CHS Hedging

May 11, 2022

<u>Via Electronic Delivery</u>

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st N.W.
Washington, DC 20581

Dear Mr. Kirkpatrick:

Thank you for the opportunity to provide comments on the proposal by LedgerX, LLC, d/b/a FTX U.S. Derivatives ("FTX") to amend its registration as a derivatives clearing organization ("DCO") for the purpose of clearing margined futures contracts on a non-intermediated basis (the "Proposal"). We applaud the Commodity Futures Trading Commission (the "Commission") for devoting its resources to such an important issue and for seeking comments from interested parties.

As a key participant in the agriculture and energy markets and as a voice for our retail cooperatives, farmers and ranchers, CHS Hedging, LLC ("CHS Hedging") respectfully writes in opposition to the Proposal. We are concerned that the FTX proposal may compromise current market participant and customer protections, the integrity of the futures market through a novel and untested liquidation approach, and the management and containment of systemic financial risk.

Moreover, while we are not direct participants in the cryptocurrency markets, we believe that, if the Proposal were to be approved, the model underlying the Proposal would quickly spread to other asset classes. We thus respectfully request the Commission to tread carefully, as approval of the Proposal would likely upend a market structure that has existed and worked successfully for many decades and withstood a number of major shocks, including the financial crisis of 2007-2009.

Ultimately, while we appreciate that the Commission understands and values the important role of innovation in the markets, we urge the Commission to consider the potential risk of unexpected consequences.

I. Background—About CHS Hedging

CHS Hedging is a wholly owned subsidiary of CHS Inc. CHS Hedging is a futures commission merchant (FCM) registered with the CFTC and a member of the National Futures Association (NFA). The firm is a clearing member of the Minneapolis Grain Exchange, Chicago Board of Trade, Chicago Mercantile Exchange and the New York Mercantile Exchange. CHS Hedging provides clearing, execution, physical delivery support, risk management and education services to farmers, ranchers and commercial agribusinesses in North America. Earnings are returned to our customers each year through patronage. CHS Inc. and CHS Hedging are owned by farmers, ranchers and agricultural cooperatives across the United States.

II. Primary Areas of Concern

CHS Hedging has several areas of primary concern. The following is not intended to be an exhaustive list, but rather reflects our salient concerns.

A. Customer Protections

The U.S. futures markets are the most robust in the world because of the unique intermediated clearing model which decentralizes risk, is backed by disparate and professionally-managed balance sheets, and provides the CFTC, through its substantive regulation of FCMs, a cross-market risk perspective. The Proposal, which seeks to allow for disintermediated access, would eliminate cross-market protection, force more risk onto customers, and ultimately increase systemic default risk across all inter-related markets beyond the clearinghouse. The clearinghouse itself may face less risk under the Proposal, but this would come at the detriment of the broader markets and their customers.

As the Commission is aware, FCMs are subject to many and varied requirements through the Commodity Exchange Act ("CEA") and the Commission's rules, which are designed to ensure and promote customer protection, particularly where the trading activity involves highly-leveraged products such as futures contracts (and options thereon). These protections include, among others, (a) regulatory-mandated minimum net capital requirements designed to guard against defaults, insolvency and subsequent customer financial loss; (b) the segregation of customer funds from FCM proprietary funds; (c) initial and on-going customer reviews and due diligence; (d) registration and being subject to regulatory review and annual audits; and (e) continuous rigorous monitoring and reporting (e.g., Form 1-FR monthly submissions and daily segregation reports); and (f) annual regulatory audits.

Collectively, these protections are intended to protect the financial integrity of clearinghouses, and therein, customers of the futures markets. Market participants and CHS Hedging's farmer, rancher and agribusiness customers engage daily in hedging and speculative activities in futures markets. They rely upon this system to provide and maintain protection of their customer funds. Importantly, that system has worked extraordinary well for many decades.

By eliminating intermediation, the Proposal would erase the foregoing key customer protections and could place our customer base of agricultural market participants in a more risky position. As added perspective and to underscore the importance of our particular customer cohort, the failure of MF Global and concurrent misuse of customer funds resulted in CME Group establishing in 2012 a specific $100 million "Family Farmers and Ranchers Fund" to provide an additional layer of customer protections for our industry.[1] As a result, we would expect any alternative model (including the FTX model) that removes intermediaries from the clearing process to be broadly responsible for providing all of the key functions and customer protections that are currently provided through the FCM structure.

B. Market Integrity and Systemic Risk

With an intermediated model, FCMs provide key functions in the clearing system by qualifying eligible customers, handling customer funds, and margining customer accounts. FCMs serve as the intermediary to meet margin calls with exchanges while simultaneously covering the risk associated with the collection of customer funds for margining. This activity is a critical function of a smoothly operating market.

We believe that, for several reasons, the removal of this structure will create, and not reduce, risk in the clearing system. First, the Proposal would rely on DCO risk management discretion to achieve the effect of a CFTC exemption predicated on fully-collateralized DCOs (under Rule 39.19). The Proposal's logic is that auto-liquidation of defaulting customers is financially equivalent to being fully collateralized. This is a flawed risk management perspective. The simplest example is that, in extreme market conditions, liquidations generally cause even more liquidity demands and more market volatility while liquidity simultaneously evaporates, which can cause systemic cascading defaults. A DCO likely would not be able to recognize customers hedged in a cross-market or OTC market, which could lead to liquidations in adjacent markets to adjust for positions becoming unhedged and thus precipitate cross-market systemic liquidations. Further, as long as a DCO has the possibility of a tear-up of positions, as in the Proposal, customers may ultimately face a mutualized loss.

Second, our customers often hold short positions given their physical inventories. We could foresee a situation in which rising prices would trigger auto-liquidation of short positions for those enrolled in an FTX style program, exacerbating overall market volatility and advances in prices beyond that which would normally be expected under the current market structure.

Third, with respect to the proposed 24/7, 365 day model, some market participants may not have the operational capability to be available 24x7 to preemptively increase margins ahead of an anticipated market move. This means that any participant who has an exposure off-exchange will need to be ready to manage risk on a 24x7 basis or be additionally collateralized at its own discretion in order to sustain a surprise market move greater than its initial margin coverage. If this is not the case, the markets face a situation where a large surprise market move eliminates a number of participants, causing forced liquidations and further moving the markets against the liquidation, causing even more liquidations.

Finally, while we understand that FTX proposes to self-fund the DCO with substantial financial resources, given the elimination of clearing FCMs and their capital requirements, the Proposal would

[1] www.cmegroup.com/media-room/press-releases/2012/2/02/cme_group_establishes100mfundtoprovideadditionalprotectionforfam.html

centralize all the financial resources on to a single balance sheet. This would pose an unprecedented concentration of risk onto a single balance sheet.

Thank you again for the opportunity to provide comments on the Proposal. We support innovation in the derivatives markets, but want to ensure that it does not come at the expense of the sound risk management principles that are central to the role of clearing.

Respectfully,

Nelson Neale

Nelson Neale
President, CHS Hedging, LLC