thus, it is important that the DCO notify the CFTC upon discovery of any security incidents or threats affecting the information, services, or data from a third party that the DCO relies upon, just as if the incident or threat had occurred at the DCO.

D. <u>The "promptly" notification standard is vague and should be revised with a more certain timeframe.</u>

The Proposed Rule would require DCOs to "promptly" notify the CFTC of a malfunction or incident. However, this standard is vague and therefore creates too much leeway for DCOs to

---

22 *See* 87 Fed. Reg. at 76701.
23 *See* 87 Fed. Reg. at 76711.
24 *Id.*

delay disclosing these important incidents.[25] With this vague description, DCOs may take full advantage of that discretion due to a potential reluctance to divulge problems or even potential violations of applicable operational requirements, or due to a desire to first conduct an internal investigation. Whatever the motive, the resulting time delay could be detrimental to the CFTC. Therefore, Better Markets believes the CFTC should specify a deadline for notification, including a "no later than" requirement. For example, the language could read "promptly" or "as soon as possible," but no later than 24 hours after discovery." The CFTC also should be clear in its guidance that the "as soon as possible" requirement is the primary reporting deadline and that a DCO should not delay notifying the Commission until just prior to the "no later than" deadline.[26]

III. THE CFTC SHOULD NOT CODIFY THE EXISTING REPORTING FIELDS FOR DAILY REPORTING IN A NEW APPENDIX C TO PART 39.

The CFTC is proposing to codify as a rule the existing reporting fields that have been contained in an existing Reporting Guidebook, which was designed by DCR to ensure all DCOs were reporting a standard set of information.[27] The goal of standardization is certainly worthwhile, but it is a mistake to codify the Guidance, as it will make it harder to update the guidance quickly as circumstances warrant. The CFTC needs to be nimble in its approach when it comes to updating reporting data fields. Technology is moving fast, and the CFTC needs to keep up. Codifying the existing Reporting Guidebook will require the full Commission's approval every time it needs to be updated. That process can be time-consuming and may obstruct the prompt reporting of information about the latest financial innovation.

The CFTC should instead reference the Reporting Guidebook in the final rule and state that it will be updated from time to time by division action. Better Markets understands generally the benefits of codifying guidance so it is, for example, enforceable. In the context of reporting, however, those benefits are outweighed by the flexibility that reliance on a more readily amended guidance can provide. Moreover, the Release provides no indication that it has encountered difficulties getting DCOs to comply with the Reporting Guidebook. Over time, the Reporting Guidebook has had to be amended numerous times. It is, therefore, unwise to codify a document that may need to be updated quickly in the future to reflect data from the latest financial products.

---

25 The formal definition of the word "promptly" has considerable flexibility—too much, in fact—built into it. For example, the Oxford English Dictionary defines promptly to mean "readily, quickly, directly, at once, without a moment's delay." But courts have uniformly held that promptness is a function of circumstance: (1) *State v. Chesson*, 948 So.2d 566, 568 (Ala. Civ. App. 2006) (stating that the term "promptly" has been construed to mean within a reasonable time in light of all the circumstances); (2) *Doe Fund, Inc. v. Royal* Indemnity Co., 825 N.Y.S.2d 450, 451 (N.Y. App. Div. 2006) ("[W]hen an insurance policy requires notice of an occurrence or action be given promptly, that means within a reasonable time in view of all of the facts and circumstances."); (3) *Buck v. Scalf*, (Tenn. Ct. App. May 20, 2003) ("It has generally been held that the terms 'promptly' or 'prompt notice' mean that notice must be given within a reasonable time in view of all the facts and circumstances of the case.").

26 *See* 87 Fed. Reg. at 76,735.

27 *See* 87 Fed. Reg. at 76,702.

IV. THE CFTC REGULATION GOVERNING CHANGE OF CONTROL REPORTING BY THE DCO NEEDS TO BE AMENDED BY RESTORING THE ORIGINAL 2011 LANGUAGE.

The Proposed Rule would require a DCO to report any change to the entity or person that holds a controlling interest, either directly or indirectly, in the DCO.[28] While this is positive as far as it goes, it is significantly weaker than the requirements established under prior versions of the rules. The CFTC should revise Regulation 39.19(c)(4)(ix)(B) to revert to its original language regarding the information that must be reported and the need to obtain Commission approval. Any change in control of a DCO must be the subject of an approval process supported by extensive reporting.

The current language in Regulation 39.19(c)(4)(ix)(B) reads as follows:

> "**Required information.** The report shall include: A chart outlining the new ownership or corporate or organizational structure; a brief description of the purpose and impact of the change; and any relevant agreements effecting the change and corporate documents such as articles of incorporation and bylaws."

The original language for Regulation 39.19(c)(4)(ix)(B) read as follows:

> "**Required information**. The report shall include: a chart outlining the new ownership or corporate or organizational structure; a brief description of the purpose and impact of the change; and any relevant agreements effecting the change and corporate documents such as articles of incorporation and bylaws. ***With respect to a corporate change for which a derivatives clearing organization submits a request for approval to transfer its derivatives clearing organization registration and open interest under § 39.3(f) of this part, the informational requirements of this paragraph (c)(4)(viii)(B) shall be satisfied by the derivatives clearing organization's compliance with § 39.3(f)(3)***."[29]

For reference, Regulation 39.3(f) used to read:

> "**Request for transfer of registration and open interest**. (1) In anticipation of a corporate change that will result in the transfer of all or substantially all of a derivatives clearing organization's assets to another legal entity, the derivatives clearing organization ***shall submit a request for approval to transfer the derivatives clearing organization's registration*** and positions comprising open interest for clearing and settlement."[30]

---

[28] *See* 87 Fed. Reg. at 76,704.

[29] Derivatives Clearing Organization General Provisions and Core Principles; 76 Fed. Reg. 69,334 (November 8, 2011).

[30] *See* 76 Fed. Reg. at 69,445.

And Regulation 39.3(f)(3) used to read:

> "**Required information**. The request shall include the following: (i) The underlying agreement that governs the corporate change; (ii) A narrative description of the corporate change, including the reason for the change and its impact on the derivatives clearing organization's financial resources, governance, and operations, and its impact on the rights and obligations of clearing members and market participants holding the positions that comprise the derivatives clearing organization's open interest; (iii) A discussion of the transferee's ability to comply with the Act, including the core principles applicable to derivatives clearing organizations, and the Commission's regulations thereunder; (iv) The governing documents of the transferee, including but not limited to articles of incorporation and bylaws;"[31]

Under the original regulation governing change of control, a DCO involved in a change of control or sale of its business needed to submit extensive information to the Commission and obtain its approval. However, the language was changed under Chairman Christopher Giancarlo's Project KISS initiative in a proposed rulemaking in 2016.[32] The rules were eventually finalized under Chairman Tarbert in early 2020. Under Project KISS, the CFTC essentially turned a blind eye to the threat of another crisis. The Commission at that time thought it could foster economic growth by watering down its regulations. Diluting regulation increases the likelihood of a financial crisis, and a financial crisis in turn does far more to destroy financial markets and economic prosperity than any set of rules and regulations possibly can.[33]

Recent events illustrate the dangers of this approach, including FTX's, through its ownership of LedgerX, attempt to facilitate the establishment of a very dangerous 24/7 disintermediated clearing model for crypto futures. Fortunately, that effort did not succeed. But with the implosion of FTX, and with interested outside bidders seeking to purchase a regulated DCO, it has been reported that the sale of LedgerX may occur in the spring with no input from the Commission.[34] It is unacceptable that the acquisition or change in control of major derivatives market participants could be effected without the approval and input from the CFTC. Therefore, it is imperative that the CFTC amend Regulation 39.19(c)(4)(ix)(B) back to its original language.[35]

V. <u>THE CFTC SHOULD REMOVE THE MATERIALITY STANDARD FOR REPORTING ISSUES WITH CREDIT FACILITY FUNDING ARRANGEMENTS, LIQUIDITY FUNDING ARRANGEMENTS, AND CUSTODIAN BANKS.</u>

---

31 *See* 76 Fed. Reg. at 69,432.

32 Derivatives Clearing Organization General Provisions and Core Principles, 84 FR 22226

33 *See* Better Markets Request for Information on Project KISS (Keep It Simple Stupid), RIN 3038-AE55 (Sept. 29, 2017)

34 [Keynote Address of Commissioner Kristin Johnson at Digital Assets @ Duke Conference, Duke's Pratt School of Engineering and Duke Financial Economics Center | CFTC]

35 The rule change should ensure inclusion of references to the original language of Regulation 39.3(f), which required the production of "any additional information requested by the Commission".

The Proposed Rule would establish an important reporting requirement if issues or concerns arise with respect to certain funding sources relied upon by the DCO. However, it would only be triggered if the concerns were "material." The proposed language states that "a DCO report to the Commission within one business day after it becomes aware of any ***material*** issues or concerns regarding the performance, stability, liquidity, or financial resources of any credit facility funding arrangement, liquidity funding arrangement, custodian bank, or settlement bank used by the DCO or approved for use by the DCO's clearing members."[36]

Incorporating this "materiality" standard is a mistake. As stated above, there is no bright-line test to determine what is considered material. DCOs will have the discretion to determine what is material or not, which will result in inadequate reporting, different materiality thresholds, and inconsistent reporting across DCOs. Furthermore, the Proposed Rule is inconsistent with what the CFTC itself expects from DCOs in terms of reporting. Although the language in the Proposed Rule refers to "material" issues or concerns, the Release reflects a broader view, observing that "it is important that the Commission be informed when a DCO experiences or becomes aware of ***any*** issues." Clearly, the materiality test should be removed, and the requirement should be written to require reporting of ***any*** concerns or issues.

CONCLUSION

We hope these comments are helpful as the Commission finalizes its Proposed Rulemaking.

Sincerely,

Dennis M. Kelleher
President and CEO

Cantrell Dumas
Director of Derivatives Policy

---

36 *See* 87 Fed. Reg. at 76,704.

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464
dkelleher@bettermarkets.org
cdumas@bettermarkets.org
http://www.bettermarkets.org