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Self-Regulation in the Derivatives Markets: Stability Through Collaboration

*Heath P. Tarbert**

* Heath Tarbert served as the 14th Chairman and Chief Executive of the Commodity Futures Trading Commission and the Vice Chair of the Board of the International Organization of Securities Commissions (IOSCO). The opinions, analyses, and conclusions expressed in this article are those of the author and do not necessarily reflect the views of the Commission, the CFTC staff, the United States government, or IOSCO.

Abstract

Sound financial regulation does not require choosing between governmental and private action. Instead, optimal regulatory solutions often blend the expertise and adaptability of private-sector influence with the stabilizing effects of federal oversight. This collaborative framework has a rich history in U.S. derivatives regulation, which has long relied on self-regulatory organizations (“SROs”) like exchanges, clearinghouses, and the National Futures Association to help promote market stability and customer protection. SROs remain subject to oversight by the Commodity Futures Trading Commission (“CFTC”), which guards against the proverbial fox-in-the-henhouse scenario while advancing quintessential government functions like mitigating systemic risk.

The advantages of this self-regulatory framework were underscored in 2020, when the coronavirus (COVID-19) pandemic spurred unprecedented volatility across U.S. derivatives markets. Effectively navigating the market effects of the pandemic required a calibrated approach that drew from the advantages of SROs and the CFTC. The integrated response that emerged is a model for how SROs and the CFTC can together promote stability through collaboration.

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INTRODUCTION¹

Debates about the ideal form of regulation often pose a false dichotomy, sorting regulatory efforts into two seemingly oppositional categories: governmental or private. But this division offers an overly simple account of the regulatory structures that define modern administrative law. Instead, sound regulation is, more often than not, the result of collaboration between traditional governmental functions and self-regulatory measures performed by private actors. Far from being at odds with each other, government and the private sector often work together to produce regulatory solutions that balance effective oversight with the flexibility needed to adapt to changing circumstances.

This article will identify and discuss the virtues of both governmental and self-regulation, identifying specific examples of each. As Chairman of the Commodity Futures Trading Commission (CFTC), my analysis will focus on the U.S. derivatives markets, which offer an ideal vantage point for examining self-regulation. The general framework for self-regulation has evolved over time, but its core structure has been preserved. As discussed in detail below, self-regulatory organizations (SROs) play a critical role in regulating the derivatives market, subject to broad CFTC oversight. This structure has for decades combined the key contributions of both the private sector and government into an integrated regulatory system that has proven adaptable to change. Just as an accurate study of government in the United States cannot consider only the President, Congress, and the Judiciary while omitting state and local governments, so too must an inquiry into U.S. derivatives market focus on SROs.

One especially timely example of the self-regulatory framework in practice followed the coronavirus (COVID-19) pandemic, which took hold in the United States in 2020 and produced unprecedented market volatility in March of that year.² For participants in the U.S. derivatives markets, successfully navigating the effects of COVID-19 required an integrated approach that tapped the strengths of both governmental and self-regulatory measures. In responding to an economic crisis of historic proportions, the CFTC and derivatives SROs came together to foster stability through collaboration.

¹ This article is based on a presentation I gave at the Annual Brodsky Family JD-MBA Lecture Series at Northwestern University, Pritzker School of Law, Chicago, Illinois on November 9, 2020. I would like to express my immense gratitude to Daniel J. Grimm, who served as Senior Counsel to the Chairman, for his outstanding work on this article.

² See Heath Tarbert, *Volatility Ain't What it Used to Be*, WALL ST. J. (Mar. 23, 2020) (describing historic volatility across nearly every asset class, including futures, equities, and fixed-income securities) [hereinafter Tarbert, *Volatility*].

I. A SELF-REGULATORY TRADITION

A. Derivatives Exchanges

Self-regulation has long been a hallmark of the U.S. derivatives markets, predating the Grain Futures Act of 1922.³ The CFTC is a relative newcomer in the long history of derivatives self-regulation, arriving long after the Governor of Illinois signed legislation granting the Chicago Board of Trade (CBOT) self-regulatory authority over its members on February 18, 1859.⁴ This act by the Illinois Governor was the first effort by government to formalize self-regulation in the derivatives markets, granting the CBOT self-regulatory authority over futures trading in the core agricultural commodities of wheat, corn, and oats.⁵ In the years that followed, the CBOT expanded its self-regulatory approach to exchange-traded futures by implementing member rules for margin⁶ and delivery, and by prohibiting “corners,” a manipulative technique that drives commodity prices higher by obtaining large positions in both spot commodities and their associated futures contracts.⁷ CBOT’s October 4, 1868 prohibition on corners was another watershed event, reflecting the first-ever regulatory effort to prevent market manipulation.⁸ These and other early exchange rules were “self-policing or enforced by contract,”⁹ laying the framework for the development of a self-regulatory system that would persist through the present day—branching out from traditional agricultural futures contracts to products involving swaps and digital assets.¹⁰

What is especially remarkable about self-regulation by derivatives

³ 42 Stat. 998 (1922), 7 U. S. C. §§ 1-17 (1926). In describing the long history of self-regulation in the derivatives markets, former President and CEO Daniel J. Roth of the National Futures Association said, “[t]he United States Congress first passed legislation regulating futures markets in 1922. By that time, self-regulatory mechanisms for those markets had already been in place for over 74 years.” Daniel J. Roth, former President and CEO of NFA, “American Experience in Self-Regulation Over Futures Markets and Jurisdictional Boundaries Between Futures and Securities in the U.S.,” speech at the International Seminar on Legislation of Futures Laws (Zhengzhou, China, Nov. 12, 2014).

⁴ U.S. CFTC, “History of the CFTC: US Futures Trading and Regulation Before the Creation of the CFTC,” https://www.cftc.gov/About/HistoryoftheCFTC/history_precftc.html. [hereinafter CFTC, History]. The CBOT was founded on April 3, 1848, and engaged in informal self-regulatory measures since that time. See, e.g., Roth, *supra* note 3.

⁵ *Id.*

⁶ CBOT’s first margin requirements took the form of “performance bonds” that were posted by buyers and sellers. See CME Group, “Timeline of CME Achievements,” <https://www.cmegroup.com/company/history/timeline-of-achievements.html>.

⁷ See CFTC, History, *supra* note 4.

⁸ *Id.*

⁹ Ethiopis Tafara & Robert J. Peterson, *In Praise of Middlemen: The Regulation of Market Intermediaries in Developing Economies*, 37 GEO. J. INT’L L. 153, 159 (2005).

¹⁰ See, e.g., Roth, *supra* note 3 (while “the markets themselves, government regulation and self-regulation have all changed dramatically over the years, but to this day privately funded self-regulation remains the first line of defense” for the derivatives markets).

exchanges¹¹ like the CBOT is that it predates the establishment of the CFTC by 115 years. During this period, the exchanges engaged in self-regulation because they recognized “that it was simply ‘good business’ to discourage sharp practices which could undermine the vital public confidence in the exchanges.”¹² Based on this view, “as long as 100 years before the first Federal legislation in the area, the exchanges . . . had some sort of a self-regulatory system complete with codes of conduct, surveillance procedures, and disciplinary powers.”¹³

It was not until October of 1974 that Congress passed and President Ford signed into law the Commodity Futures Trading Commission Act, which established the CFTC as an independent federal regulatory agency with oversight over that majority of the U.S. derivatives markets.¹⁴ Part of the motivation to create the CFTC was the perceived need to provide federal oversight over the self-regulation performed by the existing derivatives exchanges. In deliberating over the formation of the CFTC, one senator explained, “[t]o date, self-regulation has been left to the exchanges, . . . It is difficult to act both as the law enforcer and the accused.”¹⁵

The prevailing view became that while the “day-to-day operations of the exchanges should be left to the exchanges . . . a Federal agency should have broad supervisory powers” over them in turn.¹⁶ An example legislators

¹¹ It is important to note that derivatives exchanges and derivatives clearing organizations function as SROs. *See, e.g.*, Gideon Mark, *Spoofing and Layering*, 45 J. CORP. L. 399, 459 (2020) (“Self-regulation in the futures markets primarily occurs under the umbrella of CME Group, Inc., a publicly traded entity that operates four SROs and DCMs—CME, CBOT, NYMEX, and NYMEX’s subsidiary COMEX”); *see also* David B. Spence & Robert Prentice, *The Transformation of American Energy Markets and the Problem of Market Power*, 53 B.C.L. REV. 131, 151 (2012) (“Commodities exchanges like NYMEX or the Chicago Board of Trade (CBOT) . . . are membership organizations that engage in considerable self-regulation under the oversight of a federal regulator—in this case the CFTC.”); CFTC, Request for additional comments on self-regulation and self-regulatory organizations (“SROs”), 70 FED. REG. 71090, 71090 n.1 (Nov. 25, 2005) (defining SROs to “include designated contract markets . . . derivatives clearing organizations . . . and registered futures exchanges.”).

¹² 119 Cong. Rec. H11352-11355, at H11352 (daily ed. Dec. 13, 1973) (statement of Rep. Poage).

¹³ *Id.*

¹⁴ However, the federal government did have a hand in derivatives regulation prior to 1974, most particularly through Commodity Exchange Authority, the predecessor to the CFTC that was housed inside the U.S. Department of Agriculture. *See* CFTC, History, *supra* note 4; *see also* 119 Cong. Rec. S18963-18966 at S18964, S18965 (daily ed. Oct. 10, 1973) (discussing the role of the Commodity Exchange Authority in regulating the futures markets).

¹⁵ 119 Cong. Rec. S23495-520, at 496 (daily ed. Dec. 20, 1973) (statement of Sen. Hart); *See also* Jerry W. Markham, *The role of self-regulation*, 13A Commodities Reg. § 26:1 (Mar. 2020) (“Self-regulation seeks to permit the exchange members to regulate their own conduct and play the primary role in regulation, while the government plays a residual, oversight role.”).

¹⁶ 119 Cong. Rec. S23495-520, at 496 (daily ed. Dec. 20, 1973) (statement of Sen.

considered was the setting of margin for derivatives trading. In broad terms, margin is “money or other high-quality collateral that buyers and sellers exchange to protect against the risk of default.”¹⁷ Margin assumes two forms: initial and variation.¹⁸ Initial margin “is like a security deposit” and is required to trade.¹⁹ Variation margin addresses changes in market value and must be posted if a trader’s position loses value.²⁰ Together, initial and variation margin reduce counterparty credit risk associated with trading uncleared swaps.²¹

While the exchanges “are more intimately acquainted” with margin “than a Federal agency,” that alone does not address the situation of an exchange setting margin too low.²² “In such a situation, the Federal Government should have [the] power to change the margin.”²³ In balancing these interests, many in Congress sought to preserve the self-regulatory history of the derivatives market while creating appropriate federal oversight, resulting in a system that “gives the initial decisionmaking power to the exchange, with oversight power in the [CFTC].”²⁴ The CFTC’s role was to act as “an impartial umpire” to “regulate and handle the public interests, the producers’ interests, and the consumers’ interests.”²⁵

Senator Herman Talmadge put it more directly, explaining that “[t]he creation of a strong regulatory commission is not meant to deprive exchanges of self-regulation, but rather to assure they assume responsible and adequate self-regulation.”²⁶ In forming the CFTC, it was thus critical that the new agency be given “the tools to require that the exchanges perform their regulatory functions better.”²⁷ This sentiment informed the self-regulatory system that grew in the years following the CFTC’s creation in 1974.

A Senate hearing in 1982 provides historical context regarding the dual growth of self-regulatory exchanges and the oversight role of the then-recently created CFTC:

Hart).

¹⁷ Tarbert, *Volatility*, *supra* note 2.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² 119 CONG. REC. S23495-520, at 496 (Dec. 20, 1973) (Senator Philip A. Hart).

²³ *Id.*

²⁴ *Id.*

²⁵ H.R. 13113 CONG. REC. H2923, 2928 (Apr. 11, 1974) (Rep. John M. Zwach).

²⁶ 120 CONG. REC. S16127-16137, at S16131 (Sept. 9, 1974). Senator Dole added, “[f]or viable, active markets, the exchanges largely regulate themselves, as they should. The Commodity Exchange Authority has served to watch over the operations of these self-regulated exchanges.” The reason to form the CFTC was that the growth in the futures markets required more robust oversight of the exchanges’ self-regulatory efforts. *Id.*

²⁷ *Id.*

Since 1922 government . . . has exercised regulatory authority [over the derivatives markets], primarily by providing oversight of exchange self-regulation. When, in 1974, Congress provided the Commission with additional and more powerful regulatory tools than its predecessor agency had possessed . . . self-regulation was maintained as the first line of defense. The terms of the [Commodity Exchange] Act and the limited resources allotted [to] the Commission made clear that initial responsibility for the operation of the futures markets is left to the private sector and the self-regulators. The Commission plays an important oversight role in that [it] directly intercede[s] when in the Commission’s judgment it is warranted to do so.²⁸

Four years later, a congressional assessment similarly concluded that the self-regulatory arrangement was functioning as designed: the CFTC “monitors the exchanges’ activities on a continuous basis” through both on-site personnel and rule enforcement reviews “to determine the effectiveness of exchange self-regulation.”²⁹ The report concluded that this system “has proven over the decades to provide effective, but not overly burdensome, regulation of these fast-paced markets.”³⁰

While the derivatives markets of today innovate at a pace much faster than during the early days of CFTC regulation, the unique balance between self-regulation by derivatives exchanges and CFTC oversight has endured. This balanced arrangement is distinct from systems of private ordering, which posit that private industry should perform nearly all regulatory tasks independently.³¹ But striking the appropriate balance is not always a simple task, and it requires today—as it did in the 1970s—a nuanced understanding of the roles played by both industry and government.

Yet all of this begs the question: what about derivatives-related conduct that is not clearly tied to an exchange? During the 1970s, growth in the derivatives industry placed new market participants who were not members of any exchange into closer contact with the public.³² As non-members of any exchange, these entities—such as futures commission merchants, commodity pool operators, and commodity trading advisors—“created a widening gap in the regulatory structure.”³³

The solution to these system gaps arrived in the form of the National

²⁸ Hearings on S. 2109 Before the Subcomm. on Agricultural Research and General Legislation of the Senate Comm. on Agriculture, Nutrition and Forestry, 97th Cong., 2d Sess. 42 (1982), quoted by Jeffrey W. Markham, *CFTC deference to self-regulation*, 13A COMMODITIES REG. § 26:4 (Mar. 2020).

²⁹ H.R. REP. 99-624, 7-8, 1986 U.S.C.C.A.N. 6005, 6008.

³⁰ *Id.*

³¹ *See, e.g.*, Mark, *supra* note 11, at 458 (“Self-regulation differs from pure private ordering in part [because it] entails government agencies such as the CFTC . . . imposing formalities for the adoption or amendment of rules, policies, and procedures.”).

³² *See* Roth, *supra* note 3.

³³ *Id.*

Futures Association (NFA), a registered futures association with self-regulatory authority over its members.³⁴ Before describing the particular role of the NFA in modern derivatives markets, a brief contextual discussion of the relevant statutory provision is necessary.

B. Section 21 of the Commodity Exchange Act

The CFTC is authorized to designate registered futures associations pursuant to Section 21 of title III of the Commodity Exchange Act (Act), which sets forth standards for registration, such as that the association be “in the public interest” and provide formalized rules for association membership and member conduct.³⁵ Section 21 is the genesis of the NFA—the only registered futures association—and plays a central role in the rich self-regulatory history of the U.S. derivatives markets. In particular, Section 21 provides a statutory basis for implementing the modern self-regulatory system of direct member regulation by associations that are themselves subject to oversight by the CFTC.

This arrangement was designed intentionally and is reflected in the legislative history of Section 21. For instance, in describing the need to establish a protocol for registering futures associations under CFTC oversight, one senator explained that the NFA and other associations were important “for the purpose of self-regulating the practices of their members.”³⁶ As a House of Representatives conference report noted, “[s]uch authority could only be exercised if approved by the Commission, and only if the association has met the requirements of title III.”³⁷

CFTC oversight over the NFA has manifested itself in numerous ways under Section 21 of the Act. For example, no futures association can become registered with the CFTC “unless the Commission finds, under standards established by the Commission,” that the association satisfies CFTC-defined registration requirements. Once a futures association is registered with the CFTC, the agency is empowered by the Act “to abrogate any rule of the registered futures association” if the agency deems that doing so is, among other things, necessary to “effectuate the purposes” of Section 21.³⁸

The CFTC may also make written requests to an association to “adopt any specified alteration or supplement to its rules” concerning the broad

³⁴ The legislative history of the Act draws the distinction as follows: “exchanges are charged with important self-regulatory responsibilities over the members’ trading activities. Similarly, the National Futures Association . . . performs many important regulatory duties relating to off-exchange functions and activities.” H.R. REP. 99-624, 7-8, 1986 U.S.C.C.A.N. 6005, 6008.

³⁵ 7 U.S.C. § 21 (2018).

³⁶ 120 CONG. REC. S18864-18872, at S18869 (Oct. 10, 1974).

³⁷ 120 CONG. REC. H10247-10266, at H10248 (Oct. 9, 1974).

³⁸ 7 U.S.C. § 21(k)(1).

topics covered by Section 21.³⁹ These and other examples demonstrate that in the delegation of regulatory authority by Congress to the CFTC and then from the CFTC to self-regulatory organizations, CFTC oversight provides built-in accountability measures to ensure that registered futures associations are fulfilling their duties to the markets and their members.

As this section has described, self-regulation in the U.S. derivatives markets is a fundamental component of the regulatory structure. Since its formation, the CFTC has effectively partnered with both the exchanges and the NFA to promote sound regulation in the derivatives markets. While these and other SROs maintain primary responsibility for regulating the conduct of their members, the CFTC retains oversight of the SROs themselves, producing a system that balances self-regulation with federal efforts.

C. The National Futures Association

On September 22, 1981, the CFTC formally designated the Nationals Futures Association as a registered futures association under Section 21 of the Act, formalizing the NFA's self-regulatory functions and placing them under CFTC oversight.⁴⁰ This model of a registered association serving as a primary regulator under federal oversight was modeled on a similar construct from the securities industry.⁴¹

After only a few years, Congress took notice not only of the NFA's progress in providing self-regulatory support for the CFTC, but it is doing so in a fiscally responsible manner. An early House of Representatives Report lauds the NFA not only for its progress in building the self-regulatory systems still in operation today, but also for financing its efforts through member dues, "to some extent lessening the pressure to increase appropriations for the Commission."⁴²

The CFTC's designation of NFA as a registered futures association allowed NFA to begin its work⁴³ as a central component of self-regulation for the users of derivatives markets. Through authority delegated by the CFTC, the NFA manages the registration of diverse market participants including commodity pool operators, futures commission merchants, and commodity trading advisors. Moreover, after passage of the Dodd-Frank

³⁹ 7 U.S.C. § 21(k)(2).

⁴⁰ NFA, *About NFA*, <https://www.nfa.futures.org/about/index.html> [hereinafter *About the NFA*]. The CEA establishes numerous registration and governance requirements for registered futures associations. *See* 7 U.S.C. § 21 (2019).

⁴¹ H.R. 13113 CONG. REC., H 2923, 2924 (Apr. 11, 1974) (describing the Act as "authoriz[ing] the establishment of an association of commodity dealers or persons registered under the Act similar to [the National Association of Securities Dealers] in the securities industry." (Rep. Poage).

⁴² H.R. Rep. No. 99-624, at 6009 (1986).

⁴³ NFA's self-regulatory efforts began in 1982. *Id.*

Wall Street Reform and Consumer Protection Act (“the Dodd-Frank Act”)⁴⁴ in 2010, the NFA’s oversight extended to swap dealers and major swap participants.⁴⁵ In handling registration and other matters “[o]n behalf of the CFTC,”⁴⁶ the NFA is a key partner in fulfilling the CFTC’s statutory obligation to implement the Act. All told, the NFA today is responsible for seven broad categories of self-regulation that complement the CFTC’s oversight role.⁴⁷ To take one example, the CFTC delegated the job of managing the Act’s registration requirements to the NFA.⁴⁸ Today, the NFA manages more than 45,000 discrete registrations, as set forth in the chart below:⁴⁹

NFA Membership Category	Registrations
Commodity Trading Advisors	1,362
Commodity Pool Operators	1,251
Futures Commission Merchants	61
Introducing Brokers	1,051
Retail Foreign Exchange Dealers	4
Swap Dealers	109
Exchanges	6
Associates	44,526

The importance of SROs in the functioning of the U.S. derivatives

⁴⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁴⁵ See NFA, *NFA Members*, <https://www.nfa.futures.org/members/index.html> [hereinafter NFA, *NFA Members*]. Like the CFTC, the NFA’s responsibilities greatly expanded following passage of the Dodd-Frank Act. See, e.g., John Okray & Rachel V. Rose, *Interview with Jonathan Marcus, General Counsel of the U.S. Commodity Futures Trading Commission*, 63 FED. LAW. 72, 74 (Dec. 2016) (quoting Jonathan Marcus as saying, “[s]ince the passage of Dodd-Frank, . . . the [CFTC] has delegated significant additional responsibility to the NFA. For example, the NFA now helps resolve valuation disputes, and the NFA receives data directly from [swap data repositories] to support its market supervision and compliance functions.”).

⁴⁶ NFA, *NFA Members*, *supra* note 45.

⁴⁷ In broad terms, the NFA is responsible for (1) managing CFTC registration; (2) developing rules for NFA members that are subject to CFTC approval; (3) enforcement of NFA rules; (4) regulating swap dealers through registration and compliance examinations; (5) swap execution facility (SEF) surveillance, which the NFA conducts pursuant to contracts with various SEFs; (6) arbitration of customer disputes with NFA members; (7) educational outreach to customers and NFA members. Roth, *supra* note 3.

⁴⁸ See, e.g., *id.*

⁴⁹ NFA, *Membership and Directories*, <https://www.nfa.futures.org/registration-membership/membership-and-directories.html>. Note that the figures in the chart refer to discrete registrations rather than entities. An entity could, for example, be registered as both a commodity trading advisor and a commodity pool operator. There were 3,298 discrete entities registered with the NFA during the same period.

markets is made ever clearer when considering examinations of market participants. While the CFTC has a critical role in directly overseeing and conducting examinations of clearinghouses, SROs are responsible for the majority of examinations of U.S. derivatives market participants, as reflected below:

Market Participant Examinations (2015-2020)⁵⁰

	CFTC	NFA	CME
CTA	0	1,500	
CPO	0	1,300	
FCM	0	150	259
IB	0	1,100	
RFED	0	20	
SD	0	270	
CCP	21	0	
MISC.	0	0	46
TOTAL	21	4,340	305

Among its many self-regulatory responsibilities, the NFA establishes binding rules for members and is engaged in creating industry best practices.⁵¹ Violations of the NFA Rulebook are addressed by enforcement actions that the NFA can bring against its members.⁵² Through these efforts and more, the NFA has long served as “a reliable partner” to the CFTC, advancing efforts to mitigate systemic risk and curtail fraud and abuse.⁵³

⁵⁰ All data expressed in this chart is on file with the author. For the NFA column, entities that are registered in multiple capacities will be counted in every category in which they are registered. For example, a CTA that is also registered as a CPO will be counted once as a CTA and once as a CPO. Entities in the “Misc.” category fall within one or more of the other categories but are expressed only as “Misc.” to protect the confidentiality of certain information.

⁵¹ About the NFA, *supra* note 40.

⁵² See NFA, *Enforcement and Registration Actions*, <https://www.nfa.futures.org/news/EnforceRegActionsSimple.aspx>.

⁵³ See, e.g., Okray & Rose, *supra* note 45, at 74 (interview with former CFTC General

The NFA's work in these areas effectively complements, without displacing, the CFTC's efforts.

II. ADVANTAGES OF SELF-REGULATION

Self-regulation⁵⁴ offers many advantages to regulated industries, the government, and taxpayers. This section will discuss why self-regulation can be superior to traditional government regulation in appropriate circumstances.

A. Cost Savings to Taxpayers

A key reason to favor self-regulation is that it can often achieve regulatory goals while reducing costs. SROs such as the NFA are typically funded by the regulated industry, freeing up taxpayer resources for other measures.⁵⁵ As a report by the International Organization of Securities Commissions (IOSCO) explains, an SRO structure “can result in substantial cost savings to the government, because those regulatory costs are largely shifted to the regulated industry.”⁵⁶ Even where government regulators oversee and monitor SRO compliance with statutes and regulations, “the costs to government are probably less than they would be if government took on the bulk of regulatory responsibilities.”⁵⁷ Hence, government cost savings obtained through the SRO structure are effectively passed down to taxpayers who would otherwise finance the costs of regulation.⁵⁸

Counsel Jonathan Marcus).

⁵⁴ While this article focuses on SROs, a brief point should be made about designated self-regulatory organizations (DSROs). When an entity is subject to more than one SRO, the SROs are permitted to determine among themselves which one will be the “designated” regulator of the entity. A plan is then submitted to the CFTC, which can approve, modify, or reject the plan. See CFTC, Futures Glossary, *Designated Self-Regulatory Organization (DSRO)*, https://www.cftc.gov/LearnAndProtect/EducationCenter/CFTCGlossary/glossary_d.html.

⁵⁵ See NFA, *Funding*, <https://www.nfa.futures.org/about/funding.html>.

⁵⁶ IOSCO, SRO Consultive Committee, *Model for Effective Regulation* (May 2000) at 12, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD110.pdf>. See also Emily Hammond, *Double Deference in Administrative Law*, 116 COLUM. L. REV. 1705, 1718 (2016) (“Put frankly, today’s major oversight agencies could not themselves assume the responsibilities of their SROs without extraordinary increases in their staffing and budgets.”).

⁵⁷ Margot Priest, *The Privatization of Regulation: Five Models of Self-Regulation*, 29 OTTAWA L. REV. 233, 270 (1997).

⁵⁸ See, e.g., former CFTC Commissioner Walter Lukken, *Reauthorization: Let the Debate Begin*, 24 FUTURES & DERIVATIVES L. REP. 1 (2004) (“there are significant potential savings to the taxpayer in having the [derivatives] industry regulate itself.”); see also Natalie Stoeckl, *The Private Costs and Benefits of Environmental Self-Regulation: Which Firms Have Most to Gain?*, 13 BUS. STRATEGY ENV'T 135,136 (2004); see also Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C.L. Rev. 475, 475 (1984).

B. Consistent and Sustainable Financing

While fiscally appealing, the SRO self-financing model can also produce discernable improvements in regulation. The first relates to the implementation challenges of legislating large-scale regulatory efforts, and of sustaining adequate levels of financing for them over time. Legislators may justifiably be “reluctant to spend taxpayers’ money to finance ambitious regulatory plans[.]”⁵⁹ Accordingly, shifting costs to regulated industries can sidestep “the political considerations that surround” financing and budgets, “effectively ensuring that significant resources will be utilized for supervising the [regulated] industry.”⁶⁰ Predictability is also improved, as “[i]ndustry funding . . . provides greater certainty regarding the timing and availability of funding and thus greater ability to make capital investments in longer-term initiatives.”⁶¹ In short, SRO financing can avoid the problems of fiscal wrangling and budget cuts.

There is also an argument that SRO self-financing improves the quality of regulation. Financial Industry Regulatory Authority (FINRA) CEO Robert Cook has argued that under the SRO self-financing model, “[t]he industry bears the cost of its own supervision, which alleviates the need for even larger governmental expenditures for this purpose. This funding can lead to heightened supervision.”⁶² Using FINRA as an example, Cook explained that “the SRO model has resulted in a regulatory regime in which every broker-dealer member of [FINRA]” is subject to recurrent compliance examinations and application approval.⁶³ The key point is that self-regulation can scale with industry—as a regulated market expands, so too does SRO financing. This is not necessarily the case with government funding, which may not increase as regulated markets grow. On this issue, for example, the CFTC offers a case in point. While the CFTC’s jurisdiction was first extended to swaps following the Dodd-Frank Act,⁶⁴ and more recently to certain conduct involving digital assets,⁶⁵ the agency’s funding has only modestly grown.⁶⁶

⁵⁹ Stavros Gadinis & Howell E. Jackson, *Markets As Regulators: A Survey*, 80 S. CAL. L. REV. 1239, 1250–51 (2007).

⁶⁰ *Id.* at 1251.

⁶¹ Robert Cook, *Why do we need self-regulator organizations? – Cook*, INVESTMENTNEWS (April 2, 2017), <https://www.investmentnews.com/why-do-we-need-self-regulatory-organizations-cook-71012>.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁶⁵ The CFTC has enforcement jurisdiction over fraud and manipulation in connection with digital assets. *See, e.g., CFTC v. McDonnell*, 287 F. Supp. 3d 213, 217 (E.D.N.Y. 2018); *see also CFTC v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 495-98 (D. Mass. 2018).

⁶⁶ For example, the CFTC requested a budget of \$168 million in 2010 and \$216 million in 2011, the first year following passage of the Dodd-Frank Act and the beginning of the CFTC’s oversight over the multi-trillion-dollar U.S. swaps markets. COMMODITY FUTURES

C. Knowledge and Expertise

Industry knowledge and expertise are additional reasons to favor self-regulation. Many regulated industries are highly specialized and demand significant levels of expertise to manage them effectively. While the dedicated civil servants who staff our government agencies can and do obtain this expertise, drawing from industry knowledge offers additional insight that can improve regulatory outcomes both for SROs and the government. As one scholar has argued, “[p]rivate organizations are by their nature composed of individuals or groups with an interest in and knowledge of the subject area around which they are organized. This makes them useful repositories of expertise to which government regulators can turn.”⁶⁷ As organizations composed of industry members, SROs have their finger on the pulse of industry and can often obtain accurate information more quickly than their government counterparts can.

It is difficult to overstate the value of industry expertise to regulatory systems. As some scholars have posited, “[p]erhaps the greatest single benefit that self-regulation possesses over other forms of regulation is its access to direct industry expertise.”⁶⁸ This is particularly true when regulated industries are fast-moving or digitizing—such as modern derivatives markets.⁶⁹ Drawing from industry experts can also have the effect of reducing the costs of regulating, both by improving process efficiency and avoiding unnecessary or duplicative measures.⁷⁰

Among other things, SROs like the NFA publish rules and conduct standards that bind members. Drawing from specialized knowledge helps ensure that these efforts are effective and well-tailored. In addition, the NFA frequently shares information with the CFTC regarding developments in the market, issues of regulatory concern to its members, and violations of CFTC rules. The NFA even proposes rulemakings to the CFTC—ensuring that the technical knowledge of NFA members is considered by regulators as the markets evolve.⁷¹

TRADING COMM’N, PRESIDENT’S BUDGET AND PERFORMANCE PLAN, FISCAL YEAR 2011 (2010),

<https://www.cftc.gov/idc/groups/public/@newsroom/documents/file/cftcbudget2011.pdf>.

⁶⁷ Douglas C. Michael, *Federal Agency Use of Audited Self-Regulation as a Regulatory Technique*, 47 ADMIN. L. REV. 171, 181 (1995).

⁶⁸ William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 55 (2013).

⁶⁹ *Id.* (arguing that “[A] financial SRO can enjoy a greater degree of information and experience regarding the way in which financial transactions are actually performed in today’s incredibly sophisticated and specialized economy.”).

⁷⁰ See Gina-Gail S. Fletcher, *Benchmark Regulation*, 102 IOWA L. REV. 1929, 1967 (2017) (“[S]elf-regulation leverages the technical expertise and knowledge of the industry to craft a high-quality, efficient, and effective system of rules and regulations for the industry. Indeed, reliance on industry experts to design and implement the rules should result in lowered costs and increased benefits for the regulated industry.”).

⁷¹ See NFA, *Rule Submission to the CFTC*, <https://www.nfa.futures.org/news/newsRule>

The expertise and knowledge of SROs are often reflected in CFTC rulemakings. A recent example is the final rule on speculative position limits for derivatives, which the CFTC finalized in October 2020. Generally speaking, position limits determine the size of speculative derivatives positions a trader may hold in a particular commodity.⁷² The CFTC establishes the “ceiling” of speculative position limits, while exchanges can apply further levels as necessary to help prevent manipulative conduct such as corners and squeezes.⁷³ Position limits do not apply to bona fide hedging transactions.⁷⁴

In the final position limits rule, the CFTC called for enhanced cooperation between the agency and exchanges, as the latter have “obligations to carry out self-regulatory responsibilities, resources, deep knowledge of their markets and trading practices, close interactions with market participants, [and] existing programs for addressing [position limit] exemption requests, and direct ability to leverage these resources to generally act more quickly than the Commission[.]”⁷⁵

Among other efforts, exchanges can capitalize on their deep knowledge of the derivatives markets and closeness to market participants to provide the CFTC with deliverable supply information for commodities underlying futures contracts, recommend position limit levels to the CFTC, and “help administer the program for recognizing bona fide hedges.”⁷⁶

An example is the process for addressing requests for non-enumerated bona fide hedging positions.⁷⁷ Under the final position limits rule, market participants can submit one application to an exchange to request a non-enumerated bona fide hedge, and receive approval of such request for the purposes of both exchange-set limits and federal limits, provided the CFTC does not intervene within a ten-business-day review period (or two business days in the case of sudden or unforeseen bona fide hedging needs) following the exchange approval.⁷⁸ The new process leverages existing exchange processes, expertise, and resources while affording the Commission the opportunity to intervene as needed.

In sum, the CFTC’s final position limits rule follows a self-regulatory framework that has been effective for decades: wide latitude for SRO efforts, subject to ultimate CFTC oversight.

SubList.asp.

⁷² See Opening Statement of Chairman Heath P. Tarbert in Support of Final Rule on Position Limits, Nat’l Futures Ass’n (Oct. 15, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement101520b>.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ Position Limits for Derivatives, 86 Fed. Reg. 3,236, 3,238 (Jan. 14, 2021).

⁷⁶ *Id.* at 3,239.

⁷⁷ A non-enumerated bona fide hedge is one that is not expressly identified in CFTC rules.

⁷⁸ See Position Limits for Derivatives, *supra* note 75, at 3,375-76.

D. Speed and Flexibility

SROs are also advantageous because they can move quickly, which is especially useful during periods of rapid change or crisis. There are many good reasons why government rulemaking processes are generally slower than self-regulatory efforts: the Administrative Procedure Act is designed to ensure that federal agencies weigh costs and benefits, inform the public of what they are doing, and seek industry feedback before finalizing rules.⁷⁹ Nonetheless, there are situations that require flexible, quick responses,⁸⁰ and SROs are often best-able to meet this need.⁸¹

For example, in describing its supervision rules, the NFA notes that it “expects that Members’ supervisory programs will vary, and NFA’s policy is to provide firms with the flexibility to develop and implement procedures that are tailored to their operations.”⁸² While governments can also provide flexible solutions—particularly when applying principles-based regulation⁸³—SROs often have more procedural freedom to do so. As an IOSCO report concluded, “[a] product of the experience and expertise of self-regulatory bodies is their ability to modify their rules in response to changes taking place in the industry more readily than government agencies.”⁸⁴ “In many jurisdictions”—including the United States—“the more rigid requirements typically imposed on the rulemaking process of statutory regulators does not allow [them] to react as quickly to changes taking place in the financial services industry.”⁸⁵ This combination of industry expertise and fast adaptability allows SROs to pivot quickly to new focus areas and concerns. As will be seen, this ability to mobilize and adjust can greatly assist in responding to fast-moving market crises.

E. More Trust by Market Participants

SROs can also provide a trust advantage because they are composed

⁷⁹ See Susan D. Franck, *The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions*, 73 *FORDHAM L. REV.* 1521, 1605 (2005) (explaining that the Administrative Procedures Act “was designed to promote transparency and prevent arbitrary, capricious acts that amount to an abuse of discretion.”).

⁸⁰ Federal agencies have the option of using interim final rules, which provide final rules before a formal public comment period. Interim final rules can produce faster rulemakings, but they are rarely used and require certain legal conditions. See, e.g., Michael Asimow, *Interim-Final Rules: Making Haste Slowly*, 51 *ADMIN. L. REV.* 703, 748 (1999).

⁸¹ See IOSCO, *supra* note 56, at 3 (“SROs by their very nature have greater flexibility to adapt regulatory requirements to a rapidly changing business environment.”).

⁸² NFA, *Supervision*, <https://www.nfa.futures.org/members/ib/regulatory-obligations/supervision.html>.

⁸³ See Heath P. Tarbert, *Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation*, 10 *HARV. BUS. L. REV.* 1 (2020) [hereinafter Tarbert, *Principles*].

⁸⁴ IOSCO, *supra* note 56, at 6.

⁸⁵ *Id.*

of, and subject to direct insight from, regulated entities. Empirical research has shown that building the trust of regulated entities into the regulatory process can lead to better policy outcomes, as participants become vested in a program's success.⁸⁶ By gaining the trust of their members and listening to their concerns, SROs "should enhance the willingness of members to adhere to a set of standards" provided by the SRO.⁸⁷ In short, "self-regulation may result in better compliance with rules because it may be more easily accepted by the regulated parties."⁸⁸

In fact, higher levels of trust or "buy in" from regulated entities have translated into higher levels of regulatory compliance by SRO members in certain circumstances. An Organisation for Economic Cooperation and Development (OECD) report determined that:

Compliance with self-regulatory mechanisms . . . can, in some cases, be stronger [than with government regulation] due to the benefits of buy-in by industry members who may have helped design them and who may thus have a vested interest in their success (Priest, 1998). The degree of commitment engendered by industry control may also be beneficial for consumers, as it may in some cases encourage businesses to "raise the bar" and reach higher standards (OFT, 2009).⁸⁹

Industry "buy in" is possible through the SRO structure because SRO-crafted rules "are perceived by the regulated entities, because of their own participation, as more 'reasonable' from the outset compared with the more inflexible counterparts issued by government regulators."⁹⁰ In applying a criminal law analogy, one group of scholars explained of self-regulation: "[a]s any prosecutor knows, it is far easier to negotiate with and to monitor

⁸⁶ See Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 652 (2000) (discussing a study demonstrating "that merely enlisting private actors in self-regulation can enhance trust among them, which in turn contributes to the program's chance of success").

⁸⁷ CTR. FOR FIN. MKT. INTEGRITY, SELF-REGULATION IN TODAY'S SECURITIES MARKETS: OUTDATED SYSTEM OR WORK IN PROGRESS? 5 (2007), <https://www.cfainstitute.org/-/media/documents/article/position-paper/self-regulation-in-todays-securities-markets-outdated-system-or-work-in-progress.ashx>. See also SEC. EXCH. COMM'N., Rel. No. 34-50700, File No. S7-40-04, CONCEPT RELEASE CONCERNING SELF-REGULATION, (Mar. 8, 2005), <https://www.sec.gov/rules/concept/34-50700.htm> (explaining that in the SRO context, "industry participants preferred the less invasive regulation by their peers to direct government regulation and the government benefited by being able to leverage its resources through its oversight of self-regulatory organizations").

⁸⁸ Speech of Karen K. Wuertz, Senior Vice President, Strategic Planning and Communications, Nat'l Futures Ass'n, "Model for Effective Self-Regulation," presented at IOSCO Conference, Sydney, Australia, (May 19, 2000). https://www.iosco.org/library/annual_conferences/pdf/ac25-25.pdf.

⁸⁹ ORG. FOR ECON. COOPERATION AND DEV. PUBL'G PARIS, DIGITAL ECONOMY PAPERS, No. 247, INDUSTRY SELF REGULATION: ROLE AND USE IN SUPPORTING CONSUMER INTERESTS 19 (Jan. 3, 2015), <http://dx.doi.org/10.1787/5js4k1fjqkwh-en>.

⁹⁰ Michael, *supra* note 67, at 183.

the actions of parties who share a degree of trust.”⁹¹ In the SRO context, this dynamic leads to improved compliance because the particular rules of the SRO are “recognized as consistent with and not impairing or opposing the [regulated] entity’s goals.”⁹² Suffice it to say, it is considerably more difficult for a government agency, such as the CFTC, to promulgate regulations that are perceived by market participants to be inherently reasonable and free from political bias.

F. Swifter Enforcement

Building on the prior advantages of self-regulation, the SRO structure can also efficiently and effectively resolve violations of SRO rules. While the CFTC remains primarily responsible for addressing violations of the Commodity Exchange Act and CFTC regulations, SROs play an important role in reducing misconduct in the markets. SROs such as exchanges and the NFA and registered derivatives exchange engage in self-enforcement of their rules, wielding a potentially devastating consequence: the possibility of being ejected from the SRO and effectively barred from the markets.⁹³

There are many reasons to prefer enforcement by SROs in appropriate circumstances. First, self-enforcement by SROs limits government enforcement expenditures, allowing regulatory goals like position-limits compliance and non-manipulation to be achieved without costly litigation by government regulators in federal courts. As described above, transferring such costs to SROs provides a float-down effect that saves taxpayers money without compromising regulatory goals such as transparency, price discovery, and fair markets.

Second, SRO-based enforcement actions are effective for the same reason as SRO rules are: they are supported by industry expertise and buy-in.⁹⁴ Having come together to construct the rules of the game through an SRO, regulated members often have little tolerance for those who break the rules. That prudent degree of tolerance is grounded in practicality—if SROs fail to police conduct adequately, the predictable consequence will be greater government intervention.

Third, SRO enforcement can operate collaboratively and in parallel with government enforcement efforts. Many significant CFTC enforcement actions, as well as criminal prosecutions by the Department of Justice and

⁹¹ Birdthistle & Henderson, *supra* note 68, at 56.

⁹² Michael, *supra* note 67, at 183-84.

⁹³ See Roth, *supra* note 3 (“If violations [of NFA rules] are noted, the offending firm is subject to a disciplinary process which can result in the firm being expelled from NFA. Given the mandatory nature of NFA’s membership, firms that are expelled from NFA are effectively barred from the futures industry.”).

⁹⁴ See Wuertz, *supra* note 88 (asserting, in the context of derivatives market development, that “[i]ndustry participants recognized that those who were most familiar with the customs and practices of a particular trade were best suited to create rules related to that trade, to enforce those rules and to resolve the disputes that arose from those rules.”).

other law enforcement agencies, begin with SRO referrals.⁹⁵ This dynamic is not just good for overall enforcement, but it transfers some of the detection burden from government regulators such as the CFTC to industry participants who are adept at identifying misconduct.⁹⁶

Last, SROs provide valuable assistance with enforcing CFTC settlements and court-awarded judgments. An important function of the NFA in particular is to assist the CFTC in collecting restitution and disgorged funds. The NFA also works to ensure that recovered funds are provided to victims of fraud and misconduct. In addition, the NFA often acts as a monitor for registered entities subject to compliance and audit undertakings as a condition for resolving CFTC enforcement matters.⁹⁷

G. Responsible Innovation

The derivatives markets are fast-moving and rapidly digitalizing. New products and trends such as digital assets, algorithmic trading of futures and options, and reforms in the use of data to monitor the swaps markets are just a few examples of the ever-growing influence of technology.⁹⁸ While the CFTC retains the ultimate authority over these issues, SROs play an important role in fostering and responding to innovation in the markets.

SROs are able to respond to new market conditions with speed and flexibility, which is important during periods of innovation. SROs in

⁹⁵ See, e.g., COMMODITY FUTURES TRADING COMM'N, DIV. OF ENF'T, ENFORCEMENT MANUAL 8 (May 20, 2020), <https://www.cftc.gov/LawRegulation/Enforcement/EnforcementManual.pdf> (explaining that when SROs “discover potentially illegal activities that fall outside the scope of their regulatory authority or that also violates the CEA or [CFTC] Regulations, they may refer such activities to the [CFTC Division of Enforcement.]”); see also Roth, *supra* note 3 (“NFA regularly meets with the CFTC and with law enforcement officials to refer violations noted by NFA for criminal prosecutions.”).

⁹⁶ See, e.g., COMMODITY FUTURES TRADING COMM'N, *supra* note 95 at 8. (“NFA administers its own disciplinary program for violations of its rules by its members, and may refer information to the [CFTC Division of Enforcement] regarding potential violations of the CEA and the [CFTC’s] Regulations.”).

⁹⁷ Final Judgment and Order of Perm. Injunction, Disgorgement, Restitution, and Civ. Money Penalties, *CFTC v. Reisinger*, Case No. 1:11-cv-08567 *5-6 n.2 (N.D. Ill. Oct. 4, 2017) (“NFA routinely serves as a monitor in CFTC enforcement actions . . . NFA processes and administers post-judgment restitution payments . . .”).

⁹⁸ See Statement of Chairman Heath P. Tarbert in Support of Interpretive Guidance on Actual Delivery for Digital Assets (Mar. 24, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement032420a> (describing the development of digital assets and stating, “it is critically important that the United States continue to be a leader in blockchain technology. Under my leadership, the CFTC will continue to do its part to encourage innovation through sound regulation.”); see also Statement of Chairman Heath P. Tarbert in Support of the Proposed Rule on Electronic Trading Risk Principles (June 25, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement062520b> (discussing changes in automated derivatives trading and state, “[t]he markets exist to serve the needs of market participants, not the regulator. If a technological change improves the functioning of the markets, we should embrace it.”) [hereinafter Tarbert, Statement in Support of the Proposed rule on Electronic Trading Risk Principles].

particular are adept at applying principles-based regulation to developing scenarios.⁹⁹ As I have written previously, principles-based regulation “can facilitate the development of new business models, products, and internal processes.”¹⁰⁰ Moreover, “[p]rinciples-based regulation thus encourages market innovation, which is central to economic growth and prosperity.”¹⁰¹

To take one recent example, the CFTC recently proposed a principles-based approach to risk principles for electronic trading.¹⁰² In that proposal, the CFTC recognized that risk principles for electronic trading is an area “where regulated entities have greater understanding than the regulator about the risks they face and greater knowledge about how to address those risks.”¹⁰³ The result is that the exchanges need flexibility in how to address electronic trading risks. Already, exchanges provide tailored risk-control systems to help traders mitigate their exposure to credit, market, and other risks.¹⁰⁴ Providing exchanges with the same operational freedom for mitigating the risks of electronic trading is both sensible and likely to produce optimal regulatory outcomes.

III. THE ROLE OF GOVERNMENT

Although self-regulation has many advantages, it is most effective when backed up by traditional governmental regulation. This section will address the CFTC’s vital role in derivatives regulation, focusing on how the agency buttresses the self-regulatory regiment. The section concludes with additional roles played by the agency that only a government entity can undertake. In short, the government can and should play a unique role in financial regulation, particularly where the advantages lie in its favor. The recipe for sound regulation therefore is the proper blending of self-regulation with government regulation.

A. Oversight

The most important function of federal agencies with respect to SROs is that of oversight. Government oversight of SROs is the key distinguishing factor between the SRO system and other forms of private regulation.¹⁰⁵ As an IOSCO report has explained, “Government oversight is

⁹⁹ See, e.g., Tarbert, *Principles*, *supra* note 83, at 6, 14 (describing the role of SROs in performing principles-based regulation).

¹⁰⁰ *Id.* at 8.

¹⁰¹ *Id.*

¹⁰² See Tarbert, Statement in Support of the Proposed rule on Electronic Trading Risk Principles, *supra* note 98.

¹⁰³ *Id.*

¹⁰⁴ See, e.g., Cboe, *Risk Management Tools*, https://markets.cboe.com/us/options/trading/risk_management/; see also CME, *CME Global Credit Controls (GC2)*, <https://www.cmegroup.com/tools-information/webhelp/globex-credit-controls/Content/CME-Globex-Credit-Controls-Management.html>.

¹⁰⁵ See Hammond, *supra* note 56, at 1711 (“The agency’s oversight role distinguishes

an essential element in the self-regulatory structure.”¹⁰⁶ This is the case for a variety of reasons, most notably to ensure accountability and provide “a system of checks and balances.”¹⁰⁷ Just as pure governmental regulation raises questions about resource adequacy, flexibility, and whether industry voices are being heard, pure private ordering puts at risk accountability and public faith in the regulatory framework.¹⁰⁸ Oversight by public regulators is designed in part to ensure the success of SROs by shoring up accountability and preserving public trust in the SRO structure.¹⁰⁹

The key challenge with respect to public trust is the possibility of conflicts of interest.¹¹⁰ As members of industry, SROs raise the proverbial fox-in-the-henhouse question: does the SRO really protect the interests of the public, or is it beholden only to its industry stakeholders?¹¹¹ Concern about an inherent “conflict of interest that exists when an organization both serves the commercial interests of and regulates its members” has been long-standing.¹¹² The imposition of government oversight to help ensure that SROs perform their self-regulatory duties faithfully is an effective way to address this concern.

Calibrating the appropriate level of oversight is not always easy. As an IOSCO report explains, “[o]ne of the biggest challenges that government faces . . . is to provide an appropriate level of government oversight of SRO activities without encumbering or usurping an SRO’s ability to respond quickly and flexibly to changing market conditions and business needs.”¹¹³ Fortunately, the Commodity Exchange Act provides a detailed statutory scheme that assists the CFTC in striking the appropriate balance.

SROs from voluntary or purely private self-regulatory efforts.”).

¹⁰⁶ IOSCO, *supra* note 56, at 8.

¹⁰⁷ *Id.*

¹⁰⁸ See Yueh-Ping (Alex) Yang & Cheng-Yun Tsang, *RegTech and the New Era of Financial Regulators: Envisaging More Public-Private-Partnership Models of Financial Regulators*, 21 U. PA. J. BUS. L. 354, 389-90 (2018).

¹⁰⁹ *Id.*

¹¹⁰ See, e.g., former SEC Commissioner Luis A. Aguilar, *The Need for Robust SEC Oversight over SROs* (May 8, 2013), <https://www.sec.gov/news/public-statement/2013-spch050813laahm> (“Because of the inherent conflict of interests involved in self-regulation, robust SEC oversight over SROs is indispensable.”).

¹¹¹ See, e.g., Daniel Castro, *Benefits and Limitations of Industry Self-Regulation for Online Behavioral Advertising*, THE INFORMATION TECHNOLOGY & INNOVATION FOUNDATION (Dec. 2011) at 9, <https://itif.org/files/2011-self-regulation-online-behavioral-advertising.pdf> (“Some critics see self-regulation as putting the fox in charge of the hen house Rather than operating in the public interest, critics may assume that SROs operate purely to protect the interests of individual firms or the industry as a whole.”).

¹¹² Joel Seligman, *Should Investment Companies Be Subject to a New Statutory Self-Regulatory Organization?*, 83 WASH. U. L.Q. 1115, 1117 (2005) (quoting SEC Concept Release Concerning Self-Regulation, Exch. Act Rel. No. 50,700, 84 SEC Docket 619, 620 (Nov. 18, 2004)).

¹¹³ IOSCO, *supra* note 56, at 3.

1. Futures Associations

CFTC oversight of registered futures associations—in practice, only the NFA¹¹⁴—begins at formation and extends through disciplinary measures and rulemakings. The genesis of the CFTC’s oversight over futures associations begins with Section 17 of the Act,¹¹⁵ the requirements of which are further detailed in Part 170 of the CFTC’s regulations.¹¹⁶ Section 17(a) begins by requiring CFTC approval before any futures association can be formed. Formation requires, among other things, the submission to the CFTC of a registration statement that provides data concerning the prospective association’s “organization, membership, and rules of procedures.”¹¹⁷ The CFTC “shall not register an applicant” unless the conditions of registration are satisfied.¹¹⁸

To become registered, a prospective association must be found by the CFTC to be “in the public interest” and able to comply with CFTC rules.¹¹⁹ Notably, a futures association is required to “demonstrate that it will require its members to adhere to regulatory requirements governing their business practices *at least as stringent as those imposed by the Commission.*”¹²⁰ From the outset, this requirement ensures that registered futures associations do not apply a “light-touch” regulatory approach that would be less effective than direct CFTC regulation.

Futures associations registered with the CFTC must promote fairness and limit the risk of misconduct by restricting association access to qualified persons who have not previously been suspended or expelled from the NFA or a similar futures association.¹²¹ These requirements can be modified at CFTC direction in furtherance of the public interest.¹²²

CFTC oversight also extends to futures association rules. Among other requirements, association rules must be designed “to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade,” “to protect the public interest,” and “to remove impediments to and perfect the mechanism of free and open futures trading.”¹²³ Requirements for customer protection and ethical standards for dealing with customers

¹¹⁴ While the NFA is the only registered futures association, this section often addresses “registered futures associations” generally. This has been done to accurately capture the text and meaning of the Commodity Exchange Act and CFTC regulations, even though in practice the provisions relating to registered futures associations apply only to the NFA.

¹¹⁵ 7 U.S.C. § 21 (2018).

¹¹⁶ 17 C.F.R. § 170 (2020).

¹¹⁷ 7 U.S.C. § 21(a)(1).

¹¹⁸ 17 C.F.R. § 170.9; 7 U.S.C. § 21(f).

¹¹⁹ 7 U.S.C. § 21(b)(1).

¹²⁰ 17 C.F.R. § 170.1 (emphasis added).

¹²¹ 7 U.S.C. § 21(b)(2).

¹²² 7 U.S.C. §§ 21(b)(3), (4).

¹²³ 7 U.S.C. § 21(b)(7).

have also been added through CFTC regulations.¹²⁴ Further, the CFTC retains oversight over new rulemakings by associations, and has the power “by order to abrogate any rule of a registered futures association” if “necessary or appropriate to assure fair dealing” by members, or “fair representation” of members.¹²⁵ The CFTC may also request registered futures associations “to adopt any specified alteration or supplement to its rules” with respect to the requirements set forth in the Commodity Exchange Act.¹²⁶

Importantly, in crafting their rules, futures associations must ensure that members and persons associated with members “shall be appropriately disciplined, by expulsion, suspension, fine, [or] censure” from the association if they violate the association’s rules.¹²⁷ This provision requires that futures associations act in the public interest by providing consequences for the breach of their own rules. Association disciplinary proceedings are subject to CFTC review to ensure fairness.¹²⁸ In appropriate cases, the CFTC can even “set aside” disciplinary penalties, as well as remand them back to the futures association as necessary.¹²⁹ These measures ensure that association disciplinary processes are “vigorous,” “consistent with the fundamental elements of due process,” and “[are] fair and [have] a reasonable basis in fact.”¹³⁰

Two final oversight mechanisms are especially important. First, the CFTC retains the power to suspend or withdraw the registration of any registered futures association. These consequences can be triggered if the CFTC determines that the association has violated the Commodity Exchange Act or CFTC rules, “has failed to enforce compliance with its own rules, or has engaged in any other activity tending to defeat the purpose of [Section 17 of the Act].”¹³¹ Suspension or revocation of registration is the ultimate sanction to ensure that registered futures associations remain well-functioning and accountable.

Second, Congress retains an external, oversight function over registered futures associations as well as the CFTC itself. The Commodity Exchange Act requires that the CFTC, in its annual reports to Congress,

¹²⁴ 17 C.F.R. § 170.5 (2020) provides in part:

A futures association must establish and maintain a program for the protection of customers and option customers, including the adoption of rules to protect customers and option customers and customer funds and to promote fair dealing with the public. These rules shall set forth the ethical standards for members of the association in their business dealings with the public.

¹²⁵ 7 U.S.C. § 21(k)(1).

¹²⁶ 7 U.S.C. § 21(k)(2).

¹²⁷ 7 U.S.C. § 21(b)(8).

¹²⁸ 7 U.S.C. §§ 21(h), (i)(1)(B).

¹²⁹ 7 U.S.C. § 21(i)(1)(B).

¹³⁰ 17 C.F.R. § 170.6 (2020).

¹³¹ 7 U.S.C. § 21(l)(1).

“include . . . information concerning any futures associations registered” under Section 17 of that statute.¹³² The CFTC must also annually report to Congress on “the effectiveness of such associations in regulating the practices of the members.”¹³³ This second requirement in particular creates incentives both for futures associations to act appropriately, as well as for the CFTC to monitor their activities closely. A congressional backstop also creates an external accountability measure separate from the association or the CFTC, thereby limiting the risk of conflicts of interest.

2. Exchanges

The CFTC also retains oversight over derivatives exchanges, which are registered as “designated contract markets” under Section 5 of the Commodity Exchange Act and Part 38 of the CFTC’s regulations.¹³⁴ More recently, the CFTC was given authority to register swap execution facilities (SEFs), which are somewhat analogous to exchanges that allow the trading of swaps. There is a similar but distinct regulatory oversight role of SEFs, but they do not typically function as self-regulatory organizations.

As with futures associations, the CFTC retains the authority to approve or reject the registration of an exchange, which is subject to certain requirements.¹³⁵ Among other things, a registered exchange is required to comply with twenty-three “core principles,”¹³⁶ as well as “any requirement that the Commission may impose by rule or regulation” under Section 12a(5) of the Act, which provides the CFTC with broad discretion to establish “such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate” registration.¹³⁷

There are certain distinctions between the CFTC’s oversight of exchanges and its oversight of registered futures associations. First, while the CFTC primarily regulates registered futures associations as organizations with particular obligations both to their members and the public, the CFTC’s focus with respect to exchanges centers on the functioning of the derivatives markets themselves. In particular, CFTC oversight over exchanges is intended to provide for orderly markets by retaining oversight over market structure and trading activities. For example, the Commodity Exchange Act places on exchanges the responsibility “to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance,

¹³² 7 U.S.C. § 21(n).

¹³³ *Id.*

¹³⁴ 7 U.S.C. § 7 (2018); 17 C.F.R. § 38 (2020).

¹³⁵ 7 U.S.C. § 7 (2018); 17 C.F.R. § 38.3(a) (2020) (providing CFTC process and requirements for exchange registration).

¹³⁶ The twenty-three core principles can be viewed at *Designated Contract Markets (DCMs)*, COMMODITY FUTURES TRADING COMM’N, <https://www.cftc.gov/IndustryOversight/TradingOrganizations/DCMs/index.htm> (last visited Feb. 5, 2021).

¹³⁷ 7 U.S.C. § 7(d)(1)(A); 7 U.S.C. § 12a(5).

compliance, and enforcement practices.”¹³⁸ This is in addition to a requirement that exchanges only list for trading those contracts that “are not readily susceptible to manipulation.”¹³⁹ Another goal is price discovery. In this regard, exchanges are legally required to “provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process.”¹⁴⁰ In sum, CFTC oversight over exchanges is designed to ensure that they are properly monitoring trading activities.

The second notable feature of CFTC oversight of exchanges relates to how oversight occurs, which is primarily through core principles that apply to every exchange.¹⁴¹ Core principles are at the heart of self-regulation because they provide basic requirements while leaving exchanges with “reasonable discretion in establishing the manner in which the [exchange] complies.”¹⁴² Rather than applying prescriptive rules, the use of core principles to regulate exchanges is “designed to provide exchanges with more flexibility in their approaches to compliance through self-regulation.”¹⁴³ The CFTC’s Division of Market Oversight helps ensure that exchanges comply with the core principles by conducting regular rule enforcement reviews and examinations, which evaluate “the self-regulatory programs operated by the exchange[s] in order to enforce [CFTC] rules, prevent market manipulation and customer and market abuses, and ensure the recording and safe storage of trade information,” among other items.¹⁴⁴

The CFTC’s oversight over clearinghouses, also known as “derivatives clearing organizations,” is similar. Every exchange must have a relationship with a clearinghouse. Clearinghouses provide a critical function for the derivatives markets by standing between counterparties to clear and process trades that have been executed on exchanges. In this role, the clearinghouse mitigates counterparty credit risk.¹⁴⁵ Some clearinghouses have been

¹³⁸ 7 U.S.C. § 7(d)(4); 17 C.F.R. § 38.250 (2020) (Core Principle 4).

¹³⁹ 7 U.S.C. § 7(d)(3); 17 C.F.R. § 38.200 (2020) (Core Principle 3).

¹⁴⁰ 7 U.S.C. § 7(d)(9)(A); 17 C.F.R. § 38.500 (2020) (Core Principle 9).

¹⁴¹ An exchange must comply with the core principles in order “[t]o be designated, and maintain a designation, as a contract market.” 7 U.S.C. § 7(d)(1)(A). *See also* 17 C.F.R. § 38.100(a) (2020).

¹⁴² 7 U.S.C. § 7(d)(1)(B); 17 C.F.R. § 38.100(b) (2020).

¹⁴³ Former CFTC Commissioner Thomas J. Erickson, *Regulatory Uncertainty Under the Commodity Futures Modernization Act of 2000*, 21 FUTURE & DERIVATIVES L. REP. 6 (2001).

¹⁴⁴ *Designated Contract Markets (DCMs)*, COMMODITY FUTURES TRADING COMM’N, <https://www.cftc.gov/IndustryOversight/TradingOrganizations/DCMs/index.htm> (last visited Feb. 5, 2021).

¹⁴⁵ *See, e.g.*, Heath P. Tarbert, *Statement of Chairman Heath P. Tarbert in Support of Final Rule on Alternative Compliance for Non-U.S. Clearinghouses*, COMMODITY FUTURES TRADING COMM’N (Sept. 17, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement091720>; *see also Derivatives Clearing Organizations*, COMMODITY FUTURES TRADING COMM’N, <https://www.cftc.gov/IndustryOversight/ClearingOrganizations/index.htm> (last visited Feb. 5, 2021).

designated systemically important for their critical role in the financial system.¹⁴⁶ Clearinghouses operate as SROs but, like exchanges, are subject to broad CFTC oversight to ensure compliance with their own set of Core Principles.¹⁴⁷ Title VIII of the Dodd-Frank Act further makes the CFTC responsible for conducting examinations of clearinghouses to ensure that they satisfy safety and soundness, financial resources, cyber resilience, and other important requirements.¹⁴⁸ The CFTC also conducts “stress tests” of clearinghouses to help ensure they can withstand financial shocks.¹⁴⁹

B. Additional Agency Roles

While oversight of SROs is the most central role of government in self-regulatory systems, there are additional situations where federal action is preferable. Without identifying every such case, this section will focus on several that are both timely and relevant to the CFTC’s role as the primary regulator of U.S. derivatives markets.

1. Administrative Law Functions

Only a federal agency can modify, rescind, or grant exemptive or no-action relief from a federal regulation. While SROs self-regulate their members by passing rules, conducting exams, and bringing enforcement actions, they must nonetheless operate within the formal regulatory structure created by federal agencies in fulfilling their delegated mandates from Congress. SROs have flexibility to operate within this structure, but they are unable to change the structure itself.

Second, only the CFTC as a federal agency can act as the final interpretive authority of the Commodity Exchange Act and the Core Principles thereunder, subject to judicial review. While SROs retain flexibility to implement Core Principles and related requirements, the CFTC must remain the final arbiter of whether a particular effort meets applicable regulatory requirements. This role allows the CFTC to ensure that SROs are not interpreting or applying Core Principles in ways that are contradictory or unreasonable. CFTC oversight also helps prevent bad faith

¹⁴⁶ A “systemically important derivatives clearing organization” is defined in Regulation 39.2 to mean a DCO registered under section 5b of the CEA that is designated by the Financial Stability Oversight Council to be systemically important and for which the Commission acts as the Supervisory Authority pursuant to 12 U.S.C. § 5462(8). 17 C.F.R. § 39.2 (2020).

¹⁴⁷ CEA Section 5b, 7 U.S.C. § 7a-1 (2018). See *Derivatives Clearing Organizations*, *supra* note 145 (identifying Core Principles for DCOs).

¹⁴⁸ See CEA Section 5b, 7 U.S.C. § 7a-1 (2018). See also Heath P. Tarbert, *The Enduring Legacy of the Dodd-Frank Act’s Derivatives Reforms*, 6 J. FIN. REGUL. 159, 161-62 (2020) [hereinafter Tarbert, *Enduring Legacy*].

¹⁴⁹ See, e.g., *CCP Supervisory Stress Tests: Reverse Stress Test and Liquidation Stress Test*, COMMODITY FUTURES TRADING COMM’N (Apr. 2019), <https://www.cftc.gov/system/files/2019/05/01/cftcstressstest042019.pdf>.

interpretations designed to evade regulatory requirements. In sum, the CFTC's role as an interpretive authority is necessary to ensure the self-regulatory framework is even-handed and retains integrity.

While these points may seem basic, it is important to recognize that while self-regulation can advance regulatory goals, there will always remain areas that require government action. This can be especially true during a crisis, when quick administrative relief is needed. As discussed in more detail in Section IV, addressing the coronavirus pandemic (COVID-19) required no-action relief from a variety of CFTC regulations. Because only the CFTC may grant such relief, the agency had a critical role to play in managing the crisis alongside SROs.

2. International Harmonization

Another area where government action is necessary relates to international harmonization. While SROs are often adept at formulating cross-border principles and standards with other SROs,¹⁵⁰ the government—and particularly a federal agency—is critical to advancing harmonized regulatory systems with foreign governmental counterparts. An example is the recent harmonization of certain swap data reporting efforts. In proposing and finalizing a new system for data reporting by swap dealers and swap data repositories, the CFTC has worked to harmonize its framework with that of the European Securities and Markets Authority (ESMA).¹⁵¹ As data is inherently borderless and because swap dealers and swap data repositories often must report data to both the CFTC and ESMA, harmonizing reporting requirements where appropriate can produce significant cost savings and efficiencies for market participants.

For example, the CFTC's efforts to bring its swap data reporting system into greater harmony with international coordination efforts has led to the publication of a CFTC Technical Specification, which contains 128 reportable data fields.¹⁵² The Technical Specification streamlines hundreds of prior fields that were previously required by swap data repositories operating without clear CFTC guidance. This change will enable the CFTC to receive the data it needs to perform its regulatory functions while at the same time reducing duplicative reporting burdens for entities subject to

¹⁵⁰ See, e.g., Thomas W. Sexton, III, Nat'l Futures Ass'n President, Keynote Address before the Association for Financial Markets in Europe, Annual Compliance and Legal Conference, Oct. 3, 2019 (Paris, France), <https://www.nfa.futures.org/news/newsTestimony.asp?ArticleID=5164> (discussing NFA's role in coordinating international governance and compliance standards).

¹⁵¹ Domestically, the CFTC has made strides to harmonize its swap data reporting rules with the SEC's reporting requirements for security-based swaps.

¹⁵² The CFTC's Part 45 Technical Specification is available at *CFTC Technical Specification: Parts 43 and 45 swap data reporting and public dissemination requirements*, COMMODITY FUTURES TRADING COMM'N (Sept. 17, 2020), https://www.cftc.gov/media/4891/DMO_Part43_45TechnicalSpecification091720/download.

multiple jurisdictions. In proposing revisions to the swap data reporting rules, the Chairman of the CFTC stated:

As it stands today, a market participant with a swap reportable to the CFTC might also have to report the same swap to the SEC, the European Securities and Markets Authority (ESMA), and perhaps other regulators as well. The global nature of our derivatives markets has led to the preparation and submission of multiple swap data reports, creating a byzantine maze of disparate data fields and reporting timetables. Market participants should not incur the costs and burdens of reporting a grab-bag of dissimilar data for the very same swap. That approach helps neither the market nor the CFTC: conflicting data reporting requirements make regulatory coordination more difficult, preventing a panoramic view of risk.¹⁵³

Resolving situations like this requires significant federal action to coordinate with and align regulatory requirements and technical standards with foreign regulators.¹⁵⁴ While SROs can be very effective at constructing international standards, they lack the ability to place the imprimatur of the United States government, as a sovereign nation, on negotiations and regulatory efforts. In contrast, CFTC action in the swap data reporting context has given assurances to other regulators that harmonization efforts have the backing of the United States government. This is important not only for the mechanics of promulgating rules, but also for international comity: federal support for collaborative efforts sends a strong signal to foreign governmental counterparts that can lay the groundwork for future cooperation.

Signaling aside, there is a practical reason to prefer government action in the international harmonization space. Just as states and localities do not negotiate treaties,¹⁵⁵ leaving regulatory harmonization efforts primarily to federal agencies is important to produce a unified and holistic message. The numerous exchanges in the derivatives space—each an SRO in its own right—have varying interests and priorities that could complicate efforts to place them in charge of harmonization efforts with overseas regulators. The ability of the CFTC to speak with one voice on behalf of the U.S. derivatives markets when negotiating and collaborating with foreign regulators is a clear benefit of federal action in the international space.

¹⁵³ Heath P. Tarbert, *Statement of Chairman Heath P. Tarbert in Support of Proposed Rules on Swap Data Reporting*, COMMODITY FUTURES TRADING COMM'N (Feb. 20, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tabertstatement022020>.

¹⁵⁴ See, e.g., Richard B. Stewart, *The Global Regulatory Challenge to U.S. Administrative Law*, 37 N.Y.U. J. INT'L L. & POL. 695, 712 (2005) (“U.S. federal regulators have supported international harmonization of regulatory standards, and adopted international standards domestically . . .”).

¹⁵⁵ See, e.g., Michael P. Van Alstine, *Federal Common Law in the Age of Treaties*, 89 CORNELL L. REV. 892, 900 (2004) (“The authority over foreign affairs in general and treaty making in particular is perhaps the most explicit, detailed, and expansive power that the Constitution delegates to the federal government.”).

3. Systemic Risk Mitigation

CFTC action is also necessary to address systemic risk. As mentioned above, the numerous derivatives exchanges in the United States have authority over only those persons and entities that trade on a particular exchange. This can create complications for self-regulation where systemic risks are involved, as self-regulatory authority is divided among the various exchanges. In contrast, the CFTC has broad jurisdiction and surveillance capabilities that extend across the derivatives markets rather than being confined to particular exchanges. This gives the CFTC a uniquely broad picture of market-wide risk, coupled with the ability to assert jurisdiction beyond the confines of a particular exchange or market segment, allowing it to address systemic threats to the financial system.

The CFTC's 2020-2024 Strategic Plan expressly includes "[t]aking steps to avoid systemic risk," which "will not only protect market participants, but increase confidence in the soundness of U.S. derivatives markets."¹⁵⁶ An example is the finalization of the capital rule for swap dealers and major swap participants, which the CFTC approved in 2020. In establishing minimum capital requirements, the rule is intended in part to reduce systemic risk in the financial system by serving as "the ultimate backstop, ensuring that customers are protected and the financial system remains sound in the event that all other measures fail."¹⁵⁷

The CFTC as a federal agency also has a unique ability to coordinate with other federal regulators in the mitigation of systemic risk. One key example is the Financial Stability Oversight Council (FSOC), which was formed in the wake of the 2008 financial crisis. FSOC is chaired by the Secretary of the Treasury and has ten voting members, which include the heads of federal financial regulators including the CFTC.

The FSOC brings federal regulators together "to constrain excessive risk in the financial system."¹⁵⁸ Among other things, FSOC facilitates regulatory cooperation in the systemic risk space through information sharing, standard setting, and the ability to designate financial market utilities as systemically important.¹⁵⁹

Finally, someone must be responsible for examining the safety and soundness of the exchanges and clearinghouses themselves. At the time of this article, there are sixteen exchanges and ten clearinghouses registered with the CFTC. Two of these clearinghouses—CME and ICE—are

¹⁵⁶ CFTC Strategic Plan 2020-2024 at 5, 14, (2020), https://www.cftc.gov/media/3871/CFTC2020_2024StrategicPlan/download.

¹⁵⁷ CFTC, Statement of Chairman Heath P. Tarbert in Support of Final Swap Dealer Capital Rule (July 22, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement072220>.

¹⁵⁸ U.S. Dep't of the Treasury, "About FSOC," <https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/about-fsoc>.

¹⁵⁹ *Id.*

systemically important financial market utilities under Title VIII of the Dodd-Frank Act. The CFTC exercises its oversight role over clearinghouses by, among other things, developing and managing a supervision program that provides for regular examinations and supervisory stress testing.¹⁶⁰ As clearinghouses represent critical financial market infrastructure, the CFTC is uniquely situated to exercise direct oversight over them.

4. Non-Members of SROs

A final area where CFTC action is necessary is the case of non-members of SROs. While SROs have significant self-regulatory authority over their members, there is relatively little action they can take against non-members. SROs may not, for example, address fraud committed by bad actors that are neither SRO members nor trade derivatives on a registered exchange. In contrast, the CFTC's Division of Enforcement can civilly prosecute these actors regardless of their registration status or whether they have used a derivatives exchange in connection with their misconduct.

A recent example includes a series of CFTC enforcement actions¹⁶¹ against commodity trading advisors that failed to become and remain members of the NFA as required.¹⁶² As the former Division of Enforcement Director remarked, "NFA plays a critical role in the oversight of CFTC registrants But NFA can only do its part if registrants submit to its jurisdictional requirements."¹⁶³ Where CFTC registrants fail to submit to NFA jurisdiction, "the CFTC will act to ensure compliance and to preserve the NFA's ability to carry out its important oversight function."¹⁶⁴

This includes fraud and manipulation in the cash markets, which involve "spot" transactions that are not connected to any exchange. While the CFTC does not exercise general regulatory authority over spot commodity transactions, Section 6(c)(1) of the Commodity Exchange Act and Regulation 180.1 give the CFTC the ability to civilly prosecute fraud and manipulation "in connection with" a commodity in interstate commerce.¹⁶⁵ The CFTC has used this authority to target Bitcoin and digital asset fraud, the misappropriation of confidential information in connection with oil markets, leveraged precious metals transactions, and other illicit activity.¹⁶⁶

¹⁶⁰ Tarbert, *Enduring Legacy*, *supra* note 148, at 160-61.

¹⁶¹ Press Release, CFTC press rel. no. 8232-20, CFTC Charges 10 Commodity Trading Advisors for Failing to Maintain NFA Memberships (Sept. 3, 2020), <https://www.cftc.gov/PressRoom/PressReleases/8232-20>.

¹⁶² Commodity trading advisors are required to be members of a registered futures association pursuant to CFTC Regulation 170.17, 17 C.F.R. § 170.17 (2020).

¹⁶³ Press Release, James M. McDonald, CFTC press rel. no. 8232-20, *supra* note 161.

¹⁶⁴ *Id.*

¹⁶⁵ 7 U.S.C. § 9(1) (2018); 17 C.F.R. § 180.1 (2020).

¹⁶⁶ *See, e.g.*, CFTC v. McDonnell, 332 F. Supp. 3d 641, 717 (E.D.N.Y. 2018) (digital asset fraud); Order Instituting Proceedings pursuant to Section 6(c) and (d) of the

In sum, while the day-to-day regulation of members of exchanges and futures associations is committed to SROs, the CFTC retains the ultimate authority to enforce the Commodity Exchange Act and CFTC regulations as to “persons that trade or influence the trading of derivatives contracts, regardless of their CFTC registration status.”¹⁶⁷ The CFTC’s role as a backstop for all conduct affecting the U.S. derivatives markets appropriately defers to self-regulation while preventing non-registration from providing an escape hatch from either regulatory oversight or accountability for fraud and manipulative conduct.

IV. THE CORONAVIRUS PANDEMIC RESPONSE

Having identified the varying roles the CFTC and SROs play within U.S. derivatives markets, one should examine how these roles culminated in a high degree of collaboration that provided stability during one of the most challenging periods in U.S. economy history: the unprecedented market volatility wrought by the coronavirus pandemic (COVID-19). As demonstrated further below, the key to success in addressing the market fallout of the pandemic has not been relying solely on either a governmental or self-regulatory approach, but rather identifying the strengths of each and deploying them side-by-side in a collaborative way.

And that collaboration was critical to manage a severe economic crisis that produced historic volatility throughout the derivatives markets. During March of 2020, nearly every asset was in freefall, including equities, commodities, and Treasury bills.¹⁶⁸ Confidence in the markets was plummeting, as seen in the soaring prices for credit default swaps—essentially, insurance on the risk of default.¹⁶⁹ Ensuring that the derivatives markets and those who rely on them were adequately positioned to weather the storm required the knowledge and experience of both the CFTC and SROs, each acting in their appropriate capacities.

A. Formal Coordination

One response to the COVID-19 pandemic was the quick formation of new, formal structures for coordination action between the CFTC and SROs. In turn, the information gleaned from these structures has been shared with other regulators by virtue of the CFTC’s role as the primary regulator for the U.S. derivatives markets. Together, these avenues for

Commodity Exchange Act, Making Findings, and Imposing Remedial Sanctions, *In the Matter of Marcus Schultz*, CFTC Docket No. 20-76 (Sept. 30, 2020), <https://www.cftc.gov/media/4871/enfmschultzorder093020/download> (misappropriation of confidential information relating to oil swaps); *CFTC v. Monex Credit Co.*, 931 F.3d 966 (9th Cir. 2019) (leveraged precious metals transactions).

¹⁶⁷ Mark, *supra* note 11, at 459.

¹⁶⁸ See Tarbert, *Volatility*, *supra* note 2.

¹⁶⁹ *Id.*

formal coordination enabled the CFTC and SROs manage the initial fallout of COVID-19 without missteps.

A primary example was the formation of the Financial Sector Coronavirus Working Group, led by the Financial Services Information Sharing and Analysis Center (FS-ISAC), an industry consortium.¹⁷⁰ The FS-ISAC Coronavirus Working Group has brought together representatives from the financial services industries, the NFA, and federal regulators such as the CFTC to share information and market intelligence relating to the pandemic. Among other things, the Working Group facilitates information exchange relating to new threats spurred by the pandemic, including fraud and cybersecurity risks to the financial sector.¹⁷¹

The CFTC's role at the center of U.S. derivatives markets allowed it to convey intelligence gathered from coordinated efforts with SROs to other federal and state regulators, advancing unified responses to market events. The CFTC's ability to utilize its own unique data sets—while at the same time having the benefit of information provided by SROs—promoted a broader federal response to the pandemic. An example is the CFTC's participation in the FSOC and the President's Working Group on Financial Markets, which were active during the COVID-19 crisis and served as “essential channels for information sharing and coordinated action.”¹⁷²

B. Volatility and Systemic Risk Management

Perhaps the most critical financial response to COVID-19 was managing the historic market volatility of March 2020, which drew from the expertise of the CFTC, exchanges, clearinghouses, and the NFA. Systemic risk became a central issue in the coordinated response to the pandemic because much of the early market volatility, as noted above, was even more elevated than that of the 2008 financial crisis.¹⁷³ The central concern was ensuring that volatility in the markets did not create instability within the financial system more generally. It is one thing for prices to swing wildly, but quite another for clearinghouses, exchanges, and firms to face a liquidity or solvency crisis. While the CFTC as the government regulator at the helm of the U.S. derivatives markets is ideally situated to address this kind of systemic risk, it nonetheless relied on assistance and coordination from SROs in crafting its response to COVID-19-driven

¹⁷⁰ For more about FS-ISAC, see FS-ISAC, “Who We Are,” <https://www.fsisac.com/who-we-are>.

¹⁷¹ See FS-ISAC website, “Covid-19 Resources,” <https://www.fsisac.com/covid19>.

¹⁷² Statement of CFTC Chairman Heath P. Tarbert Regarding COVID-19 Before the FSOC Principals Meeting (Mar. 26, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement032620> [hereinafter Tarbert, FSOC Principals].

¹⁷³ See Tarbert, *Volatility*, *supra* note 2. See also Muhammad Suhail Rizwan et al., *Systemic risk: The impact of COVID-19*, FIN. RES. LETTERS (July 4, 2020), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC7334938/> (discussing systemic financial risks posed by the COVID-19 pandemic).

market events.

The CFTC has performed two primary roles in addressing historic levels of market volatility and its concomitant potential for systemic risk. The first builds on existing data-sharing efforts between the CFTC and SROs, and involves the CFTC's ability to act as a repository for information about market status and function. As SROs are closer than the CFTC to the actual trading of derivatives, they are best able to identify and share information concerning key market developments. During the volatility of March 2020, SROs were in regular communication with the CFTC to ensure that the markets, while subject to seesawing prices, were nonetheless functioning as expected.¹⁷⁴ These communications helped the CFTC translate real-time market intelligence into nearly twenty discrete regulatory measures designed to keep the markets operating by giving market participants the flexibility necessary to continue operations.¹⁷⁵

Second, the CFTC acted to mitigate systemic risk by ensuring that derivatives clearinghouses were functioning as necessary to prevent financial contagion.¹⁷⁶ Importantly, this aspect of the COVID-19 response is a textbook case study of self-regulation in action. Clearinghouses acted as the first line of defense, working to ensure that counterparties continued to post required collateral and margin during the unprecedented volatility of March 2020.¹⁷⁷ The rules requiring margin and collateral to be posted to clearinghouses were established by the CFTC well before the pandemic.¹⁷⁸ Clearinghouses, acting as SROs, acted to fulfill these requirements during a period of high volatility. Indeed, on the peak day, clearinghouses based in the United States held over \$333 billion in initial margin, marking a record

¹⁷⁴ See, e.g., *How is the Derivatives Industry Responding to COVID-19*, FUTURES INDUSTRY ASS'N (Mar. 20, 2020), <https://www.fia.org/articles/how-derivatives-industry-responding-covid-19>.

¹⁷⁵ See *Coronavirus*, CFTC, <https://www.cftc.gov/coronavirus> (last visited Feb. 5, 2021).

¹⁷⁶ See Tarbert, *Volatility*, *supra* note 2.

¹⁷⁷ See *id.* (“Between Feb. 24 and March 14, [2020], a record \$54 billion in margin was posted to derivatives clearinghouses, and the financial system handled these payments without incident.”); see also CFTC, SUPERVISORY STRESS TEST OF CLEARINGHOUSES 5 (Nov. 2016), <https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/cftcstressstest111516.pdf> (“Central clearing also provides a means to monitor and mitigate risk. The role of the clearinghouse is to make sure all members have posted sufficient margin or collateral at all times to cover trades in both their house and customer accounts. Clearinghouses also facilitate significant netting of positions, which tends to further reduce risk.”).

¹⁷⁸ See Tarbert, *Volatility*, *supra* note 2 (“One important remedy in the CFTC’s medicine cabinet is a post-2008 requirement that derivatives traders post margin for their swap positions. Broadly speaking, margin is money or other high-quality collateral that buyers and sellers exchange to protect against the risk of default. Many derivatives trades—such as futures and interest-rate swaps—are processed through central clearinghouses, which stand between the parties and handle the margin process. For derivatives that aren’t centrally cleared, the CFTC requires transacting parties to exchange margin through third-party custodians.”).

high.¹⁷⁹

The CFTC, for its part, monitored the clearinghouses for compliance and stability, engaging in near-constant communication with them that went far beyond the more routine examinations and supervisory efforts outlined in Section III.A.2, above.¹⁸⁰ By monitoring closely the “critical ‘pipes’ at the clearinghouses through which trades are margined and settled,” the CFTC was able to help ensure smooth operation and was poised to react quickly if the system began to break down.¹⁸¹ As in other self-regulatory models, the clearinghouses as SROs implemented regulatory mandates, but in turn were subject to oversight by the CFTC as their primary regulator and supervisor.

Nonetheless, the CFTC’s efforts to monitor for and mitigate systemic risk during the COVID-19 crisis were substantially aided by SROs. In particular, exchanges and the NFA were critical in identifying rising volatility and its impact on market participants. One of the key efforts of SROs during the period when volatility was unfolding in March 2020 was to engage their members to initiate business continuity plans. In broad terms, business continuity plans respond to contingencies that could undermine the orderly functioning of the derivatives markets, ensuring that business can continue throughout periods of dislocation.¹⁸² The NFA, for example, contacted all of its futures commission merchant and swap dealer members, as well as a large population of its remaining membership, to ensure that their business continuity plans were up-to-date and could effectively address market volatility arising from the COVID-19 pandemic.¹⁸³

The NFA also worked with members on contingency planning even before the Centers for Disease Control and Prevention formally declared that COVID-19 was a pandemic to “ensure that their [business continuity] plans” accounted for pandemic-driven dislocations, including ensuring that communication systems with key entities such as a derivatives clearing organizations were robust, and advising members to prepare for the possibility that COVID-19 could “materially impact their businesses.”¹⁸⁴ These and other efforts helped mitigate systemic risk by enabling NFA members to weather the ensuing market volatility.

¹⁷⁹ CFTC margin data for March 19, 2020 (on file with CFTC).

¹⁸⁰ *See id.*

¹⁸¹ Tarbert, FSOC Principals, *supra* note 172.

¹⁸² *See* NFA, *Notice to Members*, , Information on Coronavirus/COVID-19 (Mar. 4, 2020), <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5208>.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

C. Governmental Regulatory Relief

While SROs worked with their members to help ensure smooth trading and operations during the COVID-19 pandemic, the statutory framework governing the U.S. derivatives markets created areas where CFTC regulatory relief was necessary. That relief reflected collaboration with SROs, which helped identify areas of concern and proposed solutions necessary to navigate the market effects of the pandemic. In many instances, SROs marshalled feedback from their members and conveyed those views to the CFTC, which responded with temporary no-action relief from relevant regulations. This relief provided market participants with the flexibility to continue trading activities in a seamless manner despite historic levels of volatility combined with changes in how the nation's workforce operated.

A key example of SRO-CFTC collaboration in fashioning temporary no-action relief during the COVID-19 pandemic has been various measures designed to accommodate social distancing. It became clear early on during the COVID-19 crisis that “[s]ocial distancing . . . created novel hurdles to complying with regulatory requirements that were written with traditional centralized offices in mind.”¹⁸⁵ Recognizing this issue, exchanges contacted the CFTC’s Division of Market Oversight and “indicated that . . . market participants may be unable to comply with . . . self-regulatory requirements imposed under exchange rules,” including voice recording, location-based trading, and electronic timestamp requirements.¹⁸⁶ The exchanges also expressed concern about their ability to comply with related CFTC regulations concerning audit-trail and market-monitoring requirements.¹⁸⁷

In granting temporary no-action relief from these regulatory requirements, the CFTC made clear that exchanges were expected “to remain particularly vigilant in their self-regulatory functions and to implement compensating controls” in order to guard against market participants who might “take advantage of market volatility to engage in improper trading.”¹⁸⁸ The CFTC also stipulated that exchanges had to “continue to conduct customer business in accordance with . . . exchange rules,” and required that exchange rules not affected by social distancing efforts would “continue to apply” to trading during the period of no-action relief.¹⁸⁹

The comprehensive and diverse nature of CFTC no-action relief provides a significant window into the collaborative nature of the CFTC-SRO relationship in times of crisis. First, relying on their on-the-ground

¹⁸⁵ Tarbert, FSOC Principals, *supra* note 172.

¹⁸⁶ Letter from Dorothy DeWitt, Director, Division of Market Oversight, to CFTC Staff, Letter No. 20-09 (Mar. 17, 2020) at 2, <https://www.cftc.gov/csl/20-09/download>.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 3.

¹⁸⁹ *Id.*

position with respect to market participants and the dynamics of implementing COVID-19 response measures such as social distancing, the exchanges were quickly able to identify areas where pandemic responses would create tension with regulatory requirements. Second, the CFTC—in granting no-action relief from certain regulatory requirements—relied on exchanges to “implement compensating controls” to ensure fair trading. This is an important example of principles-based regulation¹⁹⁰ in the SRO space: the CFTC issued a broad instruction based on the principle that derivatives trading should be free of misconduct. Exchanges, acting as SROs, were left to determine the most effective means of producing that result during a period of market volatility. Furthermore, in granting no-action relief, the CFTC relied on exchanges to continue to enforce their own rules, thus trusting the SRO structure to safeguard trading during a period in which relief from certain regulatory controls was needed.

Finally, the pandemic demonstrated that certain regulatory measures must fall squarely within the CFTC’s purview, showing the enduring need for federal action alongside self-regulation. In particular, COVID-19 created implementation concerns regarding the ability of some market participants to comply with the CFTC’s margin rules for uncleared swaps.¹⁹¹ These transactions are generally conducted bilaterally, outside the exchanges and not managed by a clearinghouse. They are therefore outside traditional SROs and parties to these trades are not necessarily NFA members. The CFTC responded by issuing an interim final rule that extended the margin compliance deadline by one year.¹⁹² Unlike the no-action relief described above, here the CFTC issued an interim final rule that had the effect of modifying a prior rule that established an earlier compliance deadline for the CFTC’s margin rules.¹⁹³ As the margin rules are established by CFTC regulations, only CFTC action could provide this relief, underscoring the need for a federal role within a system that greatly benefits from the dynamism of SROs.

CONCLUSION

The U.S. derivatives markets are evolving rapidly, fueled by digitalization trends that are creating new asset types and bringing new participants into the markets. One constant has remained amidst this change: a strong self-regulatory tradition that relies on a combination of governmental and private efforts. The collaborative response to COVID-19

¹⁹⁰ For a fulsome discussion of principles versus rules-based regulation, see Tarbert, *Principles*, *supra* note 83.

¹⁹¹ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 Fed. Reg. 41,346, 41,346 (July 10, 2020).

¹⁹² *Id.*

¹⁹³ *Id.* at 41,348.

is only the most recent example of self-regulation at work in the U.S. derivatives markets. While the framework described in this article may evolve with the markets, its basic tenets of CFTC oversight coupled with self-regulation by exchanges, clearinghouses, and the NFA are time-tested and robust, while simultaneously flexible enough to address innovation and change. In sum, self-regulation in U.S. derivatives markets continues to provide stability through collaboration.