JONES DAY

51 LOUISIANA AVENUE, N.W. • WASHINGTON, DC 20001.2113

TELEPHONE: +1.202.879.3939 • JONESDAY.COM

DIRECT NUMBER: (202) 879-3769

JSTERLING@JONESDAY.COM

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BY E-MAIL

Mr. Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21 Street NW
Washington, DC 20581

Re: Comments Responding to Commission Publication of FTX's Request for Amended DCO Registration Order

Ladies and Gentlemen:

We greatly appreciate this opportunity to comment on the captioned proposal (**Proposal**), which was filed by LedgerX LLC, d/b/a FTX US Derivatives (**FTX**), on December 6, 2021 and made available by the Commission for public comment on March 10, 2022. The Commission should be lauded for undertaking a deliberate, public process for evaluating whether to approve the Proposal. Fostering responsible innovation is a hallmark of the Commission—one enshrined in the law—and we are pleased to see this important commitment to the vitality of our financial markets continue under Chairman Behnam's leadership.[1]

As a Firm, we have worked for decades to assist financial institutions, operating companies, and investment funds with all manner of transactional, litigation, and regulatory matters involving the derivatives markets. This experience is enhanced by our colleagues who have enjoyed the privilege of serving on the Commission Staff and our more recent experience representing several fintech companies.

It is from this vantage point that we have observed the growing incorporation of blockchain technology into the financial markets, as well as the growth of digital assets and associated derivatives as distinct asset classes. Indeed, we are actively engaged with several clients in the fintech space. Given this background, and for the reasons set forth below, we believe that the Commission has a sound basis under the Commodity Exchange Act and Commission Regulations for approving the Proposal as presented.[2]

[1] "It is the purpose of [the Commodity Exchange] Act," among others, "to promote responsible innovation and fair competition among boards of trade, other markets and market participants." 7 U.S.C. § 5(b).

[2] Since the Commission is well-acquainted with the Proposal, our letter only describes its terms as needed.

I. A DCO Is Permitted to Have Direct Clearing Members That Do Not Clear Through Brokers.

While it is a common practice for futures and other derivatives transactions to be submitted for clearing through a futures commission merchant (**FCM**), the Commodity Exchange Act does not require that of derivatives clearing organizations (**DCOs**). The DCO definition makes plain that trades do not need to be intermediated by an FCM. Instead, it provides that an entity is a DCO if it:

> i. enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties;
>
> ii. arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the derivatives clearing organization; or
>
> iii. otherwise provides clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such agreements, contracts, or transactions executed by the participants.[3]

Subparagraph (i) explains the novation functions for "each party" to a transaction, which refers to the parties themselves (principals) rather than an FCM (agent). Subparagraph (ii) explains the settlement and netting function for "participants" in the DCO, without any indication that a participant who "executed" a transaction must be a principal or an agent. Subparagraph (iii) explains that a DCO can "mutualize or transfer" risk among clearing participants without distinguishing between clearing participants and trade counterparties, meaning that they can be one and the same.

The Commission's Part 39 Regulations, which govern DCOs, do not require that their clearing members be FCMs or otherwise act as intermediaries for parties to the transactions that will be submitted for clearing. Indeed, the Part 39 Regulations prohibit a DCO from "hav[ing] restrictive clearing member standards if less restrictive requirements that achieve the same objective and that would not materially increase risk to the derivatives clearing organization or clearing members could be adopted."[4]

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[3] 7 U.S.C. § 1a(15)(A)(i)-(iii) (emphasis added).

[4] 17 C.F.R. § 39.12(a)(1)(i).

Further, the criteria for DCO membership cannot "exclude or limit clearing membership of certain types of market participants," except where a DCO has a risk-based reason for such a restriction, i.e., the DCO must be able to "demonstrate that the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members. . . ."[5] The Part 39 Regulations distinguish between FCM (intermediary) members and other (non-intermediary) members for financial reporting purposes, given the fundamental differences in their credit, market and other risk characteristics.[6] Finally, as the Commission is aware, several DCOs permit direct clearing memberships, provided that appropriate safeguards are met, as determined by those DCOs.

II. Mutualization of Risk Is a Common Feature Among DCOs at Present, But It Is Not Required.

Today, there are DCOs that clear fully-collateralized trades for retail market participants who trade on a disintermediated basis. Many more DCOs clear margined trades for institutions that are their direct members, i.e., without clearing through an FCM member. In the former case, there is effectively no credit or market risk since the full value of those trades is supported by an equivalent amount of collateral. In the latter case, credit and market risk on margined positions—the gap between margin levels and trade exposures, and the risk of adverse price movements, respectively—is managed through measures like margining and mutualizing the risk of loss among the DCO's membership. With one exception noted in the Proposal, no DCO clears margined trades without mutualizing risk among its members.

While mutualization of risk is a common feature of DCOs, the Commodity Exchange Act and the Commission's Part 39 Regulations do not require it. Rather, a DCO must "have adequate financial, operational, and managerial resources, as determined by the Commission, to discharge" its responsibilities.[7] A DCO must be able "to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the derivatives clearing organization in extreme but plausible market conditions," and it must have sufficient resources "to cover its operating costs for a period of at least one year, calculated on a rolling basis."[8]

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[5] 17 C.F.R. § 39.12(a)(1)(iii).

[6] *See, e.g.,* 17 C.F.R. § 39.12(a)(5)(i) (requiring periodic reports from all clearing members, including non-FCMs), (ii) (imposing a financial reporting requirement on FCM clearing members), and (iii) (requiring non-FCM clearing members to make certain financial reports).

[7] 17 C.F.R. § 39.11(a).

[8] 17 C.F.R. § 39.11(a)(1)-(2).

In calculating whether its financial requirements are satisfied, a DCO must "net[] its exposure against [each] clearing member's initial margin, calculate losses based on stress testing "of each clearing member using the same stress test scenarios," and may net "any gains in [its] house account with losses in the customer account" with certain additional requirements for netting gains and loss on cleared swap positions.[9] The Part 39 Regulations also provide a DCO with different options it may consider in establishing whether it has adequate financial resources.[10] None of these important safeguards require a DCO to determine the adequacy of its financial resources based on mutualization of the risk presented by its clearing members.

To sum up, DCOs can and do have direct clearing members (Part I), and DCOs are not required to mutualize the risk among their members in establishing and maintaining their financial resources (Part II). The Proposal would allow FTX to have direct, retail clearing members for margined trades, and the credit and market risks presented by those members would be established and monitored on an individual, de-mutualized basis. The question then is whether the Commission should approve the Proposal for policy reasons, since it has the legal ability to do so. It is our judgment that the Commission should approve it on policy grounds, for the reasons set forth below.

III. The Proposal Follows in the Spirit a Recent Commission Effort to Enable Trading of Digital Asset Derivatives in the Traditional Brokerage Model.

In October 2020, the Staff of the now-Market Participants Division issued a guidance letter that explained the manner in which FCMs would be permitted to hold digital assets in customer segregated accounts for purposes of meeting physical delivery requirements on commodity interest contracts in those same underlying digital assets.[11] The letter addressed key obligations applicable to FCMs under the Commodity Exchange Act and Commission Regulations, notably the segregation requirement for holding customer funds and securities and the requirement for FCMs to adopt and implement risk management programs that are tailored to their businesses. From these requirements, the Division Staff developed a series of guidelines under which custody of digital assets in customer segregated accounts would be permitted. In essence, the letter took existing requirements and applied them to an emerging asset class that existing law and regulation did not contemplate.

The Proposal is in this same spirit. Self-clearing digital asset derivatives is simply a different innovation that serves the same purpose of facilitating changes that accommodate this

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[9] 17 C.F.R. § 39.11(c).

[10] 17 C.F.R. § 39.11(b).

[11] CFTC Letter No. 20-34 (Oct. 21, 2020), available at https://www.cftc.gov/csl/20-34/download.

emerging asset class. Unlike the holding of digital assets in FCM customer accounts, the Proposal does not require any special interpretations or guidance. Instead, it is premised on applying enhanced margining and liquidation tools—made possible by significant technological enhancements—to satisfy existing legal and regulatory requirements for DCOs. So the technology is new, but the rules are the same. Innovation that can stick to tried and true regulatory principles should be encouraged.

IV. There Are Meaningful Benefits to the DCO's Proposed Margining Model that the Commission Should Support.

According to the Proposal, FTX will manage its risk exposure by assessing each participant's available margin approximately once per second. Positions will be marked to market every 30 seconds. The margin monitoring and adjustments will operate continuously, 24 hours a day. The Proposal also explains that FTX will rely on this monitoring to liquidate under-margined positions promptly, within the context of this real-time process:

- *First*, FTX would seek to liquidate a position on its market's central limit order book. Relying on its automated systems, FTX would attempt to liquidate the participant's portfolio in 10 percent increments until the available margin exceeds its maintenance margin requirement.

- *Second*, if liquidation is not practical under the prevailing circumstances, FTX would seek to lay off the participant's positions with its liquidity providers.

- *Third*, and if the preceding measures are unavailable or insufficient, FTX would rely on its guaranty fund ($250 million in unencumbered cash) to address any margin shortfall. The guaranty fund is not a shared risk pool—it is resourced and maintained by FTX without contributions from its clearing members.

This process, which we have only highlighted here, has many innovative features that appear likely, within their parameters, to reduce overall risk in FTX's market. The process will have fewer interdependencies than the traditional, intermediated arrangements for trading and clearing retail derivatives transactions. The real-time nature of FTX's margin measurement, maintenance margining, and position liquidation should reduce the overall risk levels quickly.

For digital asset markets that trade continuously, the Proposal's model compares favorably to an intermediated model, in which FCMs are a key dependency. While FCMs have their own robust financial resources, their ability to measure and adjust customer margin levels can create

stress in the margin linkage between FCM customers, the FCMs themselves, and the DCO as they interact with and rely on each other in a 24-hour market. A DCO calls for margin from its participants, and they must provide it promptly. In turn, an FCM clearing participant will typically collect additional margin from its customers; doing so will take time beyond the point at which the FCM has to true up with the DCO. That time lag between DCO margin collection and FCM margin collection can create more risk within a 24-hour market. It is possible that an FCM clearing member would have to contribute additional margin to the DCO at a time when its own customers may be under financial stress and unable to meet the FCM's margin calls. Meantime, the market continues to operate, customers continue to trade, and risk continues to grow.

This risk scenario can be addressed in several ways. Indeed, in our experience FCMs have been highly successful in managing their own customer relationships and dealing with margin shortfalls, including during stressed market conditions. But trading in digital asset markets continues around the clock. While FCMs can operate successfully within 24-hour markets, continuous trading is likely to place more stress on the interdependency between FCMs and a DCO. That stress may be more significant in a retail trading context involving volatile assets like digital asset derivatives. These gaps and stresses would not exist in the direct clearing model that FTX proposes.

FTX does not propose to have a shared risk pool, meaning it will not mutualize risk of loss among its clearing members. We think the margin measurement, maintenance margining, and position liquidation processes described above are more than sufficient on their own. If under-margined exposures will be addressed effectively on an individualized basis in real time, then overall risk within FTX's market will be substantially reduced.

Because of these unique and powerful features, FCM-type requirements should not be applied to FTX, as a number of the Commission's questions suggest might be appropriate (e.g., Questions 8 and 9). FCMs and DCOs are fundamentally different, so applying FCM requirements to FTX simply because FCMs may be absent from or less present in its market is unwarranted. Any FCM that were to trade for its customers in FTX's market would remain subject to FCM requirements under Commission Regulations.

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There are sound reasons for the Commission to approve the Proposal as submitted by FTX, consistent with the requirements of the Commodity Exchange Act and Commission Regulations. We also believe that approving the Proposal will make for good policy.

We thank the Commission once more for undertaking a deliberate, public process with regard to the Proposal. We are confident that, through processes like this one, the Commission will continue to be a leader in fostering responsible innovation in our financial markets.

Very truly yours,

Joshua B. Sterling

cc: The Honorable Rostin Behnam, Chairman
The Honorable Dawn DeBerry Stump, Commissioner
Clark Hutchison, Director, Division of Clearing & Risk
Robert Schwartz, General Counsel
Commodity Futures Trading Commission
David Aron, Counsel
Jones Day