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Market Structure

## Diversity is strength in US derivatives markets

*Several proposals to allow DCMs and DCOs to enter into combinations with FCMs, creating one “vertically integrated” entity, have recently reached the Commodity Futures Trading Commission. As the industry considers fundamental changes to the roles of these key pillars of derivatives market structure, we urge policymakers and market participants to carefully weigh the risks of a combined DCM/DCO/FCM.*

The US centrally cleared commodities derivatives markets are among the most vibrant and robust in the world. A diverse array of market participants – from commercial hedgers to market makers, institutional investors, asset managers and even retail participants – are able to manage risk and derive critically important price information from the infrastructure underlying these markets. Using the language of the Commodity Exchange Act, the three pillars of this market are FCMs, DCMs and DCOs.

Futures Commission Merchants (FCMs) act as the intermediaries between customers and exchanges facilitating transactions in commodity derivatives. Designated Contract Markets (DCMs) are the exchanges on which these transactions occur. Designated Clearing Organizations (DCOs) are the centralized clearing houses that allow these transactions to seamlessly occur by clearing and settling commodity derivatives positions.

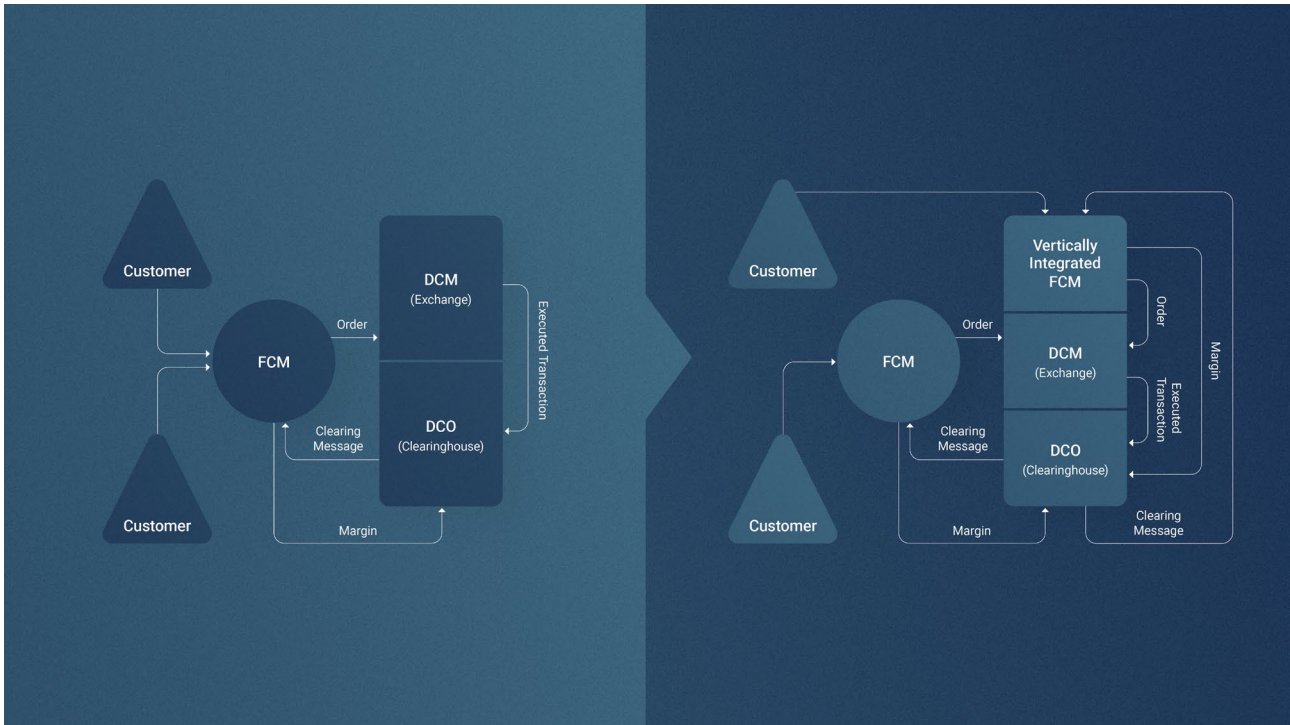
In the largest and most liquid markets, DCMs and DCOs are often combined into the same corporate entity, enabling the exchange and clearinghouse to work in a symbiotic relationship, offering significant systemic benefits to the market as a whole.

The 2008 financial crisis is often cited as an example of these benefits. With Lehman Brothers failing, the bi-lateral over-the-counter (OTC) derivatives markets – where counterparties transact directly with one another – fell into chaos. In contrast, DCOs were able to act quickly to manage their own risks by winding down and transferring positions within Lehman’s portfolio to other firms. Several academic studies have pointed out how central clearing prevented Lehman’s collapse from spiraling further out of control.<sup>1</sup> Key to the success of DCOs in managing the fall-out was their ability to access positions across the market. The DCOs’ ability to manage the default provided needed resiliency during these times of stress, and the lessons of this period informed the efforts to reform the OTC markets that followed in the Dodd-Frank Act.

Over the past few years, several proposals have reached the US derivatives markets regulator, the Commodity Futures Trading Commission (CFTC), to allow combined DCMs and DCOs to also combine with FCMs, creating one “vertically integrated” entity. These proposals seem to offer certain efficiencies and advantages. For instance, they could provide stable access to markets for

<sup>1</sup> Norman (2011), Alvarez (2019)

traditional FCM customers, including a wide range of market participants, from asset managers and pension funds, to commercial end users like farmers, ranchers, manufacturers and energy companies, as well as liquidity providers like Optiver. Nevertheless, these proposals also raise a number of concerns. As the industry considers fundamental changes to the roles played by these key pillars of derivatives market structure, we urge policymakers and market participants to proceed cautiously and carefully weigh the risks of this structure.



Source: Optiver

## The importance of Futures Commission Merchants

The access point for most participants in these markets is the FCM, which faces the DCM and DCO and clears its own trades as well as trades executed by its customers. What should be of paramount concern in grappling with the questions raised by combining a DCM/DCO with an FCM are the effects of further downward pressure on existing FCMs. In the early 2000s, at its peak, this segment of the market counted more than 175 distinct FCM entities. As of this writing, that number is only 64. There are a number of reasons for this drop – consolidation in the industry and the financial crisis among them. Suffice it to say, the decline in the number of FCMs providing access to cleared commodity derivatives markets has been a top concern of regulators and policymakers for the past fifteen years.

Market participants have responded in a number of ways to this phenomenon. Some former FCM customers that trade on DCMs have sought to become direct clearing members of their related DCOs. However, this option is available only to trading firms with the wherewithal and resources to do so and is not an option for all market participants.

Fewer FCMs means a reduction in competition and the weakening of a driving force for innovation and efficiency in markets. Further, by merging key functions that are traditionally separate, there is a risk that the natural checks and balances that exist within the current market structure become disrupted, concentrating market power and leaving what was once a vibrantly diverse system brittle in the end.

## Implications of integration

If a combined DCM/DCO/FCM were to reduce costs and fees at the FCM level – essentially using the FCM as a loss-leader for the DCM/DCO business – this would undermine the existing FCM community, compelling them to operate at unstable price-points and potentially leading to reduced investment in technology, compliance, and risk management systems. This outcome would leave customers – such as the asset manager overseeing a 401k or pension fund, or the firm providing liquidity in a variety of assets – with fewer options to access the market. It could drive smaller FCMs – including those that primarily serve the commercial end-users of commodity derivatives markets such as farmers and ranchers, energy companies, and manufacturers – out of the market altogether.

These items have been discussed in great detail in response to the CFTC's request for comment on the topic issued in the fall of 2023. An FCM's traditional roles – that of serving customers, safeguarding their collateral, and interacting on their behalf with the DCM and DCO – are inherent to its place in the market. To preserve these roles, a few things would become necessary.

If it were to be combined with a DCM/DCO, the FCM would need to remain a separate entity via an array of legal documentation, conflict of interest rules, and governance checks and balances. This would become necessary in order to address the inherent incentives for a DCM/DCO to advantage its own FCM over others, harming market confidence and ultimately the end-users who need commodity derivatives markets for price discovery and risk management. Further, today's largest DCMs perform a critical regulatory function as self-regulatory organizations (SROs), setting rules for market conduct and enforcing those rules in the event of breaches. The independence of a DCM's regulatory judgment and its discretion would need to be safeguarded from the incentives presented by an integrated model to advantage the DCM's affiliated FCM. Further, non-affiliated FCMs would have to trust that proper protocols to achieve a level playing field at the SRO level have been put in place in order to participate with confidence at the DCM.

## Conclusion

Optiver acknowledges the important roles FCMs, DCMs, and DCOs play in commodity derivative markets. We hope the CFTC will consider using robust safeguards to guard against the potential risks and downsides to the long-term health and stability of these markets. As long as some level of true separation between different market functions exists, market participants will be free to adapt, and commodity derivatives markets should maintain their structural integrity and the advantages of a competitive environment. The diversity of derivatives markets is their strength, and it should not be compromised.

## Our recommendations

- Clearly articulated principles to preserve the integrity of the DCM's own internal market regulatory functioning through documentation, governance frameworks, and conflict-of-interest rules.
- Use of policy incentives to preserve the competitive marketplace for FCMs and prevent an integrated FCM from becoming a loss-leader
- Robust safeguards to preserve client service, collateral management, and clearing pathways at an integrated FCM

## About Optiver

Optiver is a global market maker founded in Amsterdam, with offices in London, Chicago, Austin, New York, Sydney, Shanghai, Hong Kong, Singapore, Taipei and Mumbai. Established in 1986, today we are a leading liquidity provider, with close to 2,000 employees in offices around the world, united in our commitment to improve the market through competitive pricing, execution and risk management. By providing liquidity on multiple exchanges across the world in various financial instruments we participate in the safeguarding of healthy and efficient markets. We provide liquidity to financial markets using our own capital, at our own risk, trading a wide range of products: listed derivatives, cash equities, ETFs, bonds and foreign currencies.