Commodity Markets Council
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May 11, 2022

Via Electronic Submission

Christopher Kirkpatrick
Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

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

Dear Mr. Kirkpatrick:

The Commodity Markets Council (CMC) appreciates the opportunity to submit this letter in response to the Commodity Futures Trading Commission's (CFTC or Commission) request for comment on LedgerX, LLC d.b.a. FTX U.S. Derivatives (FTX) Request for Amended Derivatives Clearing Organization (DCO) Registration Order (the FTX proposal).

CMC is the leading Washington, DC based trade association that brings agriculture and energy traders together with commodity exchanges. Its members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metal, and soft commodities. Its industry member firms also include regular users and members of swap execution facilities (each, a SEF) as well as designated contract markets (each, a DCM), such as the Board of Trade of the City of Chicago, Inc., Chicago Mercantile Exchange Inc., ICE Futures US, Minneapolis Grain Exchange, and the New York Mercantile Exchange, Inc. Along with these market participants, CMC members also include regulated derivatives exchanges and price reporting agencies. The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs, and over-the-counter (OTC) markets. As a result, CMC is well positioned to provide a consensus of commercial end-user views on the impact of the FTX proposal.

The CFTC's support of innovation and its principles-based regulation has allowed the US futures markets to flourish and prosper over the years. CMC and its members strongly support the CFTC in its mission to promote and foster innovation in the derivatives markets; however, CMC has concerns over the FTX proposal as it would upend the current regulatory market structure and inject new risks into our well-functioning markets.

We recognize that FTX currently offers only a limited number of digital asset products, but CMC has concerns that approving the FTX proposal could potentially encourage FTX or other DCOs to apply this model to other markets such as traditional agriculture or energy commodities in the future. While this model is currently used in some foreign

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digital asset spot markets, as further set out below, we believe that it could cause significant issues if applied to many traditional futures markets.

CMC's concerns are related to the following points:

- The FTX proposal includes the elimination of intermediaries or Futures Commission Merchants (FCMs) for end-users accessing the futures markets, which would be a significant departure from the traditional futures model. Though FCMs can potentially increase margin requirements for customers based on market volatility or other reasons, we fear that a market structure change that would eliminate the role they play would require our members to maintain excessive margin at clearinghouses to mitigate the risk of auto-liquidations.
- The elimination of intermediaries would remove a layer of risk management that is beneficial to the functioning of the futures markets. Elimination of intermediaries would also eliminate the capital that FCMs hold to absorb client losses and guarantee client debts. This will concentrate risk at FTX which does not intend to replicate the resources or best practices in risk management employed by FCMs.
- The FTX proposal will lead to more frequent account liquidations given FTX's planned reliance on auto-liquidation as a primary risk management tool at any point where participant margins decline below the required level. We are concerned about the prospect of frequent liquidations in markets used to hedge business risk with significant institutional interest and the contagion impact this could have across traditional markets—even to those not utilizing this model. Impacts to a participant in FTX's markets could have implications for broader futures markets if that participant has exposures outside of FTX.

  > For example: Assuming FTX were to expand its offerings beyond digital asset products and were to offer agricultural products, market-makers that have exposures at FTX and are subject to auto-liquidation by FTX are likely to re-hedge their exposures at other DCMs. This could result in any cascading liquidations and pricing dislocations that occur in FTX's markets being transmitted by market makers to other DCMs and their participants. Broadly, we have concerns that this model could lead to increased volatility or market distortion, and we have serious questions regarding whether this model would impact the primary functions of price discovery and convergence. We believe that the Commission should be confident that price discovery and convergence would not be impacted before considering or approving any such a proposal, particularly since it does not appear that the CFTC has the legal authority to limit the FTX proposed market structure to digital assets markets once approved.

- FTX has a concerning policy regarding the use of participant funds, which are no longer safeguarded under the CFTC's customer protection regime, since FTX's participants are no longer considered customers. For example, FTX proposes to allow itself to use customer funds for FTX operations and replace the funds at some point in the future.[1] This would appear to violate CFTC rules on customer segregated funds which have been designed with a particular focus on protecting retail market participants.

[1] *See* proposed FTX Rule 7.1.G.5.

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- According to their proposed rules, FTX can tear up trades at any point, including before any waterfall funds have been used to cover a shortfall.[2] This is a significant departure from our understanding of how this process works on traditional futures exchanges, where DCO-mandated tear up of trades are typically used as a last resort and allowed only after all resources in the default waterfall have been exhausted. Taken to the extreme, the FTX proposal could result in canceled trades, which may be commercial hedges, at no fault of the hedger. This could create market exposure on physical commodity positions, and we fail to see how these provisions are improvements to the existing market structure.
- The FTX proposal does not appear to comply with multiple aspects of the Principles for Market Infrastructure (PFMI) laid out by the Committee on Payments and Market and Infrastructures (CPMI) and International Organization of Securities Commissions (IOSCO), as well as specific CFTC rules based on the principles. The FTX proposal does not appear to meet PFMI standards for credit risks, sufficient financial resources to cover participant exposure, liquidity risks, default management, custody and investment risks, and participation requirements. This could have implications regarding the CFTC's regulatory equivalence, as other jurisdictions including the EU and UK, rely on PFMI compliance to determine whether other jurisdictions have equivalent regulation.
- FTX's proposed Cover 3 standard does not contain sufficient resources for managing clearing member defaults. Currently, as a best practice, DCOs cover the default of their two largest clearing members (aka Cover 2), meaning that they cover the exposure of their largest two clearing members, traditionally FCMs, which means the exposures of hundreds if not thousands of these FCMs' customers. Due to the likelihood of a greater number of defaults occurring on the FTX model, due to auto-liquidation, lack of participant capital and lack of counterparty due diligence along with FTX's plan to target retail participants with higher default probabilities, the Commission should consider the unique risks of FTX's proposed offering relative to its planned resources. These issues lead us to believe that FTX's proposed Cover 3 standard would not be sufficient to cover the potential default risks of its model.
- FTX's model would likely prove attractive to many market participants, particularly retail participants, because it eliminates the expenses associated with risk management practices in the current market structure. There is a significant but necessary cost to offering futures that are subject to the risk management and standards and loss-absorbing resources required under the current model. Should a lower cost structure such as this attract significant market participation, it could reduce liquidity necessary to hedge business risk in markets with better risk management protections while encouraging other DCOs to eliminate risk management layers to remain cost competitive. This "race to the bottom" may initially be desirable for some participants as the cost of market participation is decreased, but it could greatly increase the risk of a far more costly market failure event going forward.

[2] *See* proposed FTX Rule 14.3.

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- Even if FTX's new, lower-cost model were to only to attract a small portion of market share, it could still negatively impact markets traded in the current model by drawing liquidity away from FCMs, reducing the total number of FCMs in the market, and increasing overall market volatility through more frequent defaults.

While CMC continues to support responsible market innovation and the use of novel technology, we believe that innovation cannot supersede the primary functions of futures markets for price discovery and hedging. As noted above, we have several questions and concerns regarding some of the specifics of the proposal. Additional information and certain modifications are necessary before being considered for approval by the Commission. At a minimum, we believe the Commission should ensure that all industry concerns are addressed prior to consideration for approval.

The US futures markets are the envy of the world, and it is vital for this to remain the case. Some of the changes embodied in the proposal may ultimately be beneficial modernizations to futures markets, but we must have real confidence in all aspects of the proposal prior to widespread adoption. We appreciate the Commission's consideration of our views on this critical issue.

Sincerely,

Kevin K. Batteh, Esq.
Commodity Markets Council
General Counsel