March 28, 2022

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

Re: Comment Letter on FTX Request for Amended DCO Registration Order

I appreciate the opportunity to share my views on this subject with the Commission. I noted that few commenters to date have specifically addressed the Commission's questions, so I have endeavored to do so in my comments below.

DCO rules

1.a. What standard, other than Cover-1, would be appropriate to meet the requirement in Core Principle B that a DCO "shall have adequate financial … resources, as determined by the Commission," to meet its responsibilities in extreme but plausible market conditions in a non-intermediated model?

The Cover 1 standard is a minimum standard and is properly understood as a floor not a ceiling on the financial resources that the CFTC may require a DCO to maintain. The digital asset products cleared by FTX are properly understood to be ones with a more complex risk profile that should be subject to a minimum Cover 2 requirement under the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs). This should be the minimum standard required by the Commission in this case, and not one voluntarily met by FTX subject to conditions.

In addition, the FTX proposal significantly alters the established default waterfall practices which inform the CFTC's core principles for DCOs and the PFMIs. Among other things, FTX will not review the credit risk of participants – i.e., the risk that a counterparty will be unable to meet fully its financial obligations when due - and will instead rely on participants' individual prefunded margin resources and an FTX-funded default fund for financial protection against their financial exposure to their participants. These changes fundamentally alter the credit risk of FTX compared to other DCOs clearing digital asset products and merit the application of a more conservative standard than Cover 2.

The Cover 1 and Cover 2 requirements have also been recognized as unusual risk management standards as the level of protection afforded by the standards only depend on the largest one or two stressed losses over pre-funded margin in the worst scenario.[1] The risks of the other clearing members do not contribute at all to the requirement, while, typically, adding incrementally more risk to an entity increases its measured risk. Implicitly, then, the Cover 1 and Cover 2 standards assume that the largest one or two clearing members are the only source of counterparty credit

[1] Bank of England, Financial Stability Paper No. 30, October 2014, https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-paper/2014/dear-prudence-wont-you-come-out-to-play-approaches-to-the-analysis-of-ccp-default-fund-adequacy.pdf.

risk to the CCP which are relevant for the sizing of default fund, or equivalently that no more than one additional clearing member can ever default before a CCP has replenished its default fund following an initial default.

The reasonableness of this assumption varies by DCO and the portfolio of products cleared and is ordinarily based on the detailed risk management and supervisory practices of the DCO and its FCM members. Together with the financial responsibility requirements for FCMs these practices have the effect of establishing minimum credit risk standards for each DCO. In this case, FTX is not undertaking to make such a risk assessment for each participant, so there is no analytical basis for believing that defaults by other participants will not coincide with those of one or more of those other members presenting the largest exposures.

Accordingly, absent such individualized credit risk assessments for each of its participants, FTX should be required to maintain a default fund that meets the full amount of its measured stressed loss over pre-funded margin for all of its members at all times. The reason for this is not based on whether the market is intermediated or not, but on FTX's decision not to establish practices reasonably designed to measure and monitor the credit risk of its participants as distinct from its point-in-time credit exposure to them.

1.b. In addition to characteristics about the products and specific portfolios, what metrics or market characteristics (such as the distribution of participant exposures and the number and size of market makers) should be taken into consideration when determining whether Core Principle B has been adequately satisfied by the DCO's identified resources?

An individualized credit risk assessment should be required for each DCO participant in order to meet Core Principle B. Without such an assessment by the DCO, a DCO should not be considered to have established procedures adequate to measure, monitor and manage the credit risk of its cleared positions.

1.c. The Cover-1 standard requires financial resources that will ensure adequate coverage in extreme, but plausible conditions. Are there scenarios or types of market events that could have an extreme effect on a non-intermediated market with near real-time settlement that would not have an extreme effect on intermediated markets?

Yes. In a non-intermediated market that relies solely on pre-funded margin and default fund resources for financial protection there is no basis for believing that additional resources will be contributed to meet stressed losses over initial margin in any circumstances. Without such a factual basis, all credit exposures in all extreme but plausible conditions must be assumed to result in losses in fact unless covered by default fund resources. In an intermediated market with appropriate credit risk assessment practices and associated financial responsibility standards, those practices and standards establish a reasonable basis for believing that the excess credit exposure of the extreme but plausible conditions will not result in realized losses in fact and, correspondingly, for the reasonableness of the protection provided by financial resources that meet a Cover 1, Cover 2, or similar requirement.

1.d. Are there unique position or risk limits that the Commission should require a DCO to impose on its participants in a non-intermediated model?

Not necessarily, though such limits may contribute to controlling DCO risks in practice.

2. Are there tools commonly used after a default for intermediated markets (e.g., variation margin gains haircutting or partial tear up) that would not be applicable, or even counterproductive, in the case of a non-intermediated model? Are there tools that would remain applicable in a non-intermediated model, but need adjustments to ensure effectiveness? If so, what are these and what would be the necessary revisions?

Numerous tools commonly used to address defaults are not being used in this case that could and should be used effectively to reduce the risks of the clearing model proposed by FTX. As noted above, credit risk assessments of each participant are commonly used and could be used in this case with adjustments to account for the proposed non-intermediated model. A participant funded default fund, with the option for replenishment, could also be used and may be preferred over more disruptive alternatives such as VMGH and partial tear up. There is no basis provided for believing that the proposal to rely exclusively on such measures in the event the default fund is exhausted will do anything other than increase the risk of the proposed FTX clearing model compared to other DCOs.

3.a. Does FTX's proposal provide an adequate level of financial resources to protect the DCO and its participants in the event of a default?

No. Without additional credit risk assessment of each participant there is no basis for believing that the FTX proposal will meet the requirements of Core Principle B.

3.b. Does the likelihood of more frequent, but smaller, defaults under FTX's model decrease the effectiveness of a Cover-1 (or -2 or -3) standard?

Yes. Without assessing the credit risk of each participant individually there is no basis for understanding how frequent or correlated defaults may be – and therefore the overall level of credit risk to which the DCO is exposed. Accordingly, the adequacy of a Cover 1, 2 or 3 standards also cannot be properly evaluated.

3.c. FTX does not intend to mutualize the risk of loss following a default among all participants and will fund a default fund with its own capital. Does the non-mutualized aspect of the proposed clearing model present any unique risks to the DCO?

Yes. FTX is directly exposed to risks of loss from which DCOs are ordinarily protected by the collective capital resources of its members, subject to limits established by the DCO's rules. Accordingly, additional capital and liquidity requirements should apply to FTX to ensure it maintains levels of liquidity and loss absorbing resources equivalent to those ordinarily provided by a DCO's FCM members. Not doing so will result in FTX being demonstrably riskier than other DCOs.

4. *FTX's proposal limits its participants' financial and operational obligations to ensuring adequate initial margin is on deposit prior to entering an order. Does FTX's approach, when considered in light of its proposed methodology for liquidating participant portfolios, adequately protect the integrity of the DCO?*

No. DCOs ordinarily have legal recourse to seek restitution from FCM members in insolvency proceedings to recover any losses upon the FCM's default to the DCO not covered by margin provided by the FCM. Required minimum FCM capital levels help to ensure resources are available to DCOs and other general creditors for these purposes. Without equivalent assurances that financial resources may be available in excess of pre-funded margin upon a failure to pay by a DCO participant the level of credit risk faced by FTX will necessarily be greater than that faced by any other DCO.

5. *Regulation 39.12(a) also requires a DCO to establish minimum capital requirements for clearing members. Given that FTX participants would have no obligations to FTX other than posting initial margin, does this requirement serve a risk management purpose in this context?*

Yes. The minimum capital requirements assure the availability of additional resources available to a DCO and other general creditors upon the default of a participant to the DCO, helping to lower moral hazard and strategic behavior risks. Eliminating this requirement without taking action to account for its absence will necessarily increase the risk of FTX compared to similarly situated DCOs.

FCM rules

6. *What potential market structure issues may arise from the establishment of a non-intermediated model for retail participants in which transactions are not fully collateralized? What potential impacts, if any, would these issues have on FCMs or on existing markets with FCM intermediation?*

To the extent the total direct and indirect costs of trading and clearing (including, e.g., supervisory and capital requirements of FCMs) are different under intermediated and non-intermediated clearing models, trading activity can be expected to migrate to the lower cost non-intermediated clearing model over time. The reduction of excess loss absorbing capacity would have the effect of increasing the net (uncovered) risk in those segments of the financial system that migrate to a non-intermediated model. Doing so may or may not result in measured stressed losses exceeding loss absorbing resources in those segments of the financial system, and it will not be possible to understand such risks without maintaining requirements for DCOs, FCMs and participants to measure and monitor those credit risks.

7. *Due to the absence of FCMs, the participants' collateral in a non-intermediated model is not required to be segregated under section 4d of the CEA. The orders of registration for DCOs offering a non-intermediated model require the DCO to hold funds of its participants as member property, as that term is defined by the Bankruptcy Code. Is this protection sufficient for participants' funds if a DCO begins to offer margined products?*

Points of this kind are not well settled under existing precedents. Among other things, whether a participant in a non-intermediated clearing model can properly be considered a "clearing member" for purposes of the Bankruptcy Code is subject to doubt given the lack of activity on behalf of others. In addition, segregation of customer assets should result in those assets being legally separate from the estate of a DCO in the event of its insolvency, and differently than otherwise would be the case for member property.

8. Commission regulations require FCMs to ensure that customers receive certain protections when they participate in the futures markets. Should participants in a non-intermediated model be afforded the same or similar customer protections? Which customer protections should the DCO be required to provide to participants?

All participants should get the same protections. To the extent FCMs or the DCO do not provide the protections themselves, the DCO should be required to establish equivalent protections by contracting with third parties to provide the protections as a service. In appropriate cases adjustments to standard form disclosure and similar materials may be made to reflect applicable circumstances more accurately.

9. Should a DCO offering a non-intermediated model be subject to the capital requirements applied to FCMs in addition to, or as an alternative to, DCO and DCM financial resources requirements?

Yes. Not doing so would reduce the level of financial protection associated with the non-intermediated clearing model and increase the level of risk in the financial system, potentially creating new forms of systemic risk.

9.a. Would the Commission's risk-based capital requirement for FCMs in Regulation 1.17 be the most appropriate financial resources requirement for a DCO offering a non-intermediated model if it is approved to be a DCO that directly clears margined products for retail participants without an FCM guarantee?

Yes.

9.b. If a DCO offering a non-intermediated model is subject to a risk-based capital requirement based on the risk margin amount of its participants' accounts, should the percentage be higher than eight percent to reflect that the DCO will only hold margin for its listed products and not diverse positions across multiple exchanges?

Yes.

9.c. Regulation 1.17 requires FCMs to maintain a sufficient amount of unencumbered liquid assets (after application of haircuts) that are in the possession or control of the FCM to cover each dollar of the FCM's obligations. If this type of financial resources requirement is applied to a DCO offering a non-intermediated model, should that requirement also consider the composition of the DCO's capital?

Yes.

9.d. For FTX's proposal, if a risk margin amount threshold is applied to FTX's minimum financial resources requirement, should the percentage of risk margin required be set at a higher percentage than eight percent, given that FTX's participants would not be required to contribute financial resources to the DCO beyond their required initial or maintenance margin amounts?

Yes.

10. FTX's current order of registration requires it to comply with anti-money laundering laws and regulations as if it were a covered "financial institution" under applicable law. Do FTX's proposed changes present any additional risks that would require additional anti-money laundering requirements?

Yes. FTX US is now affiliated with offshore exchange FTX.com and with Alameda Research one of the largest digital asset trading companies in the world. All AML requirements that apply to FTX US should also apply in full to each of its affiliates.

11. Are there any FCM requirements not already discussed that a DCO offering a non-intermediated model should be required to meet?

Yes – conflicts of interest. FTX US affiliate Alameda Research is one of the largest traders of digital asset in the world and trading activity of offshore exchange FTX.com and its customers materially affect market prices for digital assets relevant to the products cleared by FTX US. Accordingly, affiliates of FTX US (and those affiliates' customers) may benefit from the prompt liquidation of FTX US customer positions that might otherwise be resolved using market practices traditionally associated with intermediated clearing models that allow reasonable periods of time for customers to provide additional funds to cover margin requirements. Steps should be taken to address such conflict-of-interest concerns by, at a minimum, requiring Alameda Research and FTX.com to submit to the jurisdiction of the CFTC, and subject themselves to periodic examination by CFTC staff and by an independent self-regulatory organization such as the National Futures Association.

FTX proposals

12.a. Does liquidating positions without requesting additional funds from the participant present risks or concerns in a regulated market?

Yes. This change in well-established market practice shifts liquidity risk to DCO participants from FCMs and DCOs. In practice it would also require customers to maintain excess resources with the DCO to avoid position liquidation, effectively transforming credit risk into liquidity risk due to the DCO's failure to establish credit risk assessment practices of its own.

12.b. Given the real-time liquidation, are participant protections necessary beyond disclosures regarding the rules and liquidation process employed by FTX? If so, what other protections should be required?

Yes - conflict of interest protections. See response to question 11 above.

12.c. Are there risks to a model that is designed to result in more frequent, but smaller, defaults than traditionally occur in cleared markets?

Yes. See response to question 3.b above.

12.d. Are there concerns about an automated system's ability to liquidate a portfolio fairly and effectively? Are there additional concerns if multiple participants are liquidated at the same time, or if the automated liquidation results in price moves that result in a cascading effect of participants becoming under-margined and subject to automated liquidation?

Yes. All of the points referenced in this question are associated with procyclicality risks related to automated closeout protocols, including the risks of self-reinforcing liquidity spirals that may produce systemic risks.

12.e. Are there concerns about whether there will be adequate liquidity for position liquidation on a 24 hours a day/7 days a week basis?

Yes. Depending on the level of cleared activity by the DCO and market conditions this may certainly become a risk that should be accounted for by the DCO in advance.

12.f. What metrics or data should the Commission use to evaluate whether there is likely to be sufficient liquidity across a broad set of market conditions?

The DCO should be required to provide adequate data to support its assessment that it is able to clear positions safely in a broad set of extreme but plausible market conditions. The Commission should focus on determining whether the analytical methods used by the DCO's risk management personnel and reviewed by its senior management and board of directors are appropriately rigorous given the nature of the products proposed to be cleared and the associated market dynamics.

13. If a portfolio's initial margin falls below the full liquidation threshold, FTX will liquidate the full portfolio by assigning the positions to predetermined backstop liquidity providers.

13.a. How should FTX determine the amount of capacity it needs from its backstop liquidity providers?

The DCO should be required to provide adequate data to support its assessment that it is able to liquidate positions safely in a broad set of extreme but plausible market conditions. The Commission should focus on determining whether the analytical methods used by the DCO's risk management personnel and reviewed by its senior management and board of directors are appropriately rigorous given the nature of the products proposed to be cleared and the associated market dynamics.

13.b. How should FTX determine the level of liquidation risk an individual backstop liquidity provider can take on?

This is a form credit risk assessment that should be well within the established capabilities of a registered DCO. The Commission should focus on determining whether the analytical methods used by the DCO's risk management personnel and reviewed by its senior management and board of directors to assess the risks associated with backstop liquidity providers are appropriately rigorous given the nature of the products proposed to be cleared and the associated market dynamics.

13.c. What types of standards should FTX have for its backstop liquidity providers?

Liquidity risk assessment should be a core competency of a registered DCO. The Commission should focus on determining whether the analytical methods used by the DCO's risk management personnel and reviewed by its senior management and board of directors to qualify backstop liquidity providers are appropriately rigorous given the nature of the products proposed to be cleared and the associated market dynamics.

13.d. What risks are associated with a system that is dependent on outside liquidity providers in this way?

Utilizing outside liquidity providers may enhance or detract from the overall safety of a DCO depending on the liquidity providers chosen for the system and the total amount of liquidity resources established. Therefore, establishing appropriate methodologies for evaluating the liquidity risks of the DCO and the capabilities of the liquidity providers is critical to controlling the risk of the DCO.

Market impact

14. By reducing the number of people/entities involved in a transaction, does a non-intermediated model have an effect, positive or negative, on price discovery and efficiency?

No comment.

15. By potentially expanding the number of people able to participate in derivatives markets, does a nonintermediated model have an effect, positive or negative, on price discovery and efficiency?

No comment.

Thank you for your consideration of the comments above.

Kind regards,

/s/ ***Roger Kint***