11 May 2022

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

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

Dear Mr. Kirkpatrick:

As industry participants and derivatives experts who are committed to open, competitive, efficient, and robust derivatives markets, we appreciate the opportunity to comment on the proposal from FTX US Derivatives (FTX) to amend its derivatives clearing organization (DCO) registration order. We believe that the FTX clearing model provides significant advantages for market participants and regulators as an option when compared to the traditional intermediated model. It will facilitate efficient price discovery, provide better access to markets, and protect both customers and the financial system. Thus, we recommend that the Commodity Futures Trading Commission (CFTC or Commission) permit FTX's proposal to move forward.

The following sections discuss the advantages of FTX's clearing model, the need for an interpretation of regulatory requirements which supports this innovation, and the context of our recommendation, in more detail.

1. The Advantages of the FTX Clearing Model

The FTX clearing model provides an efficient and robust alternative to traditional clearing due to these three key features:

- Unlike conventional DCOs, **FTX extends minimal credit**;
- It has **automated, 24/7, real-time risk management**; and
- **Clients have the option of a direct relationship with the DCO** or of using a futures commission merchant (FCM) to access the DCO.

FTX assesses the adequacy of the collateral in each account on a near real-time basis. FTX's markets are open continuously, so FTX can perform this assessment based on current market prices. If the collateral present is not sufficient, FTX automatically reduces the risk in the account until it is.[1]

[1] FTX requires that customers maintain adequate margin in their accounts. The minimum maintenance margin depends on the risk of their portfolio as assessed by FTX's margin model (discussed further below). Should a customer's margin fall below the required level, FTX will automatically begin to partially liquidate the customer's position on the exchange until the customer has adequate collateral for their by-now-reduced risk. The speed of the liquidation will depend, in part, on the risk of the customer's position.

In contrast, the traditional model of clearing typically relies on issuing margin calls and waiting until they are not met – sometimes days later – before reducing the risk in an account. The traditional model therefore involves significant credit extension. This both puts the DCO at risk and places procyclical liquidity burdens on market participants: they need to find additional collateral to meet margin calls when markets are in stress.[2] Because it relies on continuous vigilance for margin calls and the liquidity to meet them, this model is less appropriate for retail investors than FTX's.

FTX's fully automated risk-management process also allows it to offer deep, efficient markets with low clearing fees. This can improve price discovery and encourages competition. It is therefore more suitable and efficient for many market participants than the traditional clearing model.

Another key feature of the FTX model is the option for market participants to directly access the DCO. Traditional clearing relies on FCMs introducing clients to the DCO. While FCM participation in the FTX model is permitted, and may still be a preferred way to access this market for some, the traditional FCM-reliant clearing model also has drawbacks that FTX's model would mitigate. For example, using an FCM can limit access to clearing[3] if sufficient FCM capacity is not available.[4] Moreover, one of the key advantages of clearing – contract continuity for clients despite FCM stress – relies on the ability to move client accounts from one FCM to another, a process known as porting. This is not assured, giving rise to the risk that clients may be closed out despite being in good standing. Finally, the default management process of some DCOs envisages selecting a small number of FCMs to bid on a defaulter's portfolio. This may be less efficient and robust, and more time-consuming, than a market-based liquidation strategy,[5] especially if portfolios are hedged before the default auction.[6]

[2] See Basel Committee on Banking Supervision Committee on Payments and Market Infrastructures, Board of the International Organization of Securities Commissions, *Consultative report – Review of margin practices*, October 2021, for a further discussion of the concerns here.

[3] Clients commonly express concerns about high FCM fees, limited access to clearing, and the risk of being denied access altogether if their business is deemed insufficiently profitable or their FCM withdraws from providing client clearing services: see Derivatives Assessment Team, *Incentives to centrally clear over-the-counter (OTC) derivatives*, 2018.

[4] The number of FCMs has steadily reduced and risk has concentrated in a small number of very large FCMs. For instance, from 2007 to 2022, the number of CFTC-registered FCMs declined from 171 to 61. Moreover, a 2019 study from the Federal Reserve Bank of Chicago found that "[i]n U.S. derivatives markets today, the largest five FCMs (as measured by customer funds held) account for almost 60 percent of all customer funds—up from about 45 percent in 2002—and the top ten FCMs account for a little over 80 percent—up from around 70 percent in 2002": see Nahiomy Alvarez, *Can Broader Access to Direct CCP Clearing Reduce the Concentration of Cleared Derivatives?*, Federal Reserve Bank of Chicago, December 2019. This concentration reduces choice for clients and makes porting less likely and, if possible, more expensive.

[5] The 2018 default of a European energy market participant, Einar Aas, is an example of the risks here. The DCO's first attempt at default management failed when an acceptable bid was not received in an auction to which only four market participants were invited. A second auction was required to manage the default. See Risk, *Nasdaq auction failure ignites anti-clearing backlash*, 8 March 2019.

[6] The close-out of Lehman Brothers' interest rate swaps portfolio at LCH took three weeks: see Michael Fleming and Asani Sarka, *The Failure Resolution of Lehman Brothers*, Federal Reserve Bank of New York Economic Policy Review, December 2014.

FTX's clearing model is based on a highly robust set of protections consistent with the CFTC's Part 39 requirements:

- Minimum margin requirements are calculated at 99% confidence with a one-day margin period of risk. This is highly conservative given FTX's near-real-time default management strategy.[7]
- The margin model also incorporates concentration risk charges, stress risk add-ons, and anti-procyclicality measures as standard.
- In liquid markets, an automated, market-based liquidation strategy will typically close-out accounts with insufficient margin at minimal risk to the DCO. However, should this strategy prove inadequate, FTX has engaged a number of back-up liquidity providers (BLPs).[8] Defaulted accounts will be allocated to BLPs if they cannot be fully de-risked on FTX. BLPs are required to maintain sufficient additional collateral in their accounts at all times to cover the risk of positions that they may be allocated.
- FTX will maintain a very substantial level of its own funds, or skin in the game, in the default waterfall.[9] These funds are available to allow positions to be transferred to the BLPs at a discount. This guaranty fund will be large enough to cover the costs of liquidating its three largest accounts in extreme but plausible market conditions.[10] Because FTX does not rely on FCMs to provide its guaranty fund, it will not place additional burdens on them if the guaranty fund needs to be refilled – another procyclical feature of traditional clearing.

Supporting this, FTX has a robust risk governance framework, including written risk procedures, and regular oversight from external auditors and independent risk experts, including formal model verification processes.

2. The Need to Support Innovation

If approved, FTX's proposal would help address several structural limitations in the current futures markets for Bitcoin (BTC) and Ethereum (ETH) that limit participation and liquidity. Namely, it

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[7] See FTX US Derivatives, *Letter re: Permissibility and Benefits of Direct Clearing Model*, 8 February 2022) at 5. https://www.cftc.gov/media/7001/ledgerx_dba_ftx_ltr_direct_clearing_model2-8-22/download

[8] See FTX.com, *Backstop Liquidity Provider Program*, January 2022. https://help ftx.com/hc/en-us/articles/360024479392-Backstop-Liquidity-Provider-Program

[9] In other words, FTX's guaranty fund will consist of 100% skin in the game. This approach incentivizes FTX to maintain robust risk-management practices. Research from the Bank for International Settlements has demonstrated that higher skin in the game is associated with "more prudent modelling, in contrast to profits": see Wenqian Huan and Elod Takats, *Model risk at central counterparties: Is skin-in-the-game a game changer?*, Bank for International Settlements, 25 May 2020. https://www.bis.org/publ/work866 htm

[10] FTX has calibrated the structure and size of the guaranty fund to ensure that it is sufficient for even the most extreme market risk situations. In an April blog post titled "Understanding FTX's Guaranty Fund Sizing," FTX explained how its margin risk management model has functioned on the international FTX.com exchange during times of market volatility. FTX notes that "[t]he single biggest daily drawdown from the FTX.com insurance fund was $4.7 million, on a week that the bitcoin price moved down 38%." Notably, the FTX.com international exchange currently experiences significantly higher trading volumes than FTX's US exchange, and it allows larger levels of leverage than what is being proposed in the FTX request. Based on FTX's past experience with this margin risk management model, the $250 million that FTX has included in its guaranty fund will be sufficient to manage risk in cases of high market volatility, rapid user growth, or both.

would provide an additional CFTC-regulated market for accessing margined BTC and ETH futures products, while providing customers the option to directly access the exchange and clearinghouse under a clearing model that is more suitable for their needs than the traditional one. This expansion of customer choice is needed: despite having some of the highest adoption rates of cryptocurrency in the world,[11] the U.S.'s regulated derivatives exchanges make up a small proportion of global derivatives trading,[12] and regulated trading on BTC and ETH futures is concentrated on one exchange.[13] U.S. customers deserve a choice of trading venues which guarantee robust markets, contract continuity despite FCM stress, and protection of their assets.

A key issue in this context is CFTC market and risk surveillance. FTX supports CFTC oversight and considers it a vital part of building and maintaining customer confidence in derivatives markets. As a registered designated contract market, FTX is subject to trading and conflicts of interest standards, as well as requirements around risk disclosures, record keeping, trading authorizations, and monthly statements and confirmations.[14] FTX also has rigorous know-your-customer (KYC) and anti-money laundering (AML) policies and procedures that are necessary for combating illicit finance and fraud in the derivatives markets.[15]

To achieve the benefits of FTX's clearing model and extend customer choice, an interpretation of regulation is needed which does not require separate DCOs and FCMs. Current CFTC rules have extensive and, in many cases, overlapping requirements for DCOs and FCMs. In particular, FCMs are subject to rules around disclosure, treatment of customer funds, and capital and liquidity requirements, among others.[16] While we support the objectives of these rules, they are not always directly applicable to a DCO where direct access is contemplated, as in FTX's model. Therefore, we encourage the CFTC to interpret its current rules to meet the Commission's objectives without duplicating requirements originally intended for a different clearing model.

3. The Context of Our Recommendation

Collectively, we possess significant experience across asset classes at regulatory agencies, exchanges, information technology providers, and academic institutions, where many of us specialize in assessing and mitigating risk. We care about market and DCO integrity and helping ensure our derivatives markets continue to serve their critical functions of providing reliable price

[11] "The 2021 Global Crypto Adoption Index," Chainalysis, (October 14, 2021). https://blog.chainalysis.com/reports/2021-global-crypto-adoption-index/

[12] "February 2022 Exchange Review," CryptoCompare, (February 2022) at 3. https://www.cryptocompare.com/media/39838277/cryptocompare_exchange_review_2022_02_nwm-1.pdf

[13] See ICE and CME Bitcoin futures monthly volumes: https://www.theice.com/products/72035464/Bakkt-Bitcoin-USD-Monthly-Futures/data?marketId=6754319 and https://www.cmegroup.com/trading/equity-index/us-index/bitcoin.html_quotes_volume_voi.html#tradeDate=20220418.

[14] See FTX US Derivatives, *Letter re: Permissibility and Benefits of Direct Clearing Model*, 8 February 2022) note 30 at 9. https://www.cftc.gov/media/7001/ledgerx_dba_ftx_ltr_direct_clearing_model2-8-22/download

[15] See FTX.com, *Individual Account KYC*, February 2022. https://help.ftx.com/hc/en-us/articles/360027668192-Individual-Account-KYC

[16] See for instance Commodity Futures Trading Commission Final Rule RIN 3038-AD88, *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations*, 14 November 2013. https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/federalregister103013b.pdf

discovery and risk-management tools. As such, we applaud the CFTC's deliberative, public process to assess the benefits and possible risks associated with FTX's request.

We believe that US customers and markets have much to gain from innovation in clearing models such as FTX's under CFTC oversight and with appropriate scrutiny. Innovative new technology, when implemented thoughtfully and with thorough risk controls, has the potential to contribute to reduced market risk, enhanced market efficiency, lower costs, and a more appropriate clearing model for retail investors. We believe that FTX has taken a considered approach and proposed a robust risk management framework which assures the financial integrity of the clearing process in its request. We encourage you to approve it.

Sincerely,

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