

# CoinFund

May 10, 2022

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

**Re: Comments Responding to Commission Publication of FTX's Request for Amended DCO Registration Order: Filing Number 22-001**

Ladies and Gentlemen:

CoinFund Management LLC ("CoinFund") is writing with respect to FTX US Derivatives' ("FTX") recent proposal requesting that the Commodities Futures Trading Commission ("CFTC" or "Commission") amend its Amended Order of Registration as a derivatives clearing organization ("DCO"), which would allow FTX to offer direct, margined clearing to its customers. In sum, CoinFund is supportive of responsible innovation in derivatives markets that thoughtfully mitigates systemic risk, increases competition and facilitates a more open and inclusive marketplace.

I serve as President of CoinFund, a web3-focused registered investment adviser founded in 2015. Prior to this role, I served as Global Co-head of the Futures, Clearing and Foreign Exchange Prime Brokerage (FXPB) businesses at Citi and also served on the Executive Committee and Board of Directors of the FIA.

I began my professional career in the United States Marine Corps, where I had the honor of serving our country on the battlefield in Ar Ramadi, Iraq. The violent urban warfare I experienced left me with a renewed perspective, deep sense of purpose and a thorough understanding of risk management. I subsequently transitioned to Lehman Brothers where I witnessed firsthand the perils of unregulated, highly speculative derivatives markets that brought the global financial system to its knees. For over a decade that followed, I worked closely with global regulators and policymakers to implement reforms to the derivatives industry, and in the process, worked with my team to build one of the most prominent intermediary clearing businesses in the world. My unique background blends deep experience in derivatives, market structure and risk management, coupled with "sell side" and "buy side" market perspectives across traditional finance and digital asset ecosystems. I see the cultivation of deep, liquid and secure derivatives markets as an important cornerstone of our economy and an essential pillar of effective risk management.

From my perspective, the United States needs to make a choice. We can embrace new technologies, like blockchain, to unlock responsible innovation and inclusion across finance and risk management, or we will risk being left behind by those that do. With principles-based,

transparent and predictable policy and regulation, the U.S. will empower entrepreneurs to build and innovate onshore, which will fuel the economy, catalyze job creation, and reinforce U.S. leadership across the global financial markets.

Recently, President Biden's Executive Order ("EO") on *Ensuring Responsible Development of Digital Assets* outlined a comprehensive policy approach to balance the risk and promise of digital asset technologies. Bipartisan themes highlighted in the EO include:

- Protect U.S. and global financial stability and mitigate risk
- Promote leadership in technology and economic competitiveness to reinforce U.S. leadership in the global financial system
- Promote equitable access to safe and affordable financial services
- Support technological advances and ensure responsible development of use of digital assets

Applying these themes to digital asset derivative markets, it is clear that our legacy, intermediated derivatives market structure is unprepared to support the risk management realities of this new asset class, leaving market participants with few effective and efficient choices to hedge risk. However, the FTX proposal to allow direct access, margined derivatives clearing, powered by real time risk and collateralization engines, promises to bring much needed, responsible innovation to U.S digital asset derivative markets, allowing it to compete globally by aligning with the shared, bipartisan ideals outlined above.

From my perspective as a former head of one of the largest derivatives intermediaries, or Futures Commission Merchants ("FCMs"), in the world, the FTX proposal, if adopted, would:

- Reduce systemic risk by moving toward real time risk monitoring and collateralization,
- Offer industry participants the ability to more dynamically hedge digital asset risk,
- Introduce incremental competition and choice which will facilitate a more inclusive, cost effective marketplace, and
- Revitalize U.S. digital asset derivative markets at a time when leadership and innovation has migrated overseas.

Certainly, there are risks to deploying new technologies and any proposed model must prove that it can meet and exceed the same "extreme but plausible" stress scenarios applied to legacy clearing houses via existing regulation. Moreover, appropriate disclosures and customer protections must be implemented to ensure that industry participants clearly and transparently understand the unique nuances and risks of participating in a direct clearing model—including the risk of liquidation (which is a risk that all current futures participants face today). Finally, guardrails to dissuade excessive speculation—as they exist today in traditional future markets—should continue to be considered by regulators. However, I believe that the impact of not embracing innovation and technology is a far greater risk to our economic future.

Like it or not, the risk management realities and challenges of cryptocurrency markets—powered by blockchain technology—that function 24 hours a day, 7 days a week, have arrived. According to a recent poll by NBC News, one in five Americans have invested in, traded or used cryptocurrencies.<sup>1</sup> The cryptocurrency market that is emerging is a more inclusive one. A survey by Ariel Investment and Charles Schwab Corp revealed that 38% of Black investors under 40 years old own digital tokens, compared with 29% for their White counterparts.<sup>2</sup> Today, these communities can legally take risk via exposure to a vast array of spot digital assets, but their ability to hedge that risk through the derivatives market is extremely limited due to the unavailability of FCMs and lack of available products. Unfortunately, legacy “batch” margining technology and existing processes simply cannot keep pace, leaving intermediaries with risk and capital challenges that impede their ability to support this rapidly emerging asset class.

The FTX proposal will give industry participants new choices and new capabilities to properly manage risk through hedging by unlocking regulated derivatives across the digital asset ecosystem. Moreover, the FTX proposal will cultivate a true “defaulter pays”<sup>3</sup> clearing model, which secures the system through real time risk management, where risk is mitigated with the collateral of risk takers and the clearing house, itself. Appropriately implemented, the direct model proposed by FTX could catalyze a new era of responsible innovation across derivatives markets and unlock new capabilities to hedge risk at a time when, by unofficial estimates, more than 90% of crypto derivatives activity has migrated overseas.

In the aftermath of the Global Financial Crisis, the [G-20](#) doubled down on the central clearing model by committing to transition the approximately \$700 trillion OTC derivative markets into this legacy futures market structure framework. Without scalable technology that could be used to distribute and decentralize risk, policy makers had few alternatives—and instead chose a highly centralized and highly regulated, intermediated market structure where clearing members, known as FCMs, guaranteed the financial performance of their clients and the ecosystem itself.

Under this model, the clearing house (“CCP”) is responsible for calibrating risk management standards of the system and must ensure that sufficient financial resources are collected under “extreme but plausible” scenarios to withstand market shocks. To meet collateralization shortfalls, clearing houses form a “waterfall” in their rulebooks and require their members to post capital to a “default” fund. To the extent a member fails to meet its obligations during an insolvency, the clearing house may use that member’s default fund contribution to offset collateral shortfalls. However, if deficits remain after applying these funds, the CCP will utilize

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<sup>1</sup> Thomas Franck, “One in five adults has invested in, traded or used cryptocurrency, NBC News poll shows,” CNBC, March 31, 2022.

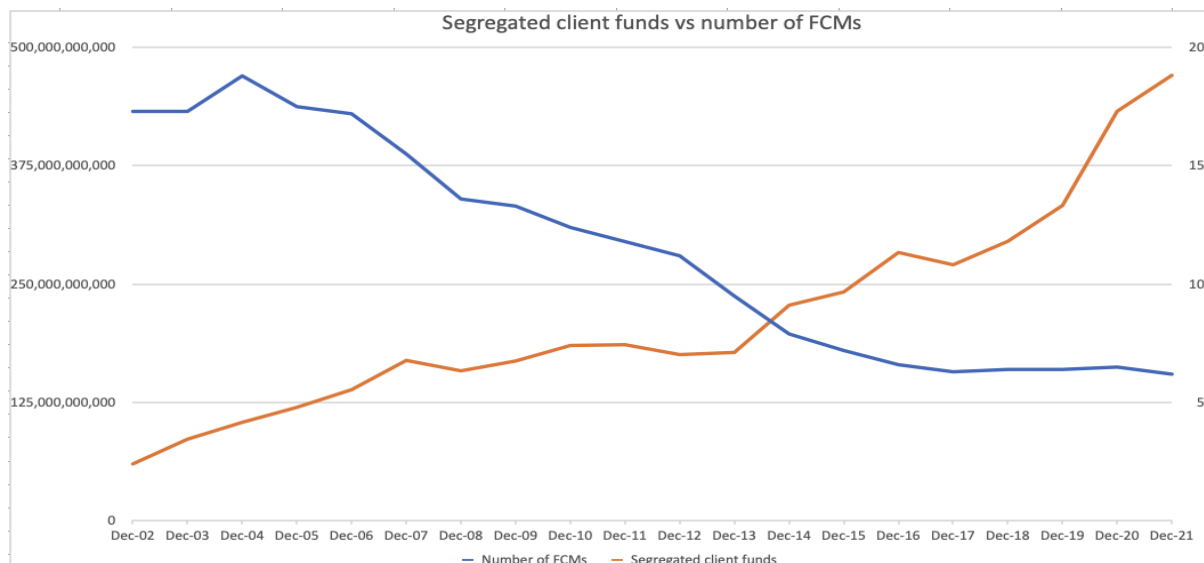
<sup>2</sup> Kelsey Butler, “Young Black Americans Wary of Stock Market Are Turning to Cryptocurrency,” Bloomberg, April 5, 2022.

<sup>3</sup> “Defaulter pays” is when a defaulter’s own contributed collateral is sufficient to mitigate losses during a liquidation scenario.

the other members' contributions (after exhausting limited proprietary capital known as "skin in the game") even when those members may have nothing to do with the default. Though market participants universally agree that initial margin levels should be sufficiently calibrated such that a "defaulter pays" model prevails, the mutualization and socialization of risk of the existing paradigm is real. As recently as 2018, clearing members were assessed millions in [losses](#) after a power trader failed to meet his obligations on NASDAQ OMX<sup>4</sup>.

Though one would think that FCM businesses would thrive under a regulatory mandate, the number of FCMs has materially *decreased* over the last two decades from a high of 188 in 2004, to just 61 by 2022. Meanwhile, the segregated client assets have skyrocketed, rising from about \$60bn in 2002 to more than \$470bn today.

Figure 1: Segregated Client Funds<sup>5</sup> versus FCM Count (2002-2021)



The obvious result of these two trends is concentration of risk, leaving market participants with fewer choices to access futures markets to hedge their risk. Today, the top five members control the preponderance of the segregated collateral pool.

This consolidation and subsequent risk concentration have been caused by a number of factors:

1. Regulations including those introduced by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* resulted in material fixed costs that uniformly apply to all clearing members, regardless of size or activity level.

<sup>4</sup> Lefteris Karagiannopoulos, "Nordic power trader's loss costs Nasdaq and member 114 million euros," Reuters, September 13, 2018.

<sup>5</sup> Segregated funds include segregated futures, foreign futures and cleared swaps. Source: CFTC.

2. A loss of interest income due to macroeconomic and capital optimization factors related to [Basel](#) capital rules, including the Supplemental Leverage Ratio, negatively impacted FCM economics.
3. Increased third party fees, including fees to maintain legacy technology infrastructure further suppressed FCM profitability.
4. With sizable fixed costs and low profit margin, the only solution was to drive scale by acquiring market share. Smaller FCMs, unable to achieve the scale needed to achieve profitability, simply could not compete with larger players and shuttered their businesses.

The FCM community has been left in a bind. Dependence on decades old, notoriously archaic technology that is only capable of delivering slow and lumbering batch cycles has resulted in a mismatch of collateral flows and an accumulation of risk. Coupled with initial margin models that often fail to sufficiently cover this concentrated risk, the legacy clearing model leaves FCMs facing the potential of material stress losses at a time when profitability is challenged at best. The legacy derivatives collateralization cycle functions as follows:

1. Client executes a derivative (and the FCM guaranties against the risk of default) on trade date "T"
2. Clearing house calls FCM for collateral (typically on T or early (~2am) on T+1)
3. FCM issues margin call (typically before 10am, T+1)
4. Clients pay margin obligation by the end of the day (T+1)

During periods of stress, it is common for clearing houses to justifiably call their members for incremental intraday collateral (which generally must be met in 1 hour according to clearing house rules), leaving unsecured FCMs scrambling to recoup collateral from their clients, often an impossible task. Unfortunately, this laborious process simply does not reconcile with the speed and volatility of crypto-derivative markets.

Against the backdrop of these operational shortfalls, acute under-collateralization continues to plague FCMs. Margin breaches are defined when intraday price movements cause the actual marked-to-market exposure in the account of a clearing member to exceed the initial margin held. Based on public [statistics](#), the derivatives markets have experienced thousands of margin breaches in recent years, including a \$2.01bn margin breach in Q1 2021.<sup>6</sup> Volatile markets often cause these breaches, leaving FCMs unsecured and undercompensated for the risk they assume.

In an era where profitability requires scale and scale attracts meaningful risk, leading to questionable financial returns, FCMs are left in a predicament. Smaller clients, who do not offer scale and only transact to hedge a few times per year, are either left on the sidelines unable to find an intermediary or are subject to substantial minimum fees, effectively pricing them out of

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<sup>6</sup> Alessandro Aimone, "GameStop frenzy triggered \$2 billion margin breach at OCC" [Risk Magazine](#), 27 July 2021.

the market. For most FCMs, the scalable clearing of digital asset derivatives--even if clearing houses offered comprehensive product coverage--is out of the question because the accumulation of risk due to their batch processes cannot keep pace with 24 hour, volatile cryptocurrency markets. Moreover, Basel regulatory capital [proposals](#) and internal risk limits leave bank FCMs simply unable to expand into this new asset class, leaving clearinghouses with little incentive to innovate. For this reason, it's no surprise that the vast preponderance of digital asset derivatives activity has largely migrated overseas in markets where there is no requirement for intermediaries.

While legacy FCMs continue to retrench, a new model is emerging that could revitalize the domestic derivatives industry, especially for digital asset derivatives, and give U.S. persons the risk management capabilities they deserve. New technologies now enable near real time risk management and collateralization capabilities--without the need for an intermediary. Calibrated correctly and fairly, a non-intermediated market structure can deliver a true "defaulter pays" model, by solely relying on the assets of the risk takers and clearing house, itself, eliminating legacy conflicts of interest, socialized losses and ushering in a new era of responsible innovation.

End users stand to benefit. Incremental competition will introduce new choices and capabilities to hedge risk, while lowering costs. The operational inefficiencies of the current model are costly (e.g., contingent liquidity funding due to the collateral timing mismatch is expensive), and the direct model will eliminate intermediary fees altogether. In theory, real time risk management should also unlock capital efficiencies across the system, since more collateral is needed to secure and backstop a system that depends on a daily batch process to collateralize--especially for volatile markets. Finally, billions of dollars in member capital, which would need to sit idly in default funds socializing risk in the system, could be redeployed back into the economy because in the direct model, the responsibility for collateralization sits with the risk takers, and is supported by the resources of the clearing house, itself.

Competition is healthy for markets, and I believe that the direct model offered by FTX's proposal will actually benefit the legacy FCM community. In a world where direct and intermediated markets coexist, FCMs will be able to identify new opportunities to deliver operational and capital efficiencies for their clients, perhaps providing agency services to prevent liquidations, while continuing to offer high touch service to top institutional clients.

In conclusion, CoinFund supports FTX's application to offer a direct clearing model for digital asset derivatives. It is time for the United States to revitalize its derivatives markets by embracing the promise of new technologies to reduce systemic risk through real time and surgically precise collateralization. Direct access will foster a more inclusive and liquid derivatives market in the United States finally giving investors the ability to access derivatives markets to hedge their risk. With the appropriate regulatory guardrails in place, this model will result in a more resilient, efficient and dynamic system.

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Sincerely,

A handwritten signature in grey ink, appearing to read "CR Perkins", with a long horizontal flourish extending to the right.

Christopher R. Perkins  
President, CoinFund Management LLC