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

Re: Comments Regarding FTX's Request for an Amended DCO Registration Order

Dear Mr. Kirkpatrick,

BAM Trading Services Inc. d.b.a. as Binance.US ("Binance.US") thanks the staff and Commissioners of the Commodity Futures Trading Corporation ("CFTC" or "Commission") for this opportunity to comment on the proposals by LedgerX, LLC d/b/a FTX US Derivatives ("FTX") to revise its Amended Order of Registration as a derivatives clearing organization ("DCO") dated September 2, 2020 to authorize FTX to clear margined products for all of its participants, including retail participants ("customers") on a non-intermediated basis (FTX's proposed revised amended order, "Revised Order").

As background Binance.US is licensed by Binance ("Binance") to offer Binance's trading technology in the United States.[1] Binance is consistently ranked as the largest crypto platform in the world on the basis of volume.[2]

We generally agree with FTX's position that the CFTC should consider the technological advances of the past twenty years as it evaluates how to improve the operation of the markets it supervises. We further agree that, if thoughtfully implemented, such improvements in technological infrastructure could enable customers of companies like FTX and Binance.US to have direct access to exchange and clearing services in a less expensive and more efficient manner.[3] We also recognize that these technological advances can affect not only the crypto space, but the broader panoply of derivatives products as well.[4]

We are, however, concerned about the bulk of FTX's proposal. We do not believe FTX has adequately supported its claims or demonstrated that it can provide customers[5] direct access to its margined products on a disintermediated basis without compromising customer protection and

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[1] To be clear, Binance.Com and Binance.US are legally distinct companies with separate corporate structures, and are governed by separate articles of incorporation, with separate boards and leadership teams.
[2] As of May 4, 2022, CoinMartketCap reflected that the 24-hour dollar volume of Binance was in excess of $14.7 billion. By comparison, the crypto platform with the second greatest dollar volume had slightly less than $2.2 billion: https://coinmarketcap.com/rankings/exchanges/
[3] We are as an isolated matter impressed by the fact that FTX has the ability to calculate a customer's margin level every thirty (30) seconds as positions are marked to market. This is the kind of technological process that allows financial institutions to better identify and mitigate risks than traditional methods.
[4] We note that on its face the FTX model does not limit itself to a particular product category.
[5] Importantly, although market participants on FTX are commonly referred to as "customers" or "clients," they are not customers under the Commodity Exchange Act or CFTC rules.

adding systemic risk. We believe FTX's goals are worthy and certainly attainable but, as explained below, we do not believe it has adequately demonstrated that its proposal will in practice achieve its goals.

Central to FTX's proposal is its plan to automatically liquidate at least portions of customers' accounts should the value of such accounts decline below maintenance margin levels. This would be done without prior episodic notice[6] or an opportunity for an FTX customer to avoid liquidation by increasing collateral on deposit. Moreover, although in most instances it is intended for FTX not to liquidate more than 10 percent of an account's value at a time, in some instances, 100 percent of a customer's positions might be transferred to backstop liquidity providers, effectively (from the customer's perspective) liquidating the totality of the customer's account.

As is explained in some detail below, we believe that FTX proposal has not adequately demonstrated that its proposed disintermediated margined model:

1) is fair to its market participants – particularly its intent to liquidate market participants automatically when the value of their accounts falls below maintenance margin levels; and
2) has adequately considered the procyclicality and cascading risks that would occur during extreme markets, especially with regard to self-reinforcing liquidity spirals that could harm other markets and related market participants. Indeed, we believe that FTX's proposal would more likely than not exacerbate procyclical cascading trends during times of extreme market stress; or
3) has provided sufficient public details regarding its calculation, use or potential augmentation of its $250 million self-funded guaranty fund.

Impact on the Financial Interests of Retail Customers

FTX has not adequately demonstrated that its proposal is fair to its retail customers.

As we read its proposal, it seems that the risk of loss will not be borne equally by all of FTX's customers but in fact it appears to us that losses will be concentrated among FTX's retail customers, especially during extreme markets. In other words, the way in which FTX's automated liquidation algorithm will operate in practice may very well be that the financial positions of FTX's retail customers will be sacrificed to protect the positions of FTX's institutional customers, market makers in general, its affiliated market maker, Alameda Research, and perhaps even the positions owned by its international entity, FTX.com. As explained in the FTX proposal, FTX customers will have their positions liquidated in thirty (30) second intervals without receiving any episodic advance notice[7] and therefore without the opportunity to protect their investment by posting additional margin.

[6] Presumably a Revised Amended Order would require FTX to at least, at the time of Participant relationship opening, disclose to a participant the liquidation risk under its model.
[7] Notice is provided to customers in the FTX Participant Agreement.

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In Question 12 of its Request for Comment, the CFTC asks "*given the real-time liquidation, are participant protections necessary beyond disclosures regarding the rule and liquidation process employed by FTX*?"

The answer to Question 12, as indicated above, is a strong yes. FTX's retail customers deserve to have their financial positions protected from being automatically liquidated without receiving any notice or any opportunity to post additional margin.[8]

Our view is that FTX can offer its proposed "innovative" non-intermediated margin products because the additional risks of doing so will, in practice, be absorbed by retail customers. Retail customers, who are the least likely to monitor their margin positions or post extra collateral against their margin positions, would appear to be the most likely group to suffer auto-liquidation events.[9] FTX's retail customers may therefore end up acting as a kind of shock absorber for risk for the entire FTX eco-system. In other words, FTX's retail customers' positions will be automatically liquidated to protect FTX and other stakeholders in the FTX system that FTX no doubt considers more important, e.g., Alameda Research, who will in practice receive notice (perhaps unofficially) and effectively by operational means be offered an opportunity to post more collateral and protect their positions.[10]

<u>The FTX Proposal is Rife with Conflicts of Interest and the Possibility of Self-Dealing</u>

We believe that FTX needs to provide a more fulsome explanation for how it can protect the auto-liquidation model from being used by sophisticated traders for manipulated conduct. We further believe this explanation is especially needed if the sophisticated traders are in fact working on behalf of the entity that wrote and deployed the liquidation algorithm in question. Additional protections are especially warranted here given that crypto-currencies and products associated with them have complex risk profiles and are especially volatile. This fact makes it more likely than for other margin products that the risk of liquidation and loss will occur in times of market stress.

[8] Other commenters have raised the same point. *See, e.g.,* Comment Letter of Roger Kint, dated March 28, 2022; Comment Letter of John J. Lothian, dated March 25, 2022.

[9] We recognize there is also concern that legitimate hedging activity could be adversely impacted the FTX auto-liquidation model. We think there needs to be a better understanding from FTX about how its model will impact both retail and institutional customers.

[10] In the interests of fairness and to avoid preferencing, we believe that FTX should clearly describe how it will treat the accounts of its Affiliated Market Makers, such as Alameda Research, as well as those of its institutional customers should liquidation of positions occur. Will they be treated any differently than the accounts of retail customers? Will FTX's retail customers be "thrown under the bus" and forced to realize losses to protect the accounts of FTX's more valuable clients? What about favored entities like Alameda Research? It is one of the largest digital asset trading companies in the world. Common sense dictates they will know in advance if their positions are going to be liquidated and will have the opportunity to post additional margin. How could they not know their positions are about to be liquidated in light of all the all the circumstances? There is a profound and we believe unsolvable conflict of interest between the best interests of Alameda Research, FTX.com and the retail customers of FTX.US.

In addition, the majority of investors in these products may not be particularly sophisticated. According to a recent survey by Pew Research, the vast majority of people investing in digital assets are young men, aged between 18 and 29 years old.[11] Thus, most of FTX's retail investors will have little investment experience, and certainly would have potentially never experienced a market meltdown. Retail investors without investment experience need additional protections – not less. They need more protection than a simple disclosure statement that they may or may not fully understand. They should not be made the first line of defense against risk for Alameda Research, FTX.com, FTX US and FTX's institutional investors and market makers.

[11] *See* Pew Research Center Article, dated November 11, 2021, authored by Andrew Perrin. According to Pew Research, roughly three-in-ten (31%) Americans aged 18 to 29 have invested in cryptocurrency. However, about four-in-ten men aged 18 to 29 (43%) have used or traded in cryptocurrency.

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Procyclicality and Cascading Risk

FTX's proposal does not present sufficient analysis for public comment regarding how its automatic liquidation algorithm would not exacerbate procyclical- and cascade- prompted market moves when its liquidation algorithm is triggered by unexpected sudden spikes and drops in market prices. Indeed, at least one self-regulatory organization has brought multiple disciplinary actions against members for failing to consider the impact of its automatic market liquidation program on prevailing market prices – despite the objectively justifiable purpose of the liquidation by the member.[12]

In our experience, sudden market moves don't impact solely one customer. When markets suddenly and unexpectedly move in an opposite direction, many customers (not just one) are impacted. In a leveraged model, this unexpected move could result in many customers' portfolios being liquidated nearly simultaneously, and this could exacerbate adverse market trends, causing other clients to be brought into the liquidation process.

FTX has not provided sufficient analysis (1) to demonstrate how its liquidation algorithm or other controls mitigate against procyclicality and cascading impacts, or (2) how and when its customers' positions might be effectively liquidated in whole when transferred to a backstop liquidity provider. It is not clear how FTX's liquidation model would not potentially constitute a disruptive trading practice expressly prohibited for persons trading on FTX[13]

We are concerned that FTX's automated system could be laying the ground work for a "flash crash" such as occurred due to the automated sale of a large block of futures by Waddell & Reed did in 2010, which touched off a chain reaction and a devastating market crash.[14] Again, technology alone is not the solution. It must be properly deployed and supervised and not allowed to operate on automatic pilot.

As a result, it seems worrisome that FTX's liquidation methodology may not withstand the stress induced by a significant market event, *e.g.*, the bankruptcy of large counterparties to trades such as Lehmann and Bear Stearns. How will FTX account for multiple defaults by perhaps millions of its retail customers (and potentially institutional customers as well)? How will it do so if other financial institutions are liquidating customer positions, some of whom may also be customers of FTX? If millions of customers holding similar assets try to sell at the same time, we believe there will not be adequate liquidity to sustain such sales. Liquidity will be reduced, perhaps even eliminated, further contributing to a market crash. We wish to point out to the CFTC that during the financial market meltdown of 2008 financial instruments with AAA ratings could not be sold and markets froze. How would FTX deal with this kind of extreme scenario?

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[12] *See, e.g.*, Saxo Bank A/S (CME Disciplinary Action 15-0158-BC, March 20, 2017) and Interactive Brokers LLC (CME Disciplinary Action 15-0303-BC), September 25, 2020).

[13] Under FTX's rules (see Rule 8.3N), it is prohibited for persons to engage in disruptive trading practices.

[14] *Lone $4.1 Billion Sale Led to 'Flash Crash" in May*, New York Times, October 1, 2010, authored by Graham Bowley. In this case, an algorithm automatically sold $4.1 billion in futures contracts over a 20-minute interval and dumped 75,000 contracts onto the market, automatically accelerating its selling as prices plunged.

$250 Million Self-funded Guaranty Fund

The $250 million "Guaranty" fund FTX proposes is, in light of the above, an acknowledgement of this flaw but it is not a practical solution. Under its proposal, FTX is directly exposed to risks of loss from which more traditional market practices would provide some protection since DCOs generally have access to the collective capital resources of their members. FTX would be on its own and therefore more likely to fail than it would otherwise be under more traditional rules of risk management. Indeed, FTX's description of its $250 million guaranty fund raises additional questions. Under what circumstances would the $250 million fund be increased? If the $250 million fund is drawn down, what is the basis and the speed for which it would be replenished, and from what source? These questions are particularly important because FTX does not have the traditional methods (FCM contributions and assessments) to back-stop the guaranty fund. FTX has not adequately explained how the size or changes in size to the guaranty fund would be enough to protect FTX, its customers and their counterparties if another significant event were to occur. This is especially true because of FTX's decision not to establish practices reasonably designed to measure and monitor the credit risks of its customers but instead simply to rely on the margin posted by customers.[15]

How does this amount, large as it is, satisfy Core Principal 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? What if FTX's customers have 20 billion dollars in assets with FTX? It is doubtful that a $250 million fund would be adequate in those circumstances. This is particularly true in the very volatile world of crypto currency.

In light of the above, we respectfully submit that FTX's proposal may not provide an adequate level of financial resources to protect itself, its customers, their counterparties and the markets as a whole should there be an extreme market event occur. We strongly believe the CFTC should require that FTX maintain as capital the greater of some minimum amount or at least eight (8) percent of its total risk margin requirement for customers and proprietary accounts, especially in light of the fact that there will be no FCMs guarantees.

We also believe that FTX should provide more public information about its "backstop liquidity providers." This is really a form of credit risk. Who are they? Are they regulated in some way? What potential conflicts of interest do they have? They may have to step into the market during times of extreme stress, times when procyclicality is occurring – and provide needed liquidity to

[15] We also believe it is relevant to point out the relative youth and inexperience of FTX's team. Mr. Bankman-Fried is only 30 years old. He has never experienced a significant market downturn. He and his team may not understand how desperate things can become when liquidity disappears as it did during the 2008 financial crisis. Good times are not inevitable and one day severe market stresses may again come. We do not believe FTX's proposal will be sufficient to protect it, its customers and its counterparties when such events occur.

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FTX to keep it from defaulting. Will they have sufficient capital and risk expertise to do this? Are they banks? Are they insurance companies? The CFTC, FTX customers and their counterparties should know their identities. We should know their capital positions. We should know their risk management capabilities. We should know how solid is their commitment to provide FTX with needed capital during difficult market conditions.

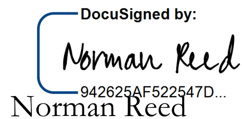
Conclusion

Again, we recognize the benefits of the Commission's decision to put the FTX model out for public comment and to discuss the way that these innovations could impact that traditional model for trading and clearing derivatives products. We welcome the opportunity to participate actively in that conversation and think that these markets will continue to innovate in productive and useful ways. For some market participants, a non-intermediated, margined DCO model may be preferable to traditional models. Nevertheless, we do not think that FTX has provided sufficient public information to assess whether its proposed model provide sufficient customer protections. For example, FTX has not sufficiently explained how automatic liquidations with little to no opportunity to cure margin deficiencies are consistent with ordinary customer protection protocols or how its model does not potentially exacerbate unexpected and dramatic market moves. We also do not think that FTX has sufficiently explained the operation and size of its proposed guaranty fund. These are significant questions that require a thorough examination by the Commission to find models that properly protect customers and provide efficient markets that are difficult to disrupt.

Thank you for your consideration of our comment letter.

Very truly yours,

BAM Trading Services Inc.



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