

Cabinet News and Views

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Risks Associated with Clearing Digital Assets



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On May 30, 2023, the Division of Clearing and Risk (“DCR”) of the Commodity Futures Trading Commission (“CFTC”) issued an [advisory](#) (“05/30/23 DCO Advisory”) relating to registered, or those seeking to register as, derivatives clearing organizations (“DCOs”) that offer clearing services involving contracts for digital assets. This advisory follows DCR’s May 17, 2023 [advisory](#) to DCOs in connection with prime brokerage (“PB”) arrangements and trading on swap execution facilities (“SEFs”) (covered previously [here](#)).

Both advisories are short one-page documents that remind DCOs and entities that have not been registered as DCOs to focus on risks associated with novel business arrangements (*i.e.*, PBs on SEFs and clearing for digital assets) and note that the DCR will be “placing emphasis on potential risks ... related to system safeguards, physical settlement procedures, and conflicts of interest.” More specifically, the 05/30/23 DCO Advisory addresses potential conflicts of interest issues related to DCOs’ affiliated entities and the “dual-hatted” executives.

Concurrently with the publication of the 05/30/23 DCO Advisory, CFTC Commissioner Kristin Johnson issued a [statement](#) encouraging the staff of the CFTC to work on drafting a proposed federal rule to address unique issues associated with clearing digital assets and focus on the following four areas: “conflicts of interest arising from vertical integration of activities and functions; custody and client asset protection; operational and technological risk, specifically cyber-risks; and market manipulation and fraud.” Commissioner Johnson noted that many of these concerns were highlighted by LedgerX DCO’s submission to the CFTC for disintermediated clearing of contracts on digital assets, which was subsequently withdrawn following the collapse of FTX in the fall of 2022.

As we had noted previously in connection with the CFTC’s September 29, 2021 SEF [advisory](#), this is a way of CFTC staff messaging the industry that it is watching that specific conduct, it has found deficiencies and that an enforcement action may be forthcoming. Also, as Commissioner Johnson has alluded in her statement, the

05/30/23 DCO Advisory could be attempting to accomplish more than it can, and a proper federal rulemaking would be more appropriate given that it would involve public comments.

Further, considering that during its [June 7 meeting](#) the CFTC finalized its DCO governance rule and has proposed the DCO winddown rule and implemented amendments to CBOE Clear Digital, LLC order of registration, the CFTC is looking at broad revision of its regulatory approach to risk management generally and in connection with DCOs specifically.
