CME Group

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**VIA ONLINE SUBMISSION**

Mr. Christopher Kirkpatrick
Secretary of the Commission
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:

CME Group Inc. ("CME Group") appreciates this opportunity to provide comments on the Commodity Futures Trading Commission's ("CFTC" or "Commission") Request for Comment on the Request for an amended DCO registration order submitted by LedgerX, LLC d.b.a. FTX US Derivatives ("FTX") to offer central clearing of margined products directly to retail customers (the "FTX Request").

CME Group, a corporate holding company, wholly owns Chicago Mercantile Exchange Inc. ("CME"). CME is a CFTC-registered derivatives clearing organization ("DCO") ("CME Clearing"). CME Clearing offers clearing and settlement services for futures and options contracts, including those listed on CME Group's CFTC-registered designated contract markets ("DCMs"), and cleared swap derivatives transactions. These DCMs are CME, Board of Trade of the City of Chicago, Inc. ("CBOT"), New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges").

## EXECUTIVE SUMMARY

Risk management, market integrity and protection of public customers are fundamental to centrally cleared derivatives markets in the United States ("U.S."). Although the Commodity Exchange Act ("CEA" or "Act") does feature innovation as a statutory goal, the Act does not promote innovation for the sake of innovation alone; rather, it supports responsible innovation in service of the public interests described in Section 3(a). This means any purported "innovation" which is found to increase risk unacceptably or to degrade exchange markets or would fail to protect customers, would be in contravention of the purpose of the law. CEA Section 3(b) only promotes responsible innovation that serves the public interests described in Section 3(a). Namely, Section 3(b) states:

> *"To foster these public interests, it is further the purpose of this chapter to deter and **prevent price manipulation or any other disruptions to market integrity**; to ensure the financial integrity of all transactions subject to this chapter and **the avoidance of systemic risk**; to protect all*

*market participants from fraudulent or other abusive sales practices and misuses of customer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants."* **(**emphasis ***added***)

The FTX Request does not meet this test. FTX proposes to implement a "risk management light" clearing regime and must not be allowed to go forward as proposed. In fact, the purported "innovations" of FTX's proposal are best understood as simple cost-cutting measures utilized in its offshore markets having launched its crypto platform approximately three years ago. These cost cutting measures would come at the expense of risk management best practices, market integrity and ultimately, financial stability. The structure proposed in the FTX Request would inject significant systemic risk into the U.S. financial system.

We believe FTX intends to offer central clearing of leveraged derivatives products directly to retail participants to save the costs associated with important protections in the current system. However, FTX does not propose any replacement of the protections it intends to remove. Notably, FTX does not plan to apply significant risk management practices and resources crucial to maintaining the long history of success of U.S. centrally cleared derivatives markets, particularly during periods of stress. The FTX risk management light regime, coupled with the elimination of customer protections and liquidation practices that undermine market integrity, provides no discernable benefits for the marketplace or customers.

The FTX Request provides no evidence that its proposed structure features any unique innovations for retail participants' access to centrally cleared markets in comparison to the current access model with futures commission merchants ("FCMs"). In fact, recent industry studies indicate that the lack of intermediation and risk management by auto-liquidation, both proposed by FTX, actually hinder crypto markets today.[1] Moreover, key financial stability benefits of the current intermediated market structure, where DCOs and FCMs monitor the credit risks of their counterparties and over $173 billion in FCM capital[2] is available to address customer defaults, are eliminated in FTX's proposal. Further, the customer protections that retail participants receive today are eliminated, including limits on utilization of collateral, required risk disclosures, and segregation of public customer funds. FTX's proposal is not innovation, but rather evasion of best practices in risk management and customer protection for the sake of reduced costs.

In fact, some of the practices promoted by FTX as innovation actually endorse structures and practices which have historically been found to be lacking. FTX will only require a participant to post initial margin once for a position without necessarily calling for additional funds to cover adverse market moves, in exchange for the right to automatically liquidate the participant's positions when an account becomes undermargined. This combination of features bears a striking resemblance to discredited FCM practices that the Commission banned in 1981 when it adopted Regulation 1.56.[3]

[1] Acuiti, *Crypto Derivatives Managers' Insight Report*, pgs. 5 and 9 (Q2 2022), *available at* https://www.acuiti.io/wp-content/uploads/2022/04/Crypto-Derivatives-Management-Insight-Report-Q2.pdf.

[2] CFTC, Financial Data for FCMs (Feb. 2022) (noting, figure includes adjusted net capital and residual interest for the customer segregated account), *available at* https://www.cftc.gov/sites/default/files/2022-04/01-%20FCM%20Webpage%20Update%20-%20February%202022.pdf.

[3] The regulation prohibits an FCM from representing in any way that it will guarantee a customer against trading losses, limit the losses of a customer or not call for or attempt to call for margin, in response to abusive practices

CME Group's concerns with the FTX Request are explained in the Overview of Specific Comments section of this letter, the main points of which are summarized as follows:

- **Risk Management Deficiencies:** In addition to eliminating the backstop of FCM capital of over $173 billion, FTX's proposal has no capital or risk-based requirements for participants, nor would FTX implement standard counterparty due diligence practices, or maintain sufficient resources for managing participant defaults (i.e., typically referred to as a guaranty fund). Of particular concern, FTX's proposal seeks to eliminate the survivor-pays model (i.e., no risk of mutualization), while failing to adequately size a mutualized guaranty fund which would reduce participants' incentive to actively manage their risks, particularly in stressed markets.

- **Market Integrity Issues:** FTX's proposal to manage risk via auto-liquidation can result in increased losses for participants, exacerbation of price moves during volatile markets, and market destabilization. Further, auto-liquidation without independent oversight risks incentivizing participants to engage in trading and sales practice abuses, including by triggering and trading opposite a liquidation. Moreover, conflicts of interest are rife in FTX's proposed auto-liquidation tool.

- **Cross Border Implications:** If the CFTC were to grant the FTX Request as proposed, it risks losing its leadership role as a promoter of best practices in risk management and hard-won cross-border equivalence agreement with the European Union ("EU") and undermining its ability to reach agreement with the United Kingdom ("UK"). This could ultimately undermine the ability of U.S. DCOs to continue to provide their risk management offering to market participants in the EU and UK.

- **Customer Protection Issues:** FTX's proposal eliminates customer protections for all of FTX's participants in margined and fully collateralized products. FTX's proposal discards these carefully crafted customer protections developed by the CFTC over decades without consideration of the rationale underpinning their design. The predominantly retail market participants that FTX plans to solicit to engage in leveraged futures trading as direct clearing members are the very type of market participants these requirements are intended to protect.

- **Legal and Regulatory Implications of the FTX Request:** The FTX Request undermines and is contrary to the objectives and spirit of the CEA and CFTC regulations promulgated thereunder, particularly related to customer protections.

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associated with offering of "limited risk" accounts to customers coupled with discretionary control over their accounts to liquidate positions. *See Prohibition Against Guarantee of Loss*, 46 FR 62841 (Dec. 29, 1981) (Final rule). The CFTC explained when proposing the rule that "customers who have been attracted to limited-risk commodity futures trading have frequently been less sophisticated and consequently more vulnerable to the use of improper sales, trading, and promotional practices," and further that firms offering such accounts may be more prone to engage in deceptive or fraudulent practices. *See Prohibition Against Guarantee of Loss*, 46 FR 11668, 11670 (Feb. 10, 1981).

We note the FTX Request is limited to derivatives based on digital assets. However, FTX has made clear in public statements that it plans to expand the proposed structure to other centrally cleared derivatives asset classes. In order to grant the FTX Request, the CFTC will be required to find that any Amended DCO Order complies the Core Principles, a finding that would have precedential value allowing other DCOs to implement this model in other markets.

## OVERVIEW OF SPECIFIC COMMENTS

We provide responses to the specific questions in the Request for Comment in the appendix to this letter. In addition, we provide specific comments below on the FTX Request.

### I. Risk Management Deficiencies in the FTX Request

FTX's proposal does not have sufficient resources or instill the necessary risk management incentives for its participants because FTX intends to operate under a risk management light regime. Under this regime, FTX will impose no capital requirements on its participants and does not intend to maintain mutualizable participant resources (i.e., loss-sharing among non-defaulting participants) to address participant defaults. The proposed FTX direct model eliminates potentially billions of dollars of loss-absorbing resources available under current centrally cleared market structure for margined derivatives. Moreover, FTX doubles down on this resource light regime by eliminating counterparty due diligence of participants.

Deficient capital requirements coupled with poor counterparty due diligence practices were identified as some of the primary shortcomings by Nasdaq Clearing Akitebolag's ("Nasdaq Clearing") regulator following the default of a direct clearing member.[4] This clearing member was a high net worth individual, perhaps similar to some potential participants at FTX. Nasdaq Clearing, unlike what is contemplated in FTX's proposal, did impose at least some capital requirements on its members and engaged in some counterparty due diligence practices. Despite these practices, the default by the clearing member, who is a natural person, resulted in approximately 60% of its commodities default fund being utilized.[5] Nasdaq Clearing's practices are considerably more robust than those described in the FTX Request, creating the risk that the impact of default events at FTX could be even more severe.

a. <u>Lack of Capital Requirements and Other Risk-Based Requirements for Participants</u>

***Key Point: To instill the necessary risk management incentives for participants, FTX must adopt appropriate risk-based capital requirements and other risk-based requirements.***

*i. Elimination of Capital Requirements*

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[4] *See* Finansinspektionen, Letter to Nasdaq Clearing Akitebolag, at pgs. 15-20 (Jan. 26, 2021), *available at* https://www.fi.se/contentassets/09352ee009544b288f6298ecddd8f995/beslut-nca-2021-01-26-eng.pdf.
[5] Nasdaq Clearing, *An Enhanced and More Robust Risk Management Framework*, https://www.nasdaq.com/solutions/nasdaq-clearing-risk-management (last visited Apr. 14, 2022).

FTX's proposed risk management light regime has no capital requirements for participants. Today, where DCOs maintain strict minimum financial requirements, retail participants exposures, as well as exposures of other customers of FCMs, are backstopped by the FCMs' own capital. FCMs, in the aggregate, maintain over $173 billion in adjusted net capital and other resources.[6] There is no indication or discussion in the FTX Request that FTX itself would hold capital or residual interest comparable to FCM levels today.

Risk-based capital requirements have long been recognized as a safeguard in financial markets, including in the U.S. centrally cleared derivatives markets,[7] where FCMs hold capital that is commensurate with their own risk-taking and that of their customers.[8] The FTX Request is severely deficient in reducing systemic risk as it does not require FTX's participants to hold similar loss-absorbing capital and be similarly incentivized to actively manage their risks. To replicate this safeguard, the capital required for each FTX participant should be the greater of a minimum amount of at least $1 million or 8% of a participant's risk margin.[9] For avoidance of doubt, this capital is separate from and in addition to the financial resources FTX must maintain to cover its operating costs for a period of at least one-year[10] and the $250 million referenced as the guaranty fund in the FTX Request.

CME Group understands from the FTX Request that FTX intends to satisfy CFTC Regulation 39.12(a)(2) that a DCO require its clearing members to "have access to sufficient financial resources to meet obligations arising from participation…in ***extreme but plausible market conditions***" (emphasis ***added***) through its proposed real-time monitoring of margin levels relative to exposures and auto-liquidation tool.[11] Without counterparty due diligence, FCM capital, and an appropriately sized guaranty fund, this requirement can only be satisfied if FTX margined its products at levels that would cover extreme but

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[6] CFTC, Financial Data for FCMs (Feb. 2022) (noting, figure includes adjusted net capital and residual interest for the customer segregated account), *available at* https://www.cftc.gov/sites/default/files/2022-04/01-%20FCM%20Webpage%20Update%20-%20February%202022.pdf.
[7] *See* 68 FR 40835, at pg. 40837 (noting, "[m]argin-based (or risk-based) capital rules have been adopted and put into effect by the Board of Trade Clearing Corporation (''BOTCC''), Chicago Board of Trade (''CBOT''), Chicago Mercantile Exchange (''CME''), and NFA. BOTCC, CBOT, and CME adopted risk-based components to their respective minimum capital requirements for clearing member firms effective January 1, 1998. NFA adopted a risk-based capital component to its minimum capital requirements for member FCMs effective October 31, 2000. Based upon the effectiveness of these rules as implemented at these organizations, the U.S. commodity exchanges and NFA, through the Joint Audit Committee (''JAC''), have requested that the Commission amend its capital rule by…adopting a calculation based on the required maintenance margin levels for customer and noncustomer futures and option positions carried by an FCM.").
[8] *See* CFTC Regulation 1.17(a) (noting, this requirement is an important tool for incentivizing FCMs to actively manage their risk, since as risk-taking increases so must capital).
[9] *See* CFTC Regulation 1.17(a)(1) (noting, to the extent applicable, capital required pursuant to Rule 15c3-1(a) of the Securities and Exchange Commission for securities and brokers dealers should also be applied equivalently).
[10] *See* CFTC Regulation 39.11(a)(2).
[11] FTX Request, Letter from Brian G. Mulherin, Gen. Counsel, FTX US Derivatives, to Clark Hutchison, Dir., Div. of Clearing & Risk, at pg. 8 (Feb. 8, 2022) (Permissibility and Benefits of Direct Clearing Model under Commodity Exchange Act and CFTC Regulations) (noting, "FTX's real-time monitoring of participant positions enables it to determine, at all times, whether a participant's account has sufficient cash and collateral to meet its margin obligations to the DCO. In the event an account does not have sufficient financial resources, FTX will immediately begin to liquidate the participant's positions until the funds in the participant account is equal to its margin obligations to the DCO."), *available at* https://www.cftc.gov/media/7001/ledgerx_dba_ftx_ltr_direct_clearing_model2-8-22/download.

plausible market conditions. The FTX Request does not provide details on its margin methodology or suggest that they plan to margin at extreme but plausible levels. In fact, the FTX Request suggests they plan to margin the Bitcoin derivative contract at 20% and 15% of the contract value for initial and maintenance margin, respectively.[12] To cover extreme but plausible market conditions, FTX's margin for a Bitcoin derivatives contract must cover approximately a 65% price move. Notably, if CME Clearing margined the products it clears using the extreme but plausible market conditions standard, margin levels would increase by nearly three-fold.[13]

*ii. Elimination of Other Risk-Based Participation Requirements*

The FTX Request also indicates that FTX does not intend to apply other risk-based participation requirements.[14] Risk-based requirements, coupled with counterparty due diligence and monitoring practices, of current DCOs that clear margined products under an intermediated model ("current DCOs") are designed to ensure direct participants have the ability to address operational, financial, and other risks that may arise from participating in a given DCO's clearing services.[15] DCOs apply these requirements to all direct participants, whether they clear for themselves or on behalf of customers. Risk-based participation requirements are the backbone of a DCO's offering as they are the first line of defense in mitigating counterparty risk. During stressed markets in particular, a lack of risk-based participation requirements coupled with no capital is a recipe for systemic risk.

b. <u>Lack of Counterparty Due Diligence</u>

***Key Point: FTX must conduct due diligence reviews of its participants.***

Counterparty due diligence is a linchpin of the modern financial system and a key part of current DCOs' risk management practices, used to confirm that clearing members are well-placed to meet the obligations that arise from their risk-taking. FTX would not be the first party, novice or otherwise, to suggest that financial modeling and algorithm design could eliminate the need for best practices in risk management. However, the eventual fate of Long-Term Capital Management[16] and bespoke financially engineered

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[12] FTX Request, Form DCO Exhibit G-Default Rules and Procedures, at pg. 2 (Feb. 2022), *available at* https://www.cftc.gov/media/6991/ledgerx_dba_ftx_formdco-exhibit_G_2-8-22/download.

[13] Note, CME Clearing simulated adjustments to the SPAN-based margin required for ten major futures and options products that are spread across asset classes to cover extreme but plausible market conditions (i.e., stress levels used for sizing the Base Guaranty Fund).

[14] *See* FTX Request, Rulebook-Margin Revisions Draft [hereafter FTX Rulebook], at FTX Rule 3.2.A.9 (Dec. 2021) (noting, the FTX Rulebook merely has a requirement that has not been amended since the FTX Request was submitted that participants "have a good reputation and business integrity and maintain adequate financial resources," but provides no further requirements for satisfying this provision. It's also unclear how FTX will verify that participants have adequate financial resources when they have no financial resource requirements.).

[15] *See* Chapter 9 of the CME Group Exchange Rulebooks (noting, CME Group Exchange Rules 901 and 982).

[16] The near-failure of Long-Term Capital Management ("LTCM") and the hedge fund it operated ("LTCM Fund") in the summer and early fall of 1998 vividly highlighted the need for using sound risk management practices in the financial markets. LTCM engaged in highly leveraged trading for the LTCM Fund based on the general strategy that liquidity, credit and volatility spreads would narrow, in a range of financial instruments including derivatives. LTCM relied on risk management models that underestimated the risk that the spreads would widen as they did. By the end of August 1998, the capital held by the LTCM Fund had declined over 50% from the start of the year to $2.3

products such as mortgage-backed securities and collateralized debt obligations suggests that it would be folly to unwind core risk management practices, such as counterparty due diligence, based on the assurance that "this time it's different."

c. Insufficient Financial Resources for Managing Participant Defaults

***Key Point: To instill the necessary risk management incentives for participants, FTX must require resources from its participants that are appropriately sized to cover tail risk that may be mutualized.***

Unsurprisingly given the proposed lack of capital requirements for participants, under FTX's proposal FTX will have insufficient financial resources to address participant default events (i.e., tail risk). Additionally, by proposing to self-fund its guaranty fund, FTX eliminates a core incentive for participants to effectively manage their risks. In contrast, current DCOs require clearing members to fund a mutualized pool of resources with knowledge of the risks they assume (in addition to a DCO's own contribution known as, "skin-in-the-game"), so that as risk-taking increases, resources increase. This provides incentives to clearing members to manage their own and their customers' risk in business-as-usual and stressed markets, while also incentivizing them to actively participate in the default management process. Removing the potential for loss mutualization, as FTX proposes, eliminates these risk management incentives.

*i. Insufficient of Size of Financial Resources*

FTX suggests that they exceed the current Cover 2 standard[17] by proposing to size its guaranty fund using a Cover 3 standard,[18] but, despite FTX's attempted justification, it is not as simple as confirming that three is a larger number than two. FTX fails to address the unique risk characteristics of its proposal to offer leveraged derivatives directly to retail and other participants. Due to this and its plans for auto-liquidation, FTX is inherently likely to experience significantly more defaults than current DCOs. This is because, under an intermediated model, customer defaults are managed and closed-out by the DCO's FCMs using, as necessary, their own capital to cover any losses, as opposed to the DCO's own resources. The significant majority of customers' risk-taking in U.S. centrally cleared derivatives markets is guaranteed by bank-affiliated FCMs whose parent companies have been deemed global systemically

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B. The LTCM Fund had incurred losses of $1.8 B in the month of August alone. Its precipitous losses caused wide-spread concern among its counterparties and others about the LTCM Fund's ability to meet its financial obligations and whether it was soon to collapse. The President's Working Group on Financial Markets issued a report in April 1999 identifying the risk management and other failures at LTCM and its counterparties and provided a number of recommendations in the report to enhance risk management practices, including counterparty due diligence. *See* "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management Report of The President's Working Group on Financial Markets" (April 1999).

[17] Cover 2 standard means to maintain resources to cover the default of the two clearing members (and their affiliates) with the largest combined exposure under extreme but plausible market conditions. *See* CFTC Regulation 39.33(a).

[18] In the context of the FTX Request, we understand that the Cover 3 standard means to maintain resources to cover the default of the three clearing members with the largest combined exposure under extreme but plausible market conditions.

important banks ("G-SIBs").[19] Despite this, these FCM clearing members are subject to significant counterparty due diligence by CME Clearing. Additionally, these bank-affiliated FCMs, like all FCMs, conduct significant due diligence on their clients. In contrast, as noted above, FTX proposes to allow direct retail participation without subjecting them to any counterparty due diligence and if they default, they are not backed by billions of dollars of FCM capital, as they are today.

The increased likelihood of retail participant failure is coupled with a significant difference in the number of direct participants (as compared to current DCOs), which inherently requires a different approach to FTX's guaranty fund sizing. To put this into context, as of December 2021, FTX had about 1.2 million users,[20] whereas CME Clearing had 56 clearing members for Base products (i.e., primarily futures and options products). While CME Clearing meets a Cover 2 standard,[21] these Cover 2 Clearing Members guarantee hundreds, if not thousands, of primarily institutional clients. To put the potential probability of default into context, we evaluated historic failures by large banks and individual households. On average from 2003 through 2021, 6.2% of outstanding household debt was in some stage of delinquency,[22] whereas only 0.55% of banks over $10 billion in assets failed.[23] This is not a perfect comparison, since the household debt measure is a percentage of borrowing, whereas the bank failure measure is a percentage of total banks and predominantly includes banks who are not G-SIBs. Further, unlike FTX's intended direct participants, households are generally subject to credit due diligence by their lenders, which suggests that FTX's participants would default at a higher rate than these traditional borrowers. However, the differences in the profiles of clearing members at FTX and CME Clearing and default probabilities demonstrate how the approach used for guaranty fund sizing for the intermediated model is inappropriate for FTX's proposal. Thus, FTX's suggestion to simply modify the Cover 2 standard designed for an intermediated model to a Cover 3 standard is insufficient and unpersuasive.

FTX has suggested that using 10% of total initial margin held at FTX can be a useful indicator in sizing its guaranty fund, but it ultimately ignores this upon a closer reading of the proposal. In particular, the FTX Request states:[24]

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[19] CFTC, Financial Data for FCMs (Feb. 2022) (noting, customer segregated margin required that is associated with G-SIB-affiliated FCMs is 81% of total customer segregated margin required), *available at* https://www.cftc.gov/sites/default/files/2022-04/01-%20FCM%20Webpage%20Update%20-%20February%202022.pdf.

[20] @Brett_FTXUS, TWITTER (Dec. 26, 2021, 2:03 PM), https://twitter.com/Brett_FTXUS/status/1475195618926735364.

[21] Cover 2 standard means to maintain resources to cover the default of the two clearing members (and their affiliates) with the largest combined exposure under extreme but plausible market conditions. *See* CFTC Regulation 39.33(a).

[22] Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit* (Feb. 2022) (noting, "Page 11 Data"), *available at* https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/xls/HHD_C_Report_2021Q4.

[23] Federal Deposit Insurance Corporation, *Bank Failures in Brief* (last visited Apr. 14, 2022) (noting, data in the column "Approx. Asset (Millions)" was filtered to only capture banks with more than $10 billion in assets), *available at* https://www.fdic.gov/bank/historical/bank/bfb-data.csv; Federal Deposit Insurance Corporation, *FDIC – Statistics on Depository Institutions Report* (last visited Apr. 14, 2022) (noting, the data filter "All Commercial Banks - Assets more than $10B – National" was used to determine the number of banks each year), *available at* https://www7.fdic.gov/sdi/main.asp?formname=standard.

[24] FTX Request, Letter from Julie L. Schoening, Ph.D, Chief Risk Officer, FTX US Derivatives, to Clark Hutchinson, Dir., Div. of Clearing & Risk, at pg. 2 (Feb. 8, 2022) (Financial Resource Requirements under Core

*"FTX will calculate the amount needed to meet its financial obligations to members and participants notwithstanding the default of: (a) the single largest clearing member (i.e., the Cover-1 amount); or (b) if Cover-1 is less than 10% of total initial margin ("IM") at the clearinghouse, then the two largest clearing members (i.e., the Cover-2 amount); or (c) if Cover-2 is less than 10% of IM, then the three largest clearing members (i.e., the Cover-3 amount)."*

It is evident that FTX believes that calculating the number of participant defaults that should be covered by FTX's financial resources based on the number of participants that is equal to 10% of total initial margin is an "appropriate and conservative" methodology.[25] Thus, FTX's proposal to ultimately ignore the 10% of initial margin consideration if it gets to the Cover 3 amount is flawed by its own logic. To further reinforce the insufficiency of the proposal, CME Clearing used "Large Trader"[26] data to determine how many customers[27] are equivalent to 10% of the customer margin required for CME Clearing's futures and options clearing offering.[28] As of April 1, 2022, nine Larger Trader customers represent 10% of customer margin required. This suggests that, using its own methodology, FTX should, at a minimum, size its guaranty fund to meet at least a Cover 9 standard (i.e., resources to cover the default of the nine clearing members (and their affiliates) with the largest combined exposure under extreme but plausible market conditions).[29]

Of course, the 10% of initial margin consideration is not equivalent to the Cover 2, or even Cover 1, standard at a major DCO, such as CME Clearing, since FTX's proposal fails to take into consideration how DCOs actually size their guaranty funds.[30] DCOs, including CME Clearing, size their financial resources considering the risks arising from clearing members' house and customer accounts consistent with best practices in risk management and CFTC requirements. In order to replicate the average amount of initial margin required from CME Clearing's clearing members driving the Cover 2 standard, using

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Principle B and CFTC Regulation 39.11(a)(1) in the Absence of Clearing Futures Commission Merchants ("FCMs")), *available at* https://www.cftc.gov/media/7006/ledgerx_dba_ftx_ltr_fin_resource_req2-8-22/download.

[25] FTX Request, Letter from Julie L. Schoening, Ph.D, Chief Risk Officer, FTX US Derivatives, to Clark Hutchinson, Dir., Div. of Clearing & Risk, at pg. 4 (Feb. 8, 2022) (Financial Resource Requirements under Core Principle B and CFTC Regulation 39.11(a)(1) in the Absence of Clearing Futures Commission Merchants ("FCMs")), *available at* https://www.cftc.gov/media/7006/ledgerx_dba_ftx_ltr_fin_resource_req2-8-22/download.

[26] *See* Parts 17 and 20 of the CFTC Regulations.

[27] Notably, customers who meet the criteria for large trader are generally institutional in nature so even these estimates are likely to be low for a more retail oriented market.

[28] Note, this was a point-in-time analysis done as of April 1, 2022 and used the SPAN Risk requirement for "Large Trader" customers, which is the margin requirement for futures and options portfolios without net option value.

[29] Note, while the Large Trader analysis CME Clearing did was a point-in-time analysis, assuming that FTX demonstrates that using this methodology is appropriate in the first place, FTX should conduct a comparable analysis using a longer lookback period (and/or proxy data given the nascency of FTX's offering) to determine the number participants that comprise 10% of total initial margin.

[30] FTX Request, Letter from Julie L. Schoening, Ph.D, Chief Risk Officer, FTX US Derivatives, to Clark Hutchinson, Dir., Div. of Clearing & Risk, at pg. 8 (Feb. 8, 2022) (Financial Resource Requirements under Core Principle B and CFTC Regulation 39.11(a)(1) in the Absence of Clearing Futures Commission Merchants ("FCMs")), *available at* https://www.cftc.gov/media/7006/ledgerx_dba_ftx_ltr_fin_resource_req2-8-22/download.

"Large Trader" customer data as of April 1, 2022,[31] FTX should, at a minimum, size its guaranty fund to cover the default of its 27 largest participants. [32]

*ii. Failure to Use Appropriate Stress Scenarios for Sizing Financial Resources*

FTX also does not appear to fully understand the concept of "***extreme but plausible market conditions***" (emphasis ***added***)[33] for the purposes of guaranty fund sizing. Surprisingly, FTX appears to suggest that increasing the assumed number of participants defaulting meets this requirement[34] and no other information is provided in the FTX Request on its stress testing methodology. DCOs today size their financial resources using both historical data and hypothetical scenarios that are designed to capture tail risk.[35] Failing to do this ignores tail risk and leads to inadequate resources to cover default losses, particularly during stressed markets.

d. Lack of Information on Risk Management Practices

***Key Point: Additional information and clarity is needed on FTX's risk management practices to fully evaluate the FTX Request and provide necessary transparency to market stakeholders.***

In our response to the CFTC's specific questions, we indicated areas where additional information is needed on FTX's risk management practices to properly evaluate its proposed practices, but this is by no means an exhaustive list. DCOs are required to provide market participants sufficient information to enable the market participants to identify and evaluate accurately the risks and costs associated with using the DCO's services.[36] The FTX Request does not meet this requirement.

Additionally, current DCOs transparently set out their risk management practices through multiple avenues, including their qualitative disclosures consistent with the *Principles for financial market infrastructures* ("PFMIs"), adopted by the Committee on Payments and Market Infrastructures ("CPMI")

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[31] Note, this was a point-in-time analysis done as of April 1, 2022 and used the SPAN Risk requirement for "Large Trader" customers, which is the margin requirement for futures and options portfolios without net option value.
[32] Note, while the Large Trader analysis CME Clearing did was a point-in-time analysis, assuming that FTX demonstrates that using this methodology is appropriate in the first place, FTX should conduct a fulsome analysis to demonstrate why using a given percentage of total initial margin is appropriate. Importantly, this analysis must consider the risk characteristics of FTX's offering, as a key feature of current DCOs practices is that a given DCO designs its practices considering the unique characteristics of its offering (e.g., products cleared and clearing membership base) and not merely because of practices of other DCOs.
[33] CFTC Regulation 39.11(a)(1).
[34] FTX Request, Letter from Julie L. Schoening, Ph.D, Chief Risk Officer, FTX US Derivatives, to Clark Hutchinson, Dir., Div. of Clearing & Risk, at pg. 3 (Feb. 8, 2022) (Financial Resource Requirements under Core Principle B and CFTC Regulation 39.11(a)(1) in the Absence of Clearing Futures Commission Merchants ("FCMs")) (noting, "[i]ncreasing the number of the largest participants that are assumed to default at the same time makes a scenario more extreme but naturally decreases the plausibility of such a scenario."), *available at* https://www.cftc.gov/media/7006/ledgerx_dba_ftx_ltr_fin_resource_req2-8-22/download.
[35] CFTC Regulation 39.11(c)(1) (noting, CFTC Regulation 39.36(a) establishes additional requirements with respect to a systemically important and electing subpart C DCO's stress testing methodology (e.g., scenarios considered)).
[36] CFTC Regulation 39.21(a).

and the International Organization of Securities Commissions ("IOSCO").[37] While only systemically important DCOs and electing subpart C DCOs are required to make these disclosures, it is an accepted industry best practice that all central counterparties ("CCPs") publish these qualitative disclosures, as well as related quantitative disclosures.[38]

## II. Market Integrity Issues with the FTX Request

The FTX Request, as designed, would have a significant negative impact on market integrity. FTX assumes that auto-liquidation is a panacea that eliminates the need for other risk management practices. FTX is arguing in favor of eliminating best practices in risk management represented by risk-based capital and other participation requirements, counterparty credit due diligence, and participant funded mutualizable resources for managing defaults, among others. This collectively eliminates core incentives for participants to effectively manage their risk-taking. Contrary to FTX's assertions, auto-liquidation is not a new concept and has not been broadly implemented due to the panoply of problems it creates, particularly in stressed markets. Auto-liquidation may, at first glance, appear to be novel but it has been evaluated and generally dismissed as a market-wide risk management tool for three primary reasons: (1) it risks creating a vicious procyclical cycle of cascading liquidations; (2) it incentivizes market abuse and bad behavior, including but not limited to, market participants triggering and trading against liquidation orders and market participants anticipating and front-running the liquidation orders, exacerbating market volatility and increasing liquidation cost; and (3) at least in the case of FTX's proposed implementation, it closes out participants' positions, including hedges, without the opportunity for them to cure the collateral shortfall. FTX proposes to immediately auto-liquidate participants' positions 24-hours a day, 7-days a week without any opportunity to cure their collateral shortfall, if at a point in time (i.e., margin is assessed approximately once per second) price moves result in their account being under-margined.[39] According to the FTX Request, a liquidation could occur every 6 seconds, with a set percentage of the participant's portfolio being liquidated each time interval, until either the participant returns to good standing (i.e., no longer under-margined) or the portfolio is completely liquidated.[40]

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[37] Committee on Payment and Settlement Systems (later renamed the Committee on Payments and Market Infrastructures) and Technical Committee of the International Organization of Securities Commissions, *Principles for financial market infrastructures* (Apr. 2012). *See* CFTC Regulation 39.37(a).
[38] Committee on Payments and Market Infrastructures and Board of the International Organization of Securities Commissions, *Public quantitative disclosure standards for central counterparties* (Feb. 2015). *See* CFTC Regulation 39.37(c).
[39] FTX Request, Letter from Brian G. Mulherin, Gen. Counsel, FTX US Derivatives, to Clark Hutchinson, Dir., Div. of Clearing & Risk, at pg. 1 (Feb. 8, 2022) (Permissibility and Benefits of Direct Clearing Model under Commodity Exchange Act and CFTC Regulations) (noting, "FTX's real-time monitoring of participant positions enables it to determine, at all times, whether a participant's account has sufficient cash and collateral to meet its margin obligations to the DCO. In the event an account does not have sufficient financial resources, FTX will immediately begin to liquidate the participant's positions until the funds in the participant account is equal to its margin obligations to the DCO."), *available at* https://www.cftc.gov/media/7001/ledgerx_dba_ftx_ltr_direct_clearing_model2-8-22/download.
[40] FTX Request, Form DCO Exhibit G-Default Rules and Procedures, at pg. 3 (Feb. 2022), *available at* https://www.cftc.gov/media/6991/ledgerx_dba_ftx_formdco-exhibit_G_2-8-22/download. .

Moreover, FTX appears to realize that its proposed auto-liquidation tool and use of backstop liquidity providers may not always be successful. However, rather than proposing additional resources or risk management incentives to address an unsuccessful liquidation, FTX's proposed solution is to tear up positions in a manner similar to what was recently observed in the nickel derivatives market in the UK.

a. Market Integrity Impacts

The following summarizes some of the problems that will result from FTX's dogmatic use of auto-liquidation:

i. *Cascading Liquidations*

FTX's proposed use of an auto-liquidation algorithm across its entire customer-base could cause widespread market disfunction and price distortions. Often referred to as a "contagion effect" in mass liquidations, the market impact associated with the liquidation of one account can cause the liquidation of other accounts, thus leading to a dysfunctional cycle of cascading account liquidations. Auto-liquidation has historically shown a propensity to exacerbate price moves during volatile markets leading to cascading liquidations and further market destabilization.[41] Further, to the extent that any issues occur within the auto-liquidation algorithms, these negative consequences can be magnified. Examples of these issues are numerous:

- **June 2017:** Ethereum's price declined from around $319 to 10 cents on GDAX exchange (owned by Coinbase Global, Inc.) in June 2017, due to a "multimillion dollar market sell order resulted in a number of orders being filled from $317.81 to $224.48", according to the Vice President of GDAX, Adam White.[42] The sell order resulted in another 800 stop loss orders and margin funding liquidations.[43]

- **March 2020:** A Bitcoin flash crash led by BitMEX in March 2020 where the price at one point fell below $4,000 (at $10,000 just the week prior) triggered liquidations worth over $702 million on BitMEX.[44]

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[41] *See* CME Group, Notice of Disciplinary Action, COMEX-15-0303-BC (Sept. 2020) (sanctioning firm that utilized functionality designed to automatically liquidate under-margined customer accounts that caused extreme price movements, liquidity and trade volume aberrations and velocity logic events on multiple occasions), *available at* https://www.cmegroup.com/notices/disciplinary/2020/09/COMEX-15-0303-BC-INTERACTIVE-BROKERS-LLC.html. *See also* CME Group, Notice of Disciplinary Action CBOT-15-0158-BC (Mar. 2017) (sanctioning firm that utilized an auto-liquidation algorithm to liquidate under-margined client accounts causing significant market disruptions on several dates), *available at* https://www.cmegroup.com/notices/disciplinary/2017/03/CBOT-15-0158-BC-SAXO-BANK-AS.html.

[42] Arjun Kharpal, *Ethereum briefly crashed from $319 to 10 cents in seconds on one exchange after 'multimillion dollar' trade*, CNBC (June 23, 2017), https://www.cnbc.com/2017/06/22/ethereum-price-crash-10-cents-gdax-exchange-after-multimillion-dollar-trade.html; Michelle Fox, *Cryptocurrency exchange to credit traders for ethereum 'flash crash'*, CNBC (June 24, 20217), https://www.cnbc.com/2017/06/24/cryptocurrency-exchange-to-credit-traders-for-ethereum-flash-crash.html.

[43] *Id*.

[44] Omkar Godbole, *Bitcoin's Crash Triggers Over $700M in Liquidations on BitMEX*, CoinDesk (Mar. 12, 2020), https://www.coindesk.com/markets/2020/03/12/bitcoins-crash-triggers-over-700m-in-liquidations-on-bitmex/; Bill

- **May 2021:** Price moves led to mass sell-offs in Bitcoin during May 2021 when bitcoin prices dropped by 30%, which coincided with traders liquidating roughly $12 billion in leveraged positions.[45]

- **October 2021:** Bitcoin's price declined from around $65,000 to $8,200 on Binance's U.S. exchange, due to a bug in an institutional trader's algorithm.[46] The Binance event caused knock-on effects at other crypto exchanges, where Bitcoin's price at Coinbase declined by $1,000 and Ethereum's price dropped by $2,000 from its price of just over $4,000 per ether.[47] This led to sell-offs in Bitcoin and Ethereum across exchanges.

- **December 2021:** In December 2021 on a Saturday, Bitcoin fell approximately 20% within an hour (before ultimately recovering) that led to a cascade of participant liquidations.[48]

These examples represent a small sample of the negative impacts of auto-liquidation, generally during non-stress market conditions. Using auto-liquidation in stressed markets would lead to particularly severe pricing impacts and market dislocations.

*ii. Market Abuse*

FTX's proposed use of an auto-liquidation algorithm across its entire customer-base also sets the table for significant abusive practices. FTX's seemingly predictable auto-liquidation algorithm (i.e., X-percent of account liquidated in Y-second intervals) paves the way for predatory order anticipation strategies to front-run or trade ahead of the liquidation, which would have the effect of removing market liquidity and thus impairing the ability of the auto-liquidation algorithm to offset positions without significant price concession. It is also conceivable that sophisticated market participants could earn significant profits triggering and trading against liquidations, particularly during times of low liquidity in the middle of the night, during illiquid market conditions and at discounted prices. As noted elsewhere in this letter, the

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Bambrough, *Dire Bitcoin Warning As Confidence 'Evaporates' Amid $100 Billion Crypto Rout*, Forbes (Mar. 14, 2020), https://www.forbes.com/sites/billybambrough/2020/03/14/dire-bitcoin-warning-as-confidence-evaporates-amid-100-billion-crypto-rout/?sh=731aa3fd2eb4; Bill Bambrough, *Here's What Caused Bitcoin's 'Extreme' Price Plunge*, Forbes (Mar. 19, 2020), https://www.forbes.com/sites/billybambrough/2020/03/19/major-bitcoin-exchange-bitmex-has-a-serious-problem/?sh=5a0781924f7d.

[45] Maggie Fitzgerald & Kate Rooney, *Bitcoin traders using up to 100-to-1 leverage are driving the wild swings in cryptocurrencies*, CNBC (May 25, 2021, updated June 1, 2021), https://www.cnbc.com/2021/05/25/bitcoin-crashes-driven-by-big-margin-bets-new-crypto-banking.html.

[46] Nick Baker, *How Crypto Exchanges Could Stop Flash Crashes If They Wanted To*, Bloomberg (Oct. 22, 2021), https://www.bloomberg.com/news/articles/2021-10-22/crypto-exchanges-can-stop-flash-crashes-if-they-want-will-they?sref=4lvaG6HM

[47] Bill Bambrough, *Binance CEO Issues Serious Crypto Price Warning As Sudden Bitcoin 'Flash Crash' Knocks Ethereum And Wider Market*, Forbes (Oct. 21, 2021), https://www.forbes.com/sites/billybambrough/2021/10/21/binance-ceo-issues-crypto-price-warning-after-sudden-bitcoin-flash-crash-knocks-ethereum-and-wider-market/.

[48] Justina Lee, *Crypto Complex Erased $480 Billion in 'Cascade of Liquidations'*, Bloomberg (Dec. 6, 2021), https://www.bloomberg.com/news/articles/2021-12-06/crypto-complex-erased-480-billion-in-cascade-of-liquidations?sref=4lvaG6HM.

CFTC has a long-standing reputation of promoting customer protections and preventing market abuse. Approval of auto-liquidation, at the scale that FTX proposes, puts that reputation at risk.

*iii. Broken Hedges*

FTX has expressed its ambition to apply its proposed model to other asset classes. Auto-liquidations could have knock-on effects on the real economy, including exacerbation of price increases already being observed due to inflationary pressures if it were utilized in core commodity markets such as agricultural, energy, and metals, as well as other markets. Commodity producers and purchasers often use derivatives markets to hedge their business risks over short-term and long-term time horizons. This has been reflected by the hedge accounting rules which, under certain conditions, allow these participants to benefit from preferential accounting treatment due to the reduced business risk associated with their well-hedged exposures.

FTX propagates a model where participants can be auto-liquidated without notice,[49] in the middle of the night, and on weekends and holidays, during illiquid market conditions and at discounted prices. This would inject uncertainty in the application of hedge accounting programs at firms because the risk of sudden broken hedges. Such a break could occur during a market event, or in the case of FTX even without significant market moves, leading to realized and unrealized gains impacting firms' accounting statements at a time when balance sheet stability is more important than ever. Hedge accounting programs have demonstrated their value over time which is why the Financial Accounting Standards Board introduced major improvements to accounting for hedging activities that had an objective of "improving the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements."[50] CME Group regularly receives feedback from market stakeholders on the importance of hedge accounting treatment; we strongly recommend further analysis of this issue.

The problems described above raise significant concerns about FTX's compliance with several statutory core principles that apply to FTX as a DCM, namely, those set forth in Sections 5(d)(4), (9), (11) , (12) and (16) of the CEA. FTX should address how it will comply with its statutory obligations as a DCM under the FTX proposal, if FTX has not already done so.[51]

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[49] See proposed FTX Rules 7.1.C.5 and 7.2.D.2.

[50] Financial Accounting Standards Board, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities* (No. 2017-12) (Aug. 2017), *available at* https://asc.fasb.org/imageRoot/38/112270638.pdf.

[51] We did not see anything in the materials publicly available on the CFTC website indicating that FTX has made any such filing as a DCM. When FTX's predecessor, LedgerX, applied for DCM designation, it stated in its application materials that it would satisfy the elements of Core Principle 11 (financial integrity of transactions) because ***all*** of the contracts it would list for trading would be cleared by LedgerX as a fully collateralized DCO. This statement prompts the question whether FTX must obtain an amendment to its DCM designation order as well to implement its proposal, as one of the conditions under the DCM order is that it will "comply with all representations and submissions" made in the DCM application record. *See* In the Matter of the Application of LedgerX LLC for Designation as a Contract Market, Order of Designation (June 24, 2019). At the least, the Commission should exercise its authority under CFTC Rule 38.5 to require FTX to demonstrate how it will satisfy the DCM Core Principles before taking any action to approve the FTX Request.

b. Partial Tear-Ups as a Front-Line Risk Management Tool

Under FTX's proposal, innocent, non-defaulting participants may be subject to liquidation if FTX employs the partial tear-up of positions as a front-line risk management tool to manage a default. In particular, FTX has the discretion to implement partial tear-up prior to any attempt at liquidation (auto-liquidation or otherwise) and/or the use of FTX's guaranty fund.[52] Thus, even a participant who deposited significant amounts of collateral in excess of their margin requirement to avoid auto-liquidation may still be subject to having their positions torn-up through no fault of their own. In other words, FTX has the power to implement a tear-up—similar to recent events in the nickel derivatives markets—in business-as-usual market conditions prior to the implementation of any risk management tools or utilization of any loss-absorbing resources, including those of FTX. This also inherently creates a conflict of interest for FTX, as it could elect to use partial tear-ups in order to avoid losses to its entirely self-funded guaranty fund.

c. Conflicts of Interests Need to be Disclosed and Explained

FTX heralds its use of backstop liquidity providers as a prudent liquidity risk management tool that can be utilized where auto-liquidation fails. There is an overall lack of information about the use of these providers, including whether these relationships are committed, their ability to effectuate liquidation where market-based liquidations have failed, and the price at which positions will be transferred to them. Setting this aside, the FTX Request does not identify these potential backstop liquidity providers. We can only speculate on who they are and their relationship to FTX and with each other, but it is worth noting that Alameda Research, which has common ownership with FTX and was originally founded to exploit cross-border crypto arbitrage opportunities, plays a significant role in managing liquidations and providing liquidity in offshore and cash crypto markets. It is important for market stakeholders and the CFTC to investigate these unknowns further in light of the clear conflicts of interest of such a structure.

## III. Cross-Border Implications of the FTX Request

Permitting the FTX Request to move forward in its current form could undermine the CFTC's position as a leader in derivatives regulation. The CFTC has long-been at the forefront of promoting best practices in risk management, including through its role in global standard-setting organizations[53] and the adoption of risk management innovations that have been exported across the globe. Examples of risk management enhancements initially adopted by the CFTC that are now used in other jurisdictions include customer gross margining, strict customer funds segregation, and straight-through processing of customer trades. The CFTC's leadership has helped to ensure that U.S. DCOs can effectively offer their risk management services to participants on a global basis.

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[52] *See* FTX Rulebook at proposed FTX Rule 14.3.
[53] The CFTC is a member of IOSCO.

The CFTC's potential abdication of this leadership role in the supervision and regulation of U.S. DCOs will have real world consequences for U.S. and global derivatives markets. More specifically, ignoring risk management best practices via the approval of FTX's proposal could have negative cross-border implications with the EU and UK at a minimum. In particular, significant deviations from the CFTC's best practices in risk management, as adopted through CFTC Part 39 Regulations, could undermine the CFTC's equivalence agreement with the EU[54] and its ability to reach agreement with the UK, which is expected to heavily weight regulatory requirements and regulatory cooperation of other jurisdictions. Ultimately, this could inhibit the ability of U.S. DCOs to effectively offer their clearing services and related hedging capabilities to EU- and UK-based market participants (and their affiliates).

As background, an equivalence agreement with EU policy-makers was only reached after years of negotiations beginning in 2012 and requiring a detailed review of the regulatory standards of the CFTC and EU. The CFTC and European Commission were able to agree to a common approach for transatlantic CCPs that ultimately led to the European Commission's adoption of an equivalence decision with respect to CFTC requirements for U.S. DCOs in March 2016.[55] The basis of this equivalence decision was the strength of the CFTC's regulation and supervision of U.S. DCOs, as implemented through CFTC Part 39 Regulations. The adoption of this decision was followed by the recognition of a number of U.S. DCOs, including CME Clearing in June 2016.[56]

The relationship between the CFTC and EU policy-makers was tested again following the UK's vote to depart from the EU. This led to the proposal and ultimate adoption of EMIR 2.2, which overhauled the recognition process for non-EU CCPs and included a process to determine whether non-EU CCPs are systemically important to the EU.[57] Similar to the negotiations that concluded in 2016, the implementation of EMIR 2.2 and subsequent confirmation of non-U.S. DCOs recognition in the EU took multiple years and required close coordination between the CFTC and EU policy-makers. In fact, this work recently concluded with respect to CME Clearing when its recognition was affirmed in March 2022. Notably, the ongoing cross-border relationship between the CFTC and EU policy-makers was a focus of the Committee on Agriculture of the U.S. House of Representatives and members of the U.S. Senate.[58]

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[54] Commission Implementing Decision 2016/377 on the equivalence of the regulatory framework of the United States of America for central counterparties that are authorised and supervised by the Commodity Futures Trading Commission to the requirements of Regulation (EU) No 648/2012 of the European Parliament and of the Council (Mar. 2016).

[55] Commission Implementing Decision 2016/377 on the equivalence of the regulatory framework of the United States of America for central counterparties that are authorised and supervised by the Commodity Futures Trading Commission to the requirements of Regulation (EU) No 648/2012 of the European Parliament and of the Council (Mar. 2016).

[56] ESMA, *List of third-country central counterparties recognised to offer services and activities in the Union* (Mar. 2022), available at https://www.esma.europa.eu/sites/default/files/library/third-country_ccps_recognised_under_emir.pdf.

[57] Regulation (EU) 2019/2099 of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs (Oct. 2019).

[58] *See* Amendment to CFTC Reauthorization Act of 2019, H.R. 4895, 116th Cong. § 114 (2019); A Bill to Amend the Commodity Exchange Act to Require a Review of Current Exemptions Granted to Foreign Entities in Response to an Attempt by a Foreign Authority to Exercise Direct Supervisory Authority over a Domestic Derivatives Clearing Organization, S. 2933, 116th Cong. (2019).; Sen. John Boozman and Sen. Dick Durbin, *Boozman, Durbin Introduce Legislation to Bolster CFTC's Authority to Review Exemptions for Entities in Foreign Jurisdictions*

Unlike the EU, the process for U.S. DCOs to achieve their ongoing recognition in the UK has only just begun. In November 2021, the Bank of England proposed (i.e., the "BoE Proposal") a framework for the treatment of non-UK CCPs that places significant reliance on a jurisdiction's local regulatory requirements and the ongoing cooperation of the jurisdiction's regulatory authority with the Bank of England, including oversight and information sharing in regard to its local CCPs.[59] The BoE Proposal has already required significant cross-border engagement designed to avoid the negative consequences that would result if U.S. DCOs were not appropriately treated under the Bank of England's nascent regime. Progress from this engagement may already be at risk by virtue of the publication of the FTX Request, but if FTX's current proposal was approved, it could do serious damage to the relationship between the U.S. and UK going forward.

CME Group fears that the adoption of a risk management light regime for U.S. DCOs -- moreover one that puts retail participants at risk -- in response to the FTX Request would call into question the CFTC's regulatory and supervisory priorities. This could undermine the ongoing relationship between the U.S. and EU and reduce the likelihood of the recognition of U.S. DCOs in the UK.

## IV. Customer Protection Issues in the FTX Request

FTX's proposal eliminates customer protections for all of FTX's participants in margined and fully collateralized products. FTX's proposal discards these carefully crafted customer protections developed by the CFTC over decades without consideration of the rationale underpinning their design.[60]
Most notably, the FTX proposal would eliminate regulatory standards designed to protect customer funds. An FCM is subject to stringent customer funds segregation requirements under the CEA and CFTC regulations with respect to holding funds it receives from public customers to guarantee, secure or margin their cleared futures and other derivatives transactions. The predominantly retail market participants that FTX plans to solicit to engage in leveraged futures trading as direct clearing members are the very type of

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*Seeking to Regulate U.S. Clearinghouses* (Nov. 25, 2019), *available at* https://www.boozman.senate.gov/public/index.cfm/2019/11/boozman-durbin-introduce-legislation-to-bolster-cftc-s-authority-to-review-exemptions-for-entities-in-foreign-jurisdictions-seeking-to-regulate-u-s-clearinghouses; Rep. David Scott and Rep. Austin Scott, *Chairman Scott, Ranking Member Scott Statement Following Meeting with European Financial Regulatory Body* (Feb. 13, 2020), *available at* https://davidscott.house.gov/news/documentsingle.aspx?DocumentID=399344; Letter of Sen. Pat Roberts and Sen. Debbie Stabenow to CFTC Chrm. J. Christopher Giancarlo (Jan. 18, 2019), *available at* https://www.agriculture.senate.gov/imo/media/doc/01-08-18%20CFTC%20EUROPEAN%20CLEARING%20LETTER.pdf.

[59] Bank of England, Consultation Paper, *The Bank of England's approach to tiering incoming central counterparties under EMIR Article 25* (Nov. 2021), *available at* https://www.bankofengland.co.uk/-/media/boe/files/paper/2021/boes-approach-to-tiering-incoming-central-counterparties-under-emir-article-25-sop.pdf.

[60] Under FTX's proposal, fully collateralized participants (who lose these customer protections) would be inordinately penalized due to the legislative mandate requiring them to share losses on a pro rata basis with margined participants. To avoid this inappropriate penalization of fully collateralized participants, the Commission would have to amend CFTC Part 190 Regulations to ring-fence fully collateralized participants from that harm, which is assuming the Commission even has sufficient flexibility under the CEA and relevant Bankruptcy Code provisions to differentiate among types of clearing members within the same account class.

market participants the segregation requirements are intended to protect, and they have a very different profile from institutional market participants that decide for business and other reasons to self-clear their leveraged trades as direct clearing members. However, because retail participants would self-clear their leveraged transactions directly on FTX, the CEA's customer funds segregation regime would not apply. If the segregation requirements do not apply, FTX's retail clearing members will lose the following protections, among others:

- FTX would not be prohibited from using one futures clearing member's funds for any purpose other than to guarantee, margin or secure such person's transactions.
- FTX would not have to hold funds of futures clearing members as customer funds subject to the statutory trust created by CEA Section 4d(b). The custodians that FTX uses likewise would not hold those funds subject to statutory trust.
- FTX would not have to open accounts with custodians to hold futures clearing members' funds under account names identifying the accounts as holding property belonging to its customers, nor would FTX have to obtain acknowledgement letters from such custodians as would be required under CFTC Regulation 1.20.
- FTX would not have to use depositories that meet the requirements of CFTC Regulation 1.49 to hold clearing members' funds.
- FTX would not be required to bear sole responsibility for any loss in its investment of clearing members' funds, as it would under CFTC Regulation 1.29 if they were protected segregated funds of an FCM's customers.

Under FTX's proposal, the failure of FTX to provide these protections would not be disclosed to the customers; in fact, new entrants to the futures markets would have no knowledge that these protections exist and that these protections would normally be provided when trading on a futures exchange through the intermediation of FCMs.

Moreover, under FTX's proposal, fully collateralized participants (who also lose the CEA's customer protections) would be inordinately penalized due to the legislative mandate requiring them to share losses on a pro rata basis with margined participants. Since both types of participants are not customers of an FCM, but members of the DCO, both fully collateralized and leveraged participants will be treated as one "pool" of assets and mutualized in the event of FTX's insolvency. To avoid this inappropriate penalization of fully collateralized participants, the Commission would have to amend CFTC Part 190 Regulations to ring-fence fully collateralized participants from that harm.

## V. The FTX Request is Contrary to and Inconsistent with the CEA and its Regulations

The FTX Request blurs the existing distinctions between an FCM, a DCO, and a DCM and the clear set of rules and principles applicable to each registrant. If approved by the Commission, FTX will be allowed to engage in otherwise regulated FCM activities without the same oversight and supervision that applies to FCMs; not only is this counter to the foundational elements of the CEA, FTX's proposal, if approved, would create a regulatory gap which will, in fact, lower regulatory standards and protections provided to retail participants.

In effect, FTX's proposal would allow it to operate as a hybrid unregistered FCM that solicits customers for leveraged trading and as a registered DCM and DCO all within the same entity. The Commission should avoid re-characterizing such FCM activities as DCO activities to circumvent important customer protections and requirements that otherwise would apply and should disallow FTX from performing them as a DCM or DCO. The answer is <u>not</u> for the Commission to decide which FCM requirements it should impose on FTX as conditions in an amended DCO order. The logical answer as the CEA intended would be for FTX to register as an FCM; in the alternative, the Commission must require that retail customers be provided with a level of protection analogous to that currently provided by FCMs. That FTX is asking for such an exception illustrates the core flaw with the FTX Request.

a. <u>The FTX Proposal does not represent responsible innovation serving the public interest</u>

The Commission should not disregard fundamental elements of the CEA oversight framework to suit FTX's plans. It is incumbent upon FTX to operate within the CEA's established legal framework. This is even more so the case when FTX's plans in no way foster the public interests underlying the CEA's regulation of derivatives markets. CEA Section 3(b) does not promote innovation in financial markets for the sake of innovation alone; it promotes ***responsible*** innovation that ***serves the public interests described in Section 3(a)***, namely, innovation that would foster fair, liquid and financially secure markets that businesses rely upon for risk management and price discovery. As we explain in this letter and in response to the CFTC's questions, FTX's proposal, if allowed and implemented, will harm market integrity, erode customer protections, and inject risk and financial instability into the markets.

Moreover, FTX's purported innovations are neither innovative nor responsible. What, precisely, is innovative or responsible about shifting FCM activities into its DCM and DCO entity to circumvent FCM registration and regulation? This seems more evasive than innovative. In addition, some FCMs today employ auto-liquidation capabilities, subject to third-party oversight, in conjunction with other risk management protections such as counterparty credit due diligence and customer protections calling into question FTX's claims of innovation.

We recognize that FTX's non-U.S. affiliate, FTX Exchange, has not failed in the few short years offering spot and derivatives markets involving crypto-assets outside the U.S., but that is not proof of responsible innovation. It is important to keep in mind that those markets operate largely in jurisdictions where its activities are subject only to modest regulation or government oversight. We understand that certain market participants are attracted to trade on such unregulated markets and may feel the protections of trading through a regulated intermediary are outweighed by the effort associated with locating an intermediary and opening a regulated trading account.

The CEA reflects Congress's normative judgement that derivatives markets and market professionals should be regulated, as prescribed in the statute. It is not the Commission's place to supplant Congress's judgment on such a fundamental point. If Congress wants to fashion an alternative framework to test how applications of new technology could enhance financial markets free of regulatory costs that is a decision for Congress to make. Instead of expending efforts on FTX's flawed proposal, the Commission should evaluate what obstacles may exist that may impede fair and open access to the U.S. derivatives markets and whether any of the requirements imposed on FCMs could be streamlined to address those obstacles consistent with protecting customers and the markets.

b. The FTX Proposal would degrade existing regulatory standards

The CEA's core principles governing a DCO under the CEA – and those of a DCM as well – are no substitute for the myriad of requirements that apply to FCMs under the CEA framework. While DCOs and DCMs are held to rigorous, comprehensive standards, these standards are designed to work in conjunction with the panoply of requirements applicable to FCMs. The requirements imposed on DCOs under CEA Section 5b and the Part 39 Regulations govern clearing and settlement activities that bring a person within the CEA definition of a "derivatives clearing organization." Likewise, the requirements imposed on DCMs under CEA Section 5 and the Part 38 Regulations govern exchanges as providers of public, centralized competitive auction markets for futures and other contracts they list for trading and their longstanding role as market and industry self-regulators. The requirements that apply to FTX as a DCO and DCM do not address the FCM activities that FTX also wants to perform within the same entity, nor does the CEA framework even contemplate that a DCO or DCM would combine solicitation of customers and their funds to open accounts for leveraged trading with the market operations or clearing functions that they perform.[61] We do not see how the Commission can move forward with FTX's proposal, when there is little or no discussion in the FTX Request or related FTX materials on how to address the core areas that are part of the comprehensive regulation scheme governing FCM activities, including those designed to protect retail customers, including, among other things, the comprehensive schemes of customer segregation, risk disclosure, sales practice protections and risk management.

Moreover, the Commission needs to ensure that regulated FCM activities are performed in registered FCM entities separate from entities registered as DCMs and DCOs to avoid compromising its own enforcement authority and resources.[62] The CEA contains very different provisions authorizing the Commission to take enforcement action against FCMs and other customer-facing registrants compared to the Commission's enforcement authority over DCMs and DCOs as registered entities. CEA Section 6(c) gives the Commission broad authority which provides significant flexibility to take action more promptly for alleged violations of the CEA and CFTC regulations by an FCM and other CFTC-registered persons.[63] With respect to DCMs and DCOs, the CEA grants the Commission enforcement authority over DCMs

[61] Putting aside the fully-collateralized disintermediated DCMs that the Commission has allowed, DCMs – those that provide for market access through the intermediation of FCMs – promote the contracts they list for trading generally to prospective market participants. They do not engage one-on-one with prospective customers to solicit them to open trading accounts, assist them with the customer onboarding process, conduct "know-your-customers" reviews, or otherwise have ongoing day-to-day engagement with customers. Those functions are performed by the FCMs and are material components of the important checks and balances that FCMs provide.

[62] If FCM activities are pulled within the scope of FTX's DCO registration, that would also compromise the authority reserved to the states under CEA Section 6d to enforce compliance with the CEA, CFTC regulations or the terms of any Commission order, because contract markets and clearinghouse are excluded from that reservation of authority.

[63] Registered entities, though, are explicitly excluded from the Commission's enforcement authority under Section 6(c).

and DCOs as registered entities under Sections 6(b)[64] and 6b which provide for a more formal, prescribed disciplinary process. For example, to suspend or revoke a registered DCM or DCO license or to impose a civil penalty, the Commission must follow the Section 6(b) procedures, including the requirement to provide notice and a hearing on the record before the Commission and provide a substantial appeals process. Assuming the Commission could somehow impose requirements on FTX as a DCO modeled on those that apply to FCMs, the Commission would be limited to the procedures in Section 6(b) to take action against FTX if it were to violate any of those conditions and would lose its flexibility to act more nimbly under Section 6(c).

In addition, FTX's proposal would result in limiting the recourse available to retail customers if FTX were to engage in fraudulent or abusive business conduct practices with its customers or mishandle customers' funds. The National Futures Association's ("NFA") arbitration and mediation would be unavailable for resolving customer disputes because FTX would not be an FCM member of NFA, nor could customers file a complaint against FTX using NFA's customer complaint process, for the same reason. Furthermore, it is hard to fathom that a harmed customer would view any arbitration process that might be available under FTX rules as a fair and unbiased venue for resolving their disputes with FTX. If the misconduct were to violate CEA provisions or CFTC regulations governing FCMs, the customer would find it challenging to pursue a claim in reparations against FTX under CEA Section 14 and the Part 12 Regulations for such violations, for the simple reason that as an unregistered FCM, FTX could not be said to have violated FCM requirements that do not apply to it. This would leave costly litigation through the courts, assuming the customer could even craft an appropriate claim for breach of contract, private right of action under CEA Section 22, or on some other grounds.

c. The FTX Proposal would undermine existing principles of self-regulation

If the Commission allows FTX to combine its contemplated FCM activities within the same legal entity that operates exchange markets, it will undermine the CEA framework's reliance on self-regulation for overseeing such activities currently performed by DCMs and the NFA. The CEA has established a clear distinction between persons that solicit customers and customer funds to trade futures and the futures exchange markets on which the trading occurs. A person that solicits futures customers and holds their funds in connection with their futures trading must register as an FCM,[65] and should be legally distinct from a DCM and DCO.

Exchanges historically have assumed self-regulatory responsibilities over the conduct of their participants – including FCMs – to assure their compliance with exchange rules. The CEA recognizes that value of that role by prescribing self-regulatory organization ("SRO") responsibilities to DCMs.

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[64] Although Section 6(b) refers to contract markets and not DCOs, CEA Section 6b applies with respect to any registered entity, including a DCO, that is not enforcing its rules, and cross-references the procedures in Section 6(b).

[65] The CEA definition of "futures commission merchant" explicitly calls out the dual activities of (1) ***soliciting*** orders from customers (which the Commission has long recognized covers soliciting customers as well), and (ii) accepting money, securities or other property from the customers they solicit to margin, guarantee or secure their customers' trades.

Further solidifying the role and importance of self-regulation over industry professionals, Congress amended the CEA to authorize the establishment of registered futures associations to assure that FCMs that did not belong to an exchange were nonetheless covered by an SRO's oversight.[66] This led to the formation of NFA as an SRO for registered futures industry professionals which all registered FCMs are required to join.[67] As the Commission has stated, mandatory membership in NFA assures "that persons soliciting business on all contract markets are within the jurisdiction of [a registered futures association] and thus subject to the same comprehensive training standards and proficiency testing requirements."[68] Under this framework, firms engaged in activities covered by the FCM definition are on the "regulated" side of the line, subject to the self-regulatory oversight performed by the NFA and DCMs, as legally distinct and independent SROs on the other side of the divide.

This clear dichotomy between regulated industry professionals and exchanges and later NFA as self-regulators, is reflected in various CEA provisions[69] and Commission rules. Notably, this includes CFTC Regulation 1.52, which today sets forth the obligations of DCMs and NFA to adopt minimum financial requirements for FCMs and coordinate their financial surveillance of FCMs.[70]

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[66] *See* Section 17, added to the CEA by the Commodity Futures Trading Commission Act of 1974. The Commission approved NFA as a registered futures association in September 1981 and NFA became operational in 1982.

[67] CFTC Regulation 170.15. To avoid duplicative oversight of FCMs, the NFA and DCMs, through the Joint Audit Committee, designate for each FCM which SRO will act as the FCM's lead or designated SRO for purposes of conducting routine financial surveillance exams and business conduct exams including sales practice reviews. Currently, NFA is the DSRO for each FCM that is not a clearing member of a DCM, and CME is the DSRO for all other FCMs. In the past, multiple DCMs were assigned DSRO responsibilities.

[68] *Registered Futures Associations; Mandatory Membership*, 48 FR 26340 at 26306 (June 7, 1983).

[69] This is perhaps most explicitly reflected in Congress's decision to authorize the formation of a registered futures exchange under CEA Section 17 to serve as an umbrella SRO for industry professionals that are registered with the CFTC. As a more targeted example, CEA Section 6(f), added to the CEA in 1994 by the Telemarketing and Consumer Fraud and Abuse Prevention Act, required either the Commission or NFA to adopt rules prohibiting abusive and deceptive telemarking or other practices by FCMs, introducing brokers, commodity trading advisors, commodity pool operators and their associated persons unless the Commission determines that its rules under the CEA applicable to such persons protect futures customers against such abusive or deceptive practices or it is not necessary or appropriate to adopt such rules to protect futures market customers or that such rules would be inconsistent with maintaining fair and orderly markets.

[70] As the Commission stated when it adopted Regulation 1.52 in 1978 (before NFA was established):

> "A fundamental purpose of the Act is to protect the national public interest in transactions involving contracts for the future delivery of a commodity. Section 3 of the Act, 7 U.S.C. 5. For this purpose, the Act imposes certain requirements both on boards of trade which wish to provide a marketplace for trading commodity futures contracts and futures commission merchants who solicit and accept customer funds for trading. For example, sections 4 and 4h of the Act provide that futures trading may lawfully take place only through the facilities of boards of trade that the Commission has designated as contract markets. Under section 5(g) of the Act, designation may only be achieved if the board of trade demonstrates that trading in the commodity for which designation is sought will not be contrary to the public interest. Futures commission merchants are required to be registered with the Commission and to refrain from fraudulent conduct in executing customer orders. Sections 4b and 4d(1) of the Act.
>
> The Act specifically seeks to protect the public from financially irresponsible futures commission merchants who handle customer funds. Section 4d(2) requires that futures commission merchants segregate customer funds from the funds of the firm. And, to assure that futures commission merchants have adequate capital resources, section 4f(2) expressly empowers the Commission to prescribe minimum financial requirements for futures commission merchants as a condition to registration. That section further provides that the financial requirements imposed by the Commission will be considered met if the futures commission merchant is a member of a contract market and conforms to those financial standards and

The Commission should preserve the CEA's construct that FCM activities – particularly those contemplated by the FTX Request – must be performed in entities that can be examined by a different entity acting as SRO. It is no answer to say that FTX, in its capacity both as exempt FCM and SRO, should be entrusted to monitor its own activities encompassed within the CEA's FCM definition.[71] FTX cannot overcome the conflict of interest inherent in surveilling its own sales practices or other customer facing activities.

If the Commission were to permit FTX's proposal to go forward, the Commission would lose the efficiencies that NFA and the DCMs provide by serving as front line regulators monitoring FCM activities in the first instance. Does the Commission plan to expand its staffing resources to monitor FTX's compliance with any FCM-like conditions the Commission may impose, to assure that FTX is subject to the same level of oversight that applies to registered-FCMs? If others follow FTX's precedent, what further strains will that place on the Commission's limited resources to replicate the surveillance functions that the SROs perform?

## CONCLUSION AND NEXT STEPS

***Key Point: In conclusion, the FTX Request as proposed is deficient and should not be approved. The Commission should engage in a formal rulemaking to allow for a broader discussion of appropriate risk management and regulatory standards that would apply to a direct leveraged clearing model offered to retail participants.***

As we have noted throughout this letter, risk management is fundamental to U.S. centrally cleared derivatives markets and, while the CEA promotes innovation as a statutory goal, the Act does not promote any purported innovation which is found to increase risk unacceptably or would fail to protect

> related reporting requirements set by contract market rules that have been approved by the Commission as adequate to effectuate the purposes of section 4f(2). Under section 5a(9) of the Act, the contract market is required to enforce these rules. Thus, section 4f(2) explicitly contemplates that contract markets have a role to effectuate the public interest considerations to be served by assuring the financial responsibility of FCM's.
> * * * *
> As institutions operating under the aegis of federal law, contract markets have not only the responsibilities made explicit by the Act, but are required to comply with those which the Commission imposes as necessary to effectuate the purposes of the Act. Thus, § 1.52 will further the Act's express purposes of assuring that FCM's remain financially sound by requiring that contract markets monitor and enforce against their members exchange rules incorporating the Commission's financial requirements."

[71] We understand that FTX's current DCO and DCM registration orders permit FTX to engage in customer solicitation activities within the purview of FCM activities delineated in the CEA. Currently though, FTX must collect margin from the customers it solicits in amounts that fully collateralize their exposures on their cleared trades, which largely addresses the regulatory concerns underlying many of the requirements that FCMs must satisfy under the CEA and under CFTC, NFA and DCM rules. In contrast, if FTX is permitted to solicit customers and their funds for leveraged margined trading free of FCM regulation and the established framework for overseeing those activities, the ramifications are quite serious, as those are the very activities that give rise to the customer protection considerations underlying the FCM regulatory regime. Leveraged trading on DCMs is the norm; the FCM oversight regime is predicated on that very fact.

customers. The FTX Request neither promotes innovation nor is it in the public interest. FTX essentially proposes to implement a risk management light regime and it must not be allowed to go forward as any of the "innovations" would come at the expense of risk management best practices, market integrity, customer protection and ultimately, financial stability.

FTX would not apply significant risk management practices and resources crucial to maintaining the long history of success of U.S. centrally cleared derivatives markets, particularly during periods of stress. The potential reputational harm to the U.S. derivatives industry is tremendous and the Commission should not put that reputation in jeopardy all for the sake of unsupported claims of "innovation."

In addition to the substantive legal and operational problems with the FTX Request noted above, the Commission must take into account certain additional considerations. There are numerous examples cited where there is a lack of sufficient information provided by FTX for CME Group and other stakeholders, including the Commission, to fully evaluate the risk management and legal implications of the proposal. CME Group can only rely on the information in the FTX Request and other publicly available information on the FTX website, which is the basis of CME Group's comments contained in this letter. There are significant gaps in this information and thus, additional information is necessary to allow for a comprehensive evaluation of FTX's proposal. For example, there is a lack of sufficient information on FTX's plans regarding its regulatory capital, margin methodology, stress testing methodology, collateral acceptance and management (e.g., haircuts and investment practices), liquidity risk management (e.g., liquidity provider backstops), settlement procedures, and governance arrangements, including approach to conflicts of interest. Further, it is unclear whether FTX plans to commingle participant collateral across cash and derivatives markets, which would certainly be novel in light of the unregulated status of cash crypto markets today.

Rather than being distracted by false claims of innovation, we also encourage the Commission to consider what new or amended regulations could accommodate actual innovations in blockchain or cryptocurrencies in conjunction with other regulators and create a cohesive and clear regulatory framework for moving forward. Finally, as noted above, the Commission should consider feedback from FCMs as to whether any of the existing requirements imposed on FCMs could be streamlined without sacrificing customer protections and market integrity.

Moreover, the Commission cannot cure FTX's attempt to circumvent FCM requirements by grafting FCM-like conditions onto an Amended DCO Order to fill the regulatory gaps and fix the serious legal problems the FTX Request raises. The Commission must recognize that granting the FTX Request is the same as granting FTX an exemption from core elements of the CEA with respect to the regulation and oversight of FCMs. If the Commission believes that FTX should be allowed to operate as an unregistered FCM within the same entity operating the markets and clearing the leveraged trades for which customers are solicited, the Commission <u>must</u> make findings mandated under CEA Section 4(a) that any exemption accommodating this unprecedented combination of activities is in the public interest. Specifically, the Commission must determine that exempting FTX from FCM registration and regulation under the terms FTX proposes would "promote responsible economic or financial innovation and fair competition," encompass trading activity "solely between appropriate persons," and not have a material adverse effect on the ability of the Commission or SROs to discharge their regulatory or self-regulatory responsibilities, among other findings.  We do not see how the Commission could credibly make such findings; as a result, the FTX Request as proposed is deficient and should not be approved.

If the Commission nonetheless proceeds, it should first follow its rulemaking procedures to propose risk management standards as well as rules for a substitute FCM compliance regime that would apply to all DCOs and DCMs that may solicit customers for leveraged trading as unregistered FCMs.[72]  This would assure more fulsome public comment and debate than interested parties are afforded under this pending process.  Following the standard rulemaking process would provide the transparency necessary to evaluate whether the CFTC's actions are consistent with the *Executive Order on Ensuring Responsible Development of Digital Assets*[73] which confirms the importance of interagency cooperation on the development of regulations for digital assets while also reinforcing the general principle of "same business, same risks, same rules." In that process, the Commission should explain the source of its authority over DCMs and DCOs to impose on them requirements tailored for activities presumed by the CEA to be activities solely engaged in by FCMs.  More generally, it should also explain how such rules are reasonably necessary to "effectuate any of the provisions of or accomplish any of the purposes of" the CEA,[74] and conduct an appropriate cost-benefit analysis and follow other requirements under the CEA and the Administrative Procedures Act.

*    *    *    *

CME Group thanks the Commission for the opportunity to comment on this very important issue.  We would be happy to discuss any of these issues with the Commission.  If you have any comments or questions, please feel free to contact me at 312-930-3488 or via email at kathleen.cronin@cmegroup.com.

Very truly yours,

Kathleen M Cronin

Kathleen Cronin
Senior Managing Director, General Counsel
and Corporate Secretary

cc:  Chairman Rostin Behnam
Commissioner Kristin Johnson
Commissioner Summer Mersinger
Commissioner Caroline Pham
Commissioner Christy Goldsmith Romero
Clark Hutchison, Director, Division of Clearing and Risk
Vincent McGonagle, Director, Division of Market Oversight
Amanda Olear, Director, Market Participants Division

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[72] CME Group would strongly oppose the adoption of such rules, as fundamentally at odds with the CEA, for all of reasons described in this letter.
[73] Exec. Order No. 14067, 87 Fed. Reg. 14143 (Mar. 14, 2022).
[74] CEA Section 8a(5).

## Appendix A

**RESPONSES TO CFTC QUESTIONS**

**DCO Rules**

1) *The Commission's regulations require a DCO to hold enough financial resources to meet its obligations after a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions (Cover-1 standard). The Cover-1 standard was calibrated based on the assumption that the DCO will be intermediated and that the clearing member creating the largest exposure will represent a significant amount of the risk a DCO faces. In a non-intermediated model where retail participants are direct clearing members, the significance of a default by the single participant presenting the largest exposure will likely be much smaller.*

   a) *What standard, other than Cover-1, would be appropriate to meet the requirement in Core Principle 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?*

A Cover 1 standard is wholly insufficient and inappropriate for FTX's proposal (i.e., central clearing of leveraged derivatives products directly to retail participants). For additional explanation, please refer to Section I.c of the Overview of Specific Comments of this letter.

The requirements under CFTC Part 39 Regulations were designed for the intermediated market structure for U.S. centrally cleared derivatives markets—including the centrally traded DCM markets that are the primary target of FTX's proposal—as is demonstrated, in part, by the numerous references to and requirements related to "customers." With respect to the Cover 1 standard, under CFTC Regulation 39.11(1)(a), the Commission directly recognizes this in Question 1 when it states, it "was calibrated based on the assumption that the DCO will be intermediated and that the clearing member creating the largest exposure will represent a significant amount of the risk a DCO faces." Based on CME Clearing's analysis of Large Trader customers, it is clear that FTX's proposed Cover 3 standard (and by default a Cover 1 and 2 standard) is inappropriate and insufficient. To maintain coverage that is comparable to current DCOs, using CME Clearing's data for Large Trader customers as a benchmark, FTX's guaranty fund, at a minimum, must be sized to cover the default of its 27 largest participants. Notwithstanding this analysis, FTX must conduct a fulsome analysis that demonstrates the appropriateness of the size of its guaranty fund. This analysis must consider the unique risk characteristics of FTX's offering, as a key feature of current DCOs' practices is that a given DCO designs its practices considering the unique characteristics of its offering (e.g., products cleared) and not merely because of practices of other DCOs.

   b) *In addition to characteristics about the products and specific portfolios, what metrics or market characteristics (such as the distribution of participant exposures and the number and size of market makers) should be taken into consideration when determining whether Core Principle B has been adequately satisfied by the DCO's identified resources?*

FTX's proposal does not adequately satisfy the requirements of Core Principle B as it does not consider the unique characteristics of its offering. In addition to CME Group's comments above, please refer to Section I.c of the Overview of Specific Comments of this letter.

c) *The Cover-1 standard requires financial resources that will ensure adequate coverage in extreme, but plausible conditions. Are there scenarios or types of market events that could have an extreme effect on a non-intermediated market with near real-time settlement that would not have an extreme effect on intermediated markets?*

FTX's proposal does not include sufficient information on the scenarios that it will consider for sizing its financial resources. Based on the information provided, it does not appear that FTX is intending to use scenarios that adequately capture extreme but plausible market conditions, including any specific scenarios that are relevant to its proposal. In addition to CME Group's comments above, please refer to Section I.c of the Overview of Specific Comments of this letter.

d) *Are there unique position or risk limits that the Commission should require a DCO to impose on its participants in a non-intermediated model?*

As stated in our letter, the Commission should avoid re-characterizing such FCM activities as DCO activities to circumvent important protections and requirements that otherwise would apply and should disallow FTX from performing them as a DCM or DCO; however, at a minimum, FTX, in its capacity as a DCO or DCM, must comply with the position limits and risk management requirements of the Act and related regulations. In addition, given that FTX is not registering as an FCM, consideration should be given as to which of the position limit and risk management regulations applicable to FCMs should apply to FTX.[1] More broadly, there are likely additional position and risk limits the Commission should apply to FTX given the unique characteristics of its proposed offering, including its focus on retail participation.

For example, FTX, as a DCO, must comply with the obligations under CFTC Regulation 39.13(h)(1)(i) that require a DCO to impose risk limits on its clearing members. These risk limits are a key part of a DCO's risk management practices that are designed to ensure that a clearing member's risk-taking does not extend beyond what it can manage in light of its capital and risk tolerance. Notwithstanding our concerns with FTX's proposed auto-liquidation,[2] we do not believe the use of auto-liquidation exempts FTX from adopting risk limits for its participants, since a participant could still carry a position that is in excess of the participant's resources (i.e., capital), regardless of satisfying applicable minimum margin requirements.[3] CFTC Regulation 39.13(h)(1)(ii) affirms this obligation by allowing a clearing member to exceed the applied risk limit only if it posts additional margin in excess of the minimum margin the DCO "deems sufficient to appropriately eliminate excessive risk exposure at the clearing members."

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[1] As discussed further below, if the Commission is not going to require FTX to register as an FCM, the Commission should undertake a formal rulemaking and consider comments as to what risk, disclosure and capital requirements would be applicable to a DCO with a non-intermediated, leveraged, retail model.

[2] *See* Section II of the Overview of Specific Comments of this letter.

[3] *See* 76 FR 69334, at pg. 69379 (noting, the use of capital with respect to setting risk limits).

Generally, there is no information in the FTX Request on how FTX intends to comply with the obligations under CFTC Regulation 39.1(h)(1) and we question its ability to do so. In particular, since FTX does not intend to impose any capital requirements on or conduct any counterparty due diligence of its participants, it will have no information on the participants' capital positions that would presumably be used to adopt appliable risk limits.

2) *Are there tools commonly used after a default for intermediated markets (e.g., variation margin gains haircutting or partial tear up) that would not be applicable, or even counterproductive, in the case of a non-intermediated model? Are there tools that would remain applicable in a non-intermediated model, but need adjustments to ensure effectiveness? If so, what are these and what would be the necessary revisions?*

It is of the utmost importance in an intermediated and non-intermediated model that a DCO's tools for managing a default instill the necessary incentives for participants to manage their risk-taking, particularly in stressed markets. As described in Sections I.c of the Overview of Specific Comments of this letter, FTX's proposal with respect to its guaranty fund does not instill these incentives. Additionally, a cornerstone of a successful default management process is executing a process that is efficient, fair, and safe[4] and it is unclear how FTX's intention to significantly rely on backstop liquidity providers achieves this. This access to liquidity is opaque and does not appear to promote a competitive bidding process.

We also are concerned with FTX's proposal to use partial tear-ups as a front-line risk management tool, as described in Section II.b of the Overview of Specific Comments of this letter.

3) *FTX has proposed to size its financial resources to cover a default by up to the three clearing members that create the largest exposure for the DCO. FTX will first calculate its financial resources based on a Cover-1 standard. If the Cover-1 clearing member does not represent at least 10% of the initial margin on deposit, FTX will calculate its financial resources based on a Cover-2 standard. If the Cover-2 clearing members do not collectively account for 10% of the initial margin on deposit, then FTX will apply a Cover-3 standard to size its financial resources.*

    a) *Does FTX's proposal provide an adequate level of financial resources to protect the DCO and its participants in the event of a default?*

No, FTX's proposal does not provide it an adequate level of financial resources to protect it and its participants in the event of a default. Please refer to CME Group's response to Question 1 and Section I.c of the Overview of Specific Comments of this letter.

    b) *Does the likelihood of more frequent, but smaller, defaults under FTX's model decrease the effectiveness of a Cover-1 (or -2 or -3) standard?*

[4] *See* CFTC Regulation 39.16(a).

Yes, the likelihood of more frequent defaults under FTX's proposal significantly decreases the effectiveness of a Cover 3 standard (and Cover 1 and 2 standards). Please refer to CME Group's response to Question 1and Section I.c of the Overview of Specific Comments of this letter.

c) *FTX does not intend to mutualize the risk of loss following a default among all participants, and will fund a default fund with its own capital. Does the non-mutualized aspect of the proposed clearing model present any unique risks to the DCO?*

Yes, the non-mutualized aspect of FTX's proposal (i.e., entirely self-funding the guaranty fund) presents unique risks to FTX, particularly because it eliminates necessary risk management incentives for participants. Please refer to CME Group's response to Question 1and Section I.c of the Overview of Specific Comments of this letter.

4) *FTX's proposal limits its participants' financial and operational obligations to ensuring adequate initial margin is on deposit prior to entering an order. Does FTX's approach, when considered in light of its proposed methodology for liquidating participant portfolios, adequately protect the integrity of the DCO?*

No, FTX's proposal, particularly its auto-liquidation tool, does not adequately protect the integrity of FTX. Please refer to Sections I and II of the Overview of Specific Comments of this letter.

Additionally, CME Group emphasizes that FTX's proposal to implement no capital or other risk-based requirements[5] does not comply with DCO Core Principle C requiring a DCO to establish appropriate admission and continuing eligibility standards for participants, including sufficient financial resources and operational capacity to meet the obligations arising from participation. Furthermore, FTX's proposal does not comply with the following obligations under CFTC regulations:

- CFTC Regulation 39.12(a) that requires a DCO to have requirements for clearing members that are risk-based;
- CFTC Regulation 39.12(a)(2)(i)-(ii) that requires that a DCO's participation requirements include capital requirements that: (i) require members to have access to sufficient financial resources to meet obligations arising from participation in the DCO in extreme but plausible market conditions; and (ii) appropriately match capital to risk; and
- CFTC Regulation 39.12(a)(3) that requires that a DCO's participation requirements include operational requirements that require members to have adequate capacity to meet obligations arising from participation in the DCO (e.g., processing expected volumes and values of transactions, including at peak times and days).

[5] FTX Rulebook at FTX 3.2.A.9 (noting, the FTX Rulebook merely has a requirement that has not been amended since the FTX Request was submitted that participants "have a good reputation and business integrity and maintain adequate financial resources," but provides no further requirements for satisfying this provision. It is also unclear how FTX will verify that participants have adequate financial resources when they have no financial resource requirements.).

These requirements are critical to affirming that the risk-taking of a DCO's clearing members is in line with risk management capabilities. Notably, these requirements are distinct from the requirements the Commission has adopted with respect to a DCO's margin requirements for clearing members under CFTC Regulation 39.13(g).

Furthermore, additional information is needed on FTX's risk management practices to understand if the integrity of FTX, as a DCO, is adequately protected. Broadly, given the insufficient information provided in the FTX Request, we question if FTX is complying with the requirements under CFTC Part 39 Regulations relating to these practices. While this is not an exhaustive list, we have enumerated a number of areas where information is insufficient:

a. Margin & Stress Testing Methodologies

Additional information is needed on FTX's margin and stress testing methodologies. The information provided in the FTX Request merely outlines that: (i) FTX intends to apply a margin methodology determined by the Chief Risk Officer ("CRO") that at least uses a 1-day margin period of risk and applies a 25% weighting in the market risk portion of margin to stressed observations;[6] and (ii) FTX intends to meet up to a Cover 3 standard for its guaranty fund.[7] This information is not sufficient, lacks clarity, and is inconsistent with the information disclosed by current DCOs.[8]

Having robust margin and stress testing methodologies that consider the unique characteristics of a DCO's products and participants are of the utmost importance, since these methodologies are the basis under which the risk-taking of participants is collateralized.[9] Moreover, the collection of margin and mutualizable resources for managing defaults incentivizes clearing members to understand and actively manage their risk-taking and mitigates the likelihood of financial non-performance on open positions. Shortcomings in methodologies can under-evaluate risk, which skews incentives, enables participants to take on more risk than appropriate, and can result in larger realized losses than anticipated if participants were to default. The robustness of FTX's margin and stress testing methodologies is even more important given FTX's planned participant base and their likely higher probability of default, as described in Section I.c of the Overview of Specific Comments of this letter. This is exacerbated by the fact that FTX is planning to rely exclusively on these methodologies to manage risk, as it has no risk-based requirements or credit due diligence practices for its participants. For example, any shortcoming in FTX's margin methodology would not be mitigated by a participant's capital base, since there are no risk-based capital requirements.

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[6] FTX Rulebook at proposed FTX Rule 7.1.C.

[7] FTX Request, Letter from Julie L. Schoening, Ph.D, Chief Risk Officer, FTX US Derivatives, to Clark Hutchison, Dir., Div. of Clearing & Risk, at pg. 2 (Feb. 8, 2022) (Financial Resource Requirements under Core Principle B and CFTC Regulation 39.11(a)(1) in the Absence of Clearing Futures Commission Merchants ("FCMs")), *available at* https://www.cftc.gov/media/7006/ledgerx_dba_ftx_ltr_fin_resource_req2-8-22/download.

[8] *See* CME Group, *CME Clearing: Principles for Financial Market Infrastructure Disclosure* [hereafter "CME Clearing PFMI Disclosure"], at Principles 4 and 6 (Nov. 2021), *available at* https://www.cmegroup.com/clearing/risk-management/files/cme-clearing-principles-for-financial-market-infrastructures-disclosure.pdf.

[9] *See* CFTC Regulations 39.11(a)(1) and (c)(1) and 39.13(g)(2) and (4) (noting, CFTC Regulation 39.36(a) establishes additional requirements with respect a systemically important and electing subpart C DCOs).

Furthermore, as discussed further in Section I.a.i of the Overview of Specific Comments of this letter, since FTX does not intend to impose capital requirements on participants, it is unclear how it would comply with the requirements under CFTC Regulation 39.12(a)(2), unless it calculated margin levels to cover "extreme but plausible market conditions." As such, FTX must not only have a sufficiently robust margin methodology that considers the risks characteristics of its proposal, but it would be expected that such methodology would be calibrated to cover extreme but plausible market conditions (i.e., stress shocks that would typically be captured in current DCOs' stress testing methodologies for sizing their mutualizable financial resources for managing defaults). Regarding this, please refer to Section I.a.i of the Overview of Specific Comments of this letter.

Please also refer to Section I.c of the Overview of Specific Comments of this letter regarding the size of FTX's proposed financial resources to address participant defaults, particularly the need to capture extreme but plausible market conditions.

b. Collateral Risk Management

Additional information is needed on FTX's collateral risk management practices, particularly the specific collateral types that FTX intends to accept as initial margin and how it will manage such collateral, including its investment practices. Proposed FTX Rules 7.1.G, 7.2, and 7.4, in part, only outline the legal considerations for accepting collateral, authority to invest it, and impose concentration limits, but this information is not sufficient, lacks clarity, and is inconsistent with the information disclosed by current DCOs.[10]

Having appropriate collateral acceptance and related risk management practices are of the utmost importance, particularly with respect to margin, since a DCO is reliant on using this collateral to address clearing members' exposures should they default.[11] This is even more important given FTX's planned participant base and their likely higher probability of default, as described in Section I.c of the Overview of Specific Comments of this letter. Based on the current practices of FTX and FTX's affiliate, we understand that a diverse set of collateral is accepted, including cryptocurrency and stocks.[12] It is unclear if each

[10] *See* CME Clearing PFMI Disclosure at Principle 5.
[11] *See* CFTC Regulations 39.11(e)(4), 39.13(g)(10)-(13), and 39.15(a) and (c).
[12] FTX.US, *Margin Trading*, https://help.ftx.us/hc/en-us/articles/360046850054-Margin-Trading (last visited Apr. 18, 2022) (noting, FTX.US states, "[a]ll margin is posted in 'USD' in your wallet. USD can be funded by depositing either USDC, TUSD, USDP, BUSD, or HUSD. By default all positions use the same collateral pool, and all USD, non-USD fiat, BTC, USDT, ETH, and many other tokens in your wallet count as collateral. Each subaccount has one central collateral wallet and uses cross margining for the account. Each subaccount has separate margin and collateral from other subaccounts."); FTX Exchange, *Margin/Collateral*, https://help.ftx.com/hc/en-us/articles/360027946371-Margin-Collateral (last visited Apr. 14, 2022) (noting, FTX states, "[a]ll margin is posted in 'USD' in your wallet. USD can be funded by depositing either USDC, TUSD, USDP, BUSD, or HUSD. By default all positions use the same collateral pool, and all USD, non-USD fiat, BTC, USDT, ETH, and many other tokens in your wallet count as collateral. Each subaccount has one central collateral wallet and uses cross margining for the account. Each subaccount has separate margin and collateral from other subaccounts...FTX will trade your non-USD collateral into USD if your USD balance is negative and any of the following hold:

- You are close to liquidation: your account's margin fraction is less than (20bps + maintenance margin fraction requirement)
- Your negative USD balance is large: over $30,000 in magnitude
- Your negative USD balance is large when compared to overall collateral: its magnitude is over 4 times larger

collateral type has minimal credit, market, and liquidity risks, which risks must be independently verified. Notwithstanding this and notably, one acceptable collateral type for FTX's affiliate is FTT, which is the token of an affiliate of FTX.[13] If it were accepted at FTX, as a DCO, it would be a conflict of interest and present significant wrong-way risk, as it is a source of value for FTX's affiliate and FTX's affiliate is responsible for taking actions to manage its value, including through repurchasing and burning the token.[14] CME Clearing does not accept as collateral CME Group stocks nor does it allow its Clearing Members to post collateral that has been issued by themselves or any of their affiliates.

In addition to the lack of transparency on FTX's intended collateral acceptance practices, there is little to no information on its approach to haircuts, if any, and concentration limits. Based on our review of the practices of FTX and its affiliate, the haircuts applied do not appear to account for stressed market conditions, which could easily be the prevailing market condition where a clearing member defaults and collateral needs to be liquidated.[15] For example, CME Clearing conducted the following value-at-risk ("VaR") analysis to the haircuts applied by FTX, which demonstrate the inappropriateness of their haircuts compared to the VaR:

| Collateral Type* | FTX Haircut[16] | 1-day VaR w/a 4-year lookback[17] | 2-day VaR w/a 4-year lookback[18] |
|---|---|---|---|
| BTC | 2.5% | 14% - 15% | 18% - 20% |
| ETH | 5% | 18% - 26% | 25% - 29% |
| XRP | 5% | 20% - 32% | 27% - 41% |
| Litecoin | 5% | 18% - 32% | 24% - 36% |

** Note, FTX and FTX's affiliate apply a weighting factor to collateral that they accept that increases haircuts as the amount of a given collateral type posted increases. Additionally, FTX's affiliate applies haircuts that vary based on purpose (i.e., to determine collateral for the purposes of liquidations and for the purpose of opening new positions).*[19]

c. Investment Practices

Additional information is needed on FTX's investment practices. Proposed FTX Rule 7.1.G.5 merely states that FTX may invest participants' collateral in accordance with FTX's investment policies and applicable law, but more troublingly states that FTX may use participants' collateral (regardless of whether or not they

than your net account collateral").

[13] FTX Exchange, *Non-USD Collateral*, https://help.ftx.com/hc/en-us/articles/360031149632-Non-USD-Collateral (last visited Apr. 14, 2022).

[14] FTX, *FTT*, https://ftx.com/FTT (last visited May 4, 2022).

[15] *See* CFTC Regulation 39.12(g)(12).

[16] FTX.US, *Margin Trading*, https://help.ftx.us/hc/en-us/articles/360046850054-Margin-Trading (last visited Apr. 19, 2022).

[17] Note, CME Clearing calculated these amounts using Bloomberg data.

[18] *Id*.

[19] FTX Exchange, *Non-USD Collateral*, https://help.ftx.com/hc/en-us/articles/360031149632-Non-USD-Collateral (last visited Apr. 14, 2022).

are in default) to meet the temporary liquidity needs of FTX. This information is not sufficient, lacks clarity, and is inconsistent with the information disclosed by current DCOs.[20]

Having appropriate investment practices are of the utmost importance, particularly with respect to margin, since this collateral needs to be readily available and in a sufficiently liquid form such that it can be used in a timely manner in the event a clearing member defaults.[21] Not only do we question how the ability of FTX to use initial margin collateral to meet its temporary liquidity needs would provide FTX timely access to this collateral, but this is clear misuse of collateral, as the purpose of initial margin collateral is to cover participants' potential future exposures and not a pool of resources that can be used to meet any liquidity needs of a DCO. Notwithstanding this, this use of margin collateral also does not appear to sufficiently protect or ensure the safety of these funds. Any misuse of collateral is even more problematic for FTX given its planned participant base and their likely higher probability of default, as described in Section I.c of the Overview of Specific Comments of this letter.

d. Liquidity Risk Management

Additional information is needed on FTX's liquidity risk management practices, particularly how it intends to maintain sufficient liquid resources to meet its same-day obligations when due, manage the risks to its liquidity providers, and who will act as providers. Chapter 4 of the FTX Rulebook, in part, establishes minimum requirements for liquidity providers, but this information is not sufficient, lacks clarity, and is inconsistent with the information disclosed by current DCOs.[22]

Robust liquidity risk management practices are of the utmost importance, since they support a DCO's core responsibility to meet obligations to non-defaulting clearing members in the event a clearing member defaults.[23] Shortcomings could result in a DCO default if it has insufficient liquidity resources to meet its obligations. Notwithstanding our concerns with FTX's proposed auto-liquidation tool,[24] robust liquidity risk management practices are even more important given FTX's reliance on this tool. Additionally, the accentuated role of liquidity providers in managing a participant default must be fully explained and managed by FTX, particularly given its planned participant base and their likely higher probability of default, as described in Section I.c of the Overview of Specific Comments of this letter. If a liquidity provider were to fail to liquidate a defaulter's portfolio, risk to FTX could increase significantly due to unsatisfied credit losses, which would likely prolong the period of time during which FTX does not have a matched book, a core feature of a DCO's operations.

Furthermore, a liquidity provider's inability to liquidate a defaulter's portfolio could expose FTX's non-defaulting participants to losses via the tear-up of positions, our concerns with this are addressed in Section II.c of the Overview of Specific Comments of this letter. Given the ability to penalize non-defaulting

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[20] *See* CME Clearing PFMI Disclosure at Principle 16.
[21] See CFTC Regulation 39.15(e) (noting, CFTC Regulation 39.36(f) establishes additional requirements with respect a systemically important and electing subpart C DCOs).
[22] *See* CME Clearing PFMI Disclosure at Principle 7.
[23] *See* CFTC Regulation 39.11(e)(1) (noting, CFTC Regulations 39.33(c)-(d) and 39.36(c) establishes additional requirements with respect a systemically important and electing subpart C DCOs).
[24] *See* Section II of the Overview of Specific Comments of this letter.

participants in good standing, FTX must consider and address the impact of the failure of a liquidity provider on its default management practices and non-defaulting participants.

e. Settlement Procedures

Additional information is needed on FTX's settlement procedures, particularly the frequency at which it will execute settlement cycles and how it will execute such cycles (e.g., in a 24/7 market and with a "net loss…due and payable or immediately in U.S. dollars on deposit with" FTX).[25] Proposed FTX Rule 7.1.F, in part, outlines that FTX intends to conduct intraday profit and loss settlements at a frequency determined by the CRO, but this information is not sufficient, lacks clarity, and is inconsistent with the information disclosed by current DCOs.[26]

Well-defined settlement procedures for a DCO are of the utmost importance since they set-out the obligations that clearing members must meet to cover their risk-taking.[27] Moreover, the settlement of a clearing member's profits and losses incentivizes them to understand and actively manage their risks and limits the accumulation of losses by removing debt from the system. Vaguely defined settlement procedures can result in a situation where clearing members are unclear on what their obligations are or how to meet them and could inadvertently result in them defaulting.

f. Governance Arrangements

Additional information is needed on FTX's governance arrangements, particularly how such arrangements will consider financial stability. Chapter 2 of the FTX Rulebook establishes requirements for FTX's governance, but this information is not sufficient, lacks clarity and is inconsistent with the information disclosed by current DCOs.[28]

Throughout history DCOs have supported financial stability by well-defined governance arrangements that clearly affirm that financial stability considerations are at the forefront a DCO's practices and decision-making.[29] FTX's reliance on an auto-liquidation algorithm to manage risk can itself be detrimental to financial stability, as described in CME Group's response to Question 12 and Section II of the Overview of Specific Comments of this letter. Furthermore, and perhaps more importantly, the conflicting interests between FTX and its "liquidity providing" affiliate, Alameda Research, should cause a fulsome review of FTX's governance arrangements.

5) *Regulation 39.12(a) also requires a DCO to establish minimum capital requirements for clearing members. Given that FTX participants would have no obligations to FTX other than posting initial margin, does this requirement serve a risk management purpose in this context?*

[25] FTX Rulebook at proposed FTX Rule 7.1.F.3.
[26] *See* CME Clearing PFMI Disclosure at Principles 6 and 8.
[27] *See* CFTC Regulation 39.14.
[28] *See* CME Clearing PFMI Disclosure at Principle 2.
[29] *See* CFTC Regulation 39.24(a).

Yes, even though FTX's proposal does not incorporate this requirement, capital requirements for clearing members serve a risk management purpose, Please refer to CME Group's response to Question 4 and Section I.a of the Overview of Specific Comments of this letter.

**FCM Rules**

6) *What potential market structure issues may arise from the establishment of a non-intermediated model for retail participants in which transactions are not fully collateralized? What potential impacts, if any, would these issues have on FCMs or on existing markets with FCM intermediation?*

Implementing a risk management-light regime will have contagion effects on other areas of the financial markets. Historically, the U.S. futures market has provided stability where other areas of the financial markets (uncleared markets during the 2008-2009 time period for example) have suffered losses that expanded to other areas of the financial system. Despite the stability demonstrated by U.S. futures markets during past stress events, events that were external to the U.S. futures markets still had knock-on effects on its market participants. Based on past experience, it is difficult to see how this market structure, as currently proposed, could operate in a vacuum without impacting the stability of other areas of the financial system. Further, as expanded upon in our letter, we do not believe that the CFTC has the legal authority to limit the market structure proposed by FTX to a single clearing house or single asset class.

7) *Due to the absence of FCMs, the participants' collateral in a non-intermediated model is not required to be segregated under section 4d of the CEA.8 The orders of registration for DCOs offering a non-intermediated model require the DCO to hold funds of its participants as member property, as that term is defined by the Bankruptcy Code. Is this protection sufficient for participants' funds if a DCO begins to offer margined products?*

The short answer is no. The changes that FTX proposes to its current operations as a DCO raise unprecedented complications and significant issues for a DCO liquidation that the recently amended CFTC Part 190 Regulations (or "Part 190") do not contemplate or adequately address,[30] and implicate the policies reflected in the Bankruptcy Code (or "Code") and Part 190. The risk that FTX could fail and be subject to a commodity broker liquidation proceeding cannot be ignored, in particular given FTX's disregard of important risk management practices and resources that have allowed traditional DCOs to successfully manage periods of stress, as described in Section I of the Overview of Specific Comments of this letter. The fact that FTX will promote its proposed direct leveraged clearing services to retail participants further underscores the need to address the issues raised below.

Subchapter IV of chapter 7 of the Code contains special provisions governing the bankruptcy trustee's liquidation of a "commodity broker," a term that covers both FCMs and DCOs. Part 190 provides the details around how the trustee must liquidate a commodity broker, the scope of what is included in or excluded from "customer property," and, for purposes of a DCO commodity broker liquidation, the sub-

[30] The Commission first adopted the Part 190 Regulations in 1983 pursuant to its authority under CEA Section 20 and general rulemaking authority under CEA Section 8a(5). The Commission approved comprehensive amendments to update and improve the transparency of the rules in December 2020 following an extensive, multi-year effort.

classification of customer property into "member property" and "customer property other than member property."

Part 190 is designed around core concepts, certain of which are embedded in the Code sections within subchapter IV. These core concepts include organizing customers by public customer and non-public customer classes; organizing customer property and customers by separate account classes for futures, foreign futures, cleared swaps and delivery accounts; and *pro rata* distribution of customer property by account class with priority given to public customers ahead of a commodity broker's non-public customers in the distribution of customer property. The Part 190 distinctions between public customers and non-public customers of an FCM, and the way the rules reflect that distinction at the DCO level, align with the Commission's differentiation between FCM public customers that are afforded segregation protections for their funds versus affiliates and other "insider" customers of an FCM that are not.

The rules in Part 190 subpart B governing an FCM liquidation reflect the mandate in Code Section 766(h)—**which applies to any commodity broker liquidation**—that claims of a commodity broker's public customers have absolute priority over those of its non-public customers, i.e., those for which the commodity broker carries accounts classified as proprietary accounts of the commodity broker under the CFTC's definition of the term. As reaffirmed in the subpart B rules, this means that claims of a failed FCM's public customers must be satisfied in full before any customer property may be distributed to pay claims of its affiliates or others whose accounts carried by the FCM are considered proprietary.[31]

The Part 190 subpart C rules governing a DCO commodity broker liquidation focus on the distribution of "customer property other than member property" and "member property" to satisfy claims made by clearing members acting in different capacities. By design, the subpart C rules favor the interests of public customers of FCM clearing members, in that they preferentially assign customer property to "customer property other than member property" rather than to "member property," to the extent of any shortfall in the funded balances available to satisfy FCM clearing members' claims on behalf of their public customers. Public customers of FCMs receive the protections of the CEA segregation regime. Those protections carry forward to how their funds are held by the DCO. The segregation protections are intended to ensure that the funds that public customers entrust to commodity brokers are protected against the risks of the commodity broker's business and are available to distribute to them in a commodity broker insolvency. The Commission's policy determination that an FCM's public customers should receive preferential treatment in a DCO liquidation reflects the special protections afforded to them under the segregation regime.

FTX's proposal raises troubling implications for the protection of FTX's participants in the event of an FTX commodity broker liquidation.[32] First, it is not as clear cut as the Commission seems to assume that FTX

[31] The Part 190 Regulations also set out the core concept that the trustee should use "best efforts" in liquidating an FCM to transfer customer positions and account equity to another (solvent) FCM in lieu of liquidating such property.

[32] It could also raise complications and issues if the Secretary of the Treasury were to exercise its authority to appoint the Federal Deposit Insurance Corporation ("FDIC") as receiver to handle an FTX insolvency as an orderly liquidation proceeding under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, as an alternative to a commodity broker liquidation. At the very least, it would seem that absent amendments to Part 190 to address the issues identified above, the Part 190 Regulations would fall short of the Commission's goal that the rules serve as guidance to the FDIC as to distribution of customer property in such a proceeding. *See* CFTC

would be liquidated under the Part 190 subpart C provisions that apply to a DCO. FTX will operate both as a DCO and by actively soliciting customers to open leveraged trading accounts as an unregistered FCM,[33] which creates legal uncertainty as to whether it should be liquidated as a DCO or an FCM. That uncertainty could result in costly and protracted litigation that could impede a speedy administration of an FTX bankruptcy proceeding.

Second, FTX will carry house accounts for affiliates that are proprietary accounts of FTX under the definition in CFTC Regulation 1.3. Although Part 190 expressly provides for the subordination of the claims of an FCM's proprietary account (non-public) customers, they do not contemplate the wrinkle that a DCO would carry house accounts for affiliates whose accounts are proprietary accounts of the DCO.[34] Thus, the rules do not expressly provide that member property must first be distributed to pay claims of participants whose house accounts at a DCO are non-proprietary accounts (such as the retail leveraged participants/members) before any member property may be used to pay claims of proprietary house account holders. FTX, though, will carry house accounts for affiliates that are proprietary house accounts of FTX under the definition in CFTC Regulation 1.3[35] namely house accounts for LedgerPrime and any commodity pools it manages (and potentially other FTX affiliates such as Alameda Research[36]) that clear their trades as participants. Although Section 766(h) of the Bankruptcy Code would mandate the subordination of FTX's affiliates' claims based on their house accounts in any event, Part 190's silence on the matter creates the risk that Section 766(h) may not be followed or that FTX's affiliates may challenge that their claims should not be subordinated under Section 766(h).

Third, because FTX plans to continue clearing trades executed on Kalshi, it will be performing fully collateralized non-intermediated clearing for transactions in the swap event contracts that Kalshi lists along with non-intermediated leveraged clearing of any swaps that FTX may list for trading on its DCM—such as options on digital assets—or swaps executed by non-retail participants (ECPs) on FTX's SEF or bilaterally. By virtue of *pro rata* distribution, absent amendments to Part 190 to ring-fence fully collateralized participants, such participants will subsidize distributions to leveraged participants if there is a shortfall of customer property to distribute in the cleared swaps account class, even though they pose no default risk to the DCO in contrast to the leveraged participants.[37]

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Regulation 190.00(d)(iii).

[33] A traditional DCO does not actively solicit clearing members to self-clear their trades, and such clearing members have a very different profile than the participants that FTX will actively solicit to open leveraged trading accounts who very much fit the profile of FCM public customers. Self-clearing member firms of traditional DCOs have significant operational and financial resources and are experienced market participants, which have decided to become self-clearing for business reasons after carefully evaluating the choice between self-clearing and accessing clearing through an FCM.

[34] This is understandable because one would not expect a traditional DCO to carry house accounts for affiliates, and to our knowledge no traditional DCO does.

[35] The definition in CFTC Regulation 1.3 applies to the account carried on the books and records of any individual, partnership, corporation or other legal entity

[36] See FTX Rulebook at FTX Rule 2.5 which permits LedgerPrime and its commodity pools to make markets in FTX contracts, which means they would be clearing participants of FTX. FTX may well decide to expand the scope of affiliates covered by FTX Rule 2.5

[37] This same issue would exist for the futures account class if FTX were to provide leveraged and fully collateralized clearing with respect to futures and options on futures.

Finally, FTX's stated intention of permitting market participants to access FTX through an FCM[38] highlights how FTX's proposal is misaligned with the CEA customer funds protection regime and related Code and Part 190. As explained above, the overall Code and Part 190 framework favors FCM public customers over non-public customers in the event of an FCM liquidation, and also favors an FCM's public customers over participants in respect of their house accounts in the event of a DCO liquidation. Part 190 referentially assigns customer property to "customer property other than member property" rather than to "member property," meaning that any aggregate excess property in participants' house accounts (by account class) is used first to cover a shortfall in any segregated pool available to pay claims on behalf of FCMs' public customers, ahead of applying any such excess to cover a shortfall of member property in another account class.[39]

8) *Commission regulations require FCMs to ensure that customers receive certain protections when they participate in the futures markets. Should participants in a non-intermediated model be afforded the same or similar customer protections? Which customer protections should the DCO be required to provide to participants?*

Notably, the Commission has previously expressed that the protection of customers is a fundamental component of its disclosure and financial responsibility framework. As such, we suggest that the question is better stated by asking what is the reason for not affording the same protections to participants under FTX's proposal that offers a non-intermediated model for leveraged products? That question, of course, leads to the question of how best to assure that FTX's intended participants receive those customer protections.

We do not believe it is appropriate for FTX to offer a leveraged product to individual customers where it will engage in FCM activities of soliciting customers to open accounts to trade leveraged products without FCM registration. That said, FCM activities should be performed in entities that are separate and distinct from a DCO or DCM to ensure that those activities are subject to proper oversight by an independent SRO, as the CEA framework establishes.

The answer is not for the Commission to decide which FCM requirements it should impose on FTX as conditions in an amended DCO order. If the Commission goes down that path, as the Commission's questions suggest, that would be the same as granting FTX an exemption from FCM registration and any FCM requirements not imposed through some other means. If the Commission believes that FTX should be allowed to operate as an unregistered FCM within the same entity operating the markets and clearing the leveraged trades for which customers are solicited, it <u>must</u> make findings mandated under CEA Section 4(a) that any exemption accommodating this unprecedented combination of activities is in the public

[38] *See* FTX.US, *Understanding FTX's Guaranty Fund Sizing,* https://www.ftxpolicy.com/ftx-guaranty-fund (last visited May 9, 2022).

[39] *Id*. Beyond Part 190 and the Code, there are additional implication to FTX's stated intention to permit participants to access the platform through an FCM. FTX notes that, "…For users that connect through an FCM to FUSD, there are a variety of methods the FCM could deploy to "shield" an investor from auto-liquidation of her position, including the fee-service of re-collateralizing to the investor's account as necessary to prevent liquidation of the position." The Commission should obtain information from FTX regarding its and the FCM's compliance with CFTC Regulation 1.56 which prevents anyone from suggesting the FCM could guaranty against loss and the FCM's compliance with CFTC Regulation 1.30 which prohibits unsecured loans by the FCM for customer trading.

interest. We do not see how the Commission could find that exempting FTX from FCM registration and regulation would "promote responsible economic or financial innovation and fair competition," encompass trading activity "solely between appropriate persons," and would not have a material adverse effect on the ability of the Commission or SROs to discharge their regulatory or self-regulatory responsibilities, among other findings it would have to make.

Nonetheless, we respond to the specific questions to illustrate the magnitude of the undertaking to attempt to fill regulatory gaps by imposing conditions on FTX as an unregistered FCM. Though, it is difficult to answer the last query in this question and the following questions, with the limited information published in the FTX Request. However, as a general matter, the rules noted in the sub-sections below are a comprehensive set of customer protections developed over many years based on underlying regulatory obligations of an FCM, most recently as a result of the 2008 financial crisis. If an FCM must comply with customer protection, notice and disclosure requirements, no compelling reason has been presented as to why FTX should not also comply. As a DCO's regulatory obligations differ from those of an FCM in respect of its customers, we are unable to recommend with greater specificity which notice and disclosure requirement should apply to them in a non-intermediated leveraged offering in this letter.[40]

a) *Should a DCO offering a non-intermediated model be required to provide participants with the standard customer risk disclosures statements contained in Regulation 1.55? If so, should the standard customer risk disclosure statement be modified in light of the trading and clearing structure?*

Yes. If customers are entitled to these disclosures in an intermediated model, there is no compelling reason not to require them for FTX's proposal to offer a non-intermediated retail model for leveraged products as risks remain. Further, the interaction of Part 190 and the Bankruptcy Code is illustrative and complicated for even the most seasoned finance professional. Additional clear and concise disclosure is recommended to inform participants that they will not be afforded any customer protection when dealing directly with a DCO in a non-intermediated clearing offering should the DCO become insolvent.

Moreover, given the inherent conflicts of interest that the DCO has when the same legal entity is acting simultaneously as the broker, market, collateral custodian and liquidity provider, the DCO should be required to disclose prominently its conflicts of interest.

b) *For FTX's proposal, are different modifications needed due to its process and rules regarding the liquidation of participant accounts? If so, how should the standard risk disclosure statement be revised?*

Yes, due to the risk involved in FTX's proposal, there should be significant disclosure of the various pitfalls the customer could encounter. For example, the FTX Rulebook simultaneously does all of the following and thus, the risk disclosure should at a minimum, be revised accordingly:

[40] For example, the FCM requirements to disclose the amount it holds as capital at least in the amount of 8% of customer risk margin, excess net capital and its residual interest on deposit have no comparable DCO requirements.

- Requires the customer to deposit and maintain initial and variation margin (proposed FTX Rule 7.1).
- Does not require the FTX to notify the customer if it changes initial margin requirements (proposed FTX Rule 7.1.C.3).
- Does not require FTX to notify the customer of minimum maintenance margin requirements other than a website posting (proposed FTX Rule 7.1.D.1).
- If the customer fails to maintain initial or maintenance margin FTX reserves the right to auto-liquidate the customer's account (proposed FTX Rules 7.1.C.5 and 7.1.D.2).
- Does not obligate the FTX to liquidate and the customer cannot rely on it to do so if the market is moving and customer's margin levels are dropping. Customer remains responsible for any deficiency (proposed FTX Rules 7.1.C.5 and 7.1.D.2).
- Permits FTX to allow a customer to deposit additional amounts to prevent liquidation, but only as a courtesy and does not state what the qualifications are for such courtesy being extended (proposed FTX Rule 7.1.E.1).
- Allows the FTX to use the customers assets (whether or not such customers are in default) for the FTX's liquidity needs (proposed FTX Rule 7.1.G.5).
- If FTX in its discretion chooses to not to liquidate, it may sell the customers position to a liquidity provider (including potentially companies owned or controlled by FTX or its executives) and the customer remains responsible for the losses and expenses (proposed FTX Rule 14.3).

Under our reading of FTX's rules, customers, at all times, must determine the sufficiency of their own collateral in meeting FTX's initial and maintenance margin requirements, without benefit of routine margin calls or knowing if they will be extended the courtesy of depositing additional funds to keep their positions open. On a troubling note, the FTX's proposed rules[41] providing that FTX could hold customers responsible for losses beyond their initial deposits of margin when they establish positions are contrary to FTX's public touting of how it will employ the auto-liquidation feature with its implicit promise to customers that they are only at risk for what they initially deposit. Beyond FTX's proposed rules, other materials also make it clear that FTX will revalue accounts once per second[42] and liquidations will occur automatically (e.g., every six seconds)[43] and at any point in time, 24-hours a day, 7-days a week, when the margin level is breached (i.e., price moves result in their account being under-margined), while providing customers no opportunity to cure their collateral shortfall.

In short, it would seem there are significant risks to be disclosed to customers and disclosed clearly to counter any misimpressions they may have based on FTX's promotional marketing.

[41] FTX Rulebook at proposed FTX Rules 7.1.C.5 and 7.1.D.2 (noting also, Section VI.P and Q of the LedgerX Participant Agreement).

[42] FTX Request, Letter from Brian G. Mulherin, Gen. Counsel, FTX US Derivatives, to Clark Hutchison, Dir., Div. of Clearing & Risk, at pg. 1 (Feb. 8, 2022) (Permissibility and Benefits of Direct Clearing Model under Commodity Exchange Act and CFTC Regulations), *available at* https://www.cftc.gov/media/7001/ledgerx_dba_ftx_ltr_direct_clearing_model2-8-22/download.

[43] FTX Request, Form DCO Exhibit G-Default Rules and Procedures, at pg. 3 (Feb. 2022), *available at* https://www.cftc.gov/media/6991/ledgerx_dba_ftx_formdco-exhibit_G_2-8-22/download.

c) *Should a DCO offering a non-intermediated market be required to make certain financial information publicly available on its website consistent with Regulation 1.55 so that current and prospective participants have information regarding the firm? If so, which information should be publicly available?*

It seems that given the inherent conflicts of interest presented in the FTX Request, disclosure should be provided. However, as noted above, it is difficult to say exactly what information the DCO should have to disclose consistent with CFTC Regulation 1.55, as it neither has a net capital requirement nor is it required to prepare a Statement of Segregation regarding customer segregated funds (and related CFTC Regulation 30.7 funds) comparable to an FCM.

d) *Should a DCO offering a non-intermediated model be required to provide participants with daily trade confirmations and monthly account statements in the form and manner specified in Regulation 1.33?*

Yes, the DCO should provide the customer some reporting of its holdings on a daily basis. As noted above, based on the FTX Rules, given that FTX does not intend to make margin calls to customers or notify them of changes in margin requirements beyond a website posting, it would seem that, at a minimum, daily summaries of the accounts should be provided in a format easily consumable by the customer.

e) *Should a DCO offering a non-intermediated model investment of participant funds be subject to the list of permitted investments under Regulation 1.25?*

Yes. Please refer to CME Group's response to Question 4. If FTX were required to register as an FCM, this limitation would apply. A DCO is held to a standard of care and permitted investments with respect to clearing member funds (which is what these direct participants would be) under CFTC Regulation 39.15.

f) *Should a DCO offering a non-intermediated model be subject to limitations on the use of participant funds in a manner consistent with the restrictions that Regulation 1.20 places on FCMs?*

Yes. Segregation of customer funds is at the heart of the CFTC's customer protection regime. FTX's proposal to disintermediate suggests that they believe that all the regulations the CFTC has put into place are latencies, and not the checks and balances that the CFTC intended to be in place to offer the highest level of protection to customers. FTX should be required to hold funds of its public customers separate and apart from the funds it holds from affiliates whose house accounts at FTX are proprietary accounts under the CFTC's definition, and should have to hold the public customer funds in accordance with the safeguards afforded to segregated funds under CFTC Regulation 1.20. These measures will help assure that funds are available to pay claims of FTX's public customers in the event of an FTX commodity broker liquidation and, moreover, that those claims are first paid in full before proprietary account customers of FTX are entitled to receive any payment on their claims out of customer property, as mandated by Code Section 766(h). The Commission should also amend Part 190, including the subpart C rules, to set out explicitly that claims of proprietary account customers of a DCO are subordinated to the claims of the DCO's public customers, to assure that Section 766(h) is followed.

g) *Should a DCO offering a non-intermediated model be subject to regulatory notice provisions in a manner similar to Regulation 1.12? If so, what notice provisions should apply to FTX?*

Yes, there should be some level of reporting for this activity but again, it is difficult to say which notices should apply when FTX is suggesting that it should not be subject to the regulatory and capital obligations of an FCM that require notice under CFTC Regulation 1.12.

h) *Should a DCO offering a non-intermediated model be subject to daily reporting of the holding of participant funds in a manner similar to Regulation 1.32?*

We believe in the FCM model and that, under FTX's proposal, where it is planning to deal with leveraged customers, it should be registered as an FCM and follow the rules that have existed for decades.

9) *Should a DCO offering a non-intermediated model be subject to the capital requirements applied to FCMs in addition to, or as an alternative to, DCO and DCM financial resources requirements?*
   a) *Would the Commission's risk-based capital requirement for FCMs in Regulation 1.17 be the most appropriate financial resources requirement for a DCO offering a non-intermediated model if it is approved to be a DCO that directly clears margined products for retail participants without an FCM guarantee?*
   b) *If a DCO offering a non-intermediated model is subject to a risk-based capital requirement based on the risk margin amount of its participants' accounts, should the percentage be higher than eight percent to reflect that the DCO will only hold margin for its listed products and not diverse positions across multiple exchanges?*
   c) *Regulation 1.17 requires FCMs to maintain a sufficient amount of unencumbered liquid assets (after application of haircuts) that are in the possession or control of the FCM to cover each dollar of the FCM's obligations. If this type of financial resources requirement is applied to a DCO offering a non-intermediated model, should that requirement also consider the composition of the DCO's capital?*
   d) *For FTX's proposal, if a risk margin amount threshold is applied to FTX's minimum financial resources requirement, should the percentage of risk margin required be set at a higher percentage than eight percent, given that FTX's participants would not be required to contribute financial resources to the DCO beyond their required initial or maintenance margin amounts?*

With respect to Questions 9a through 9d, please refer to Sections I.a of the Overview of Specific Comments of this letter, which outlines why FTX's participants must, at a minimum, meet risk-based capital requirements that are equivalent to those under CFTC Regulation 1.17 and that such requirements must be separate from and in addition to the financial resources requirements imposed on FTX, as a DCO and DCM. In addition, CME Group agrees with the Commission that if FTX is not going register as an FCM, the percentage of risk margin required should be set higher than 8%.

10) *FTX's current order of registration requires it to comply with anti-money laundering laws and regulations as if it were a covered "financial institution" under applicable law. Do FTX's proposed*

*changes present any additional risks that would require additional anti-money laundering requirements?*

We defer to others to respond.

11) *Are there any FCM requirements not already discussed that a DCO offering a non-intermediated model should be required to meet?*

As discussed in Section V of the Overview of Specific Comments of this letter, if the FTX Request is approved, FTX will be unprecedented in operating as a hybrid unregistered FCM for leveraged trading, a DCM, and a DCO all within the same entity. This creates a novel conflict of interest with respect to oversight of solicitation activities that the current CEA regime presupposes are performed by FCMs subject to the oversight of independent SROs. The Commission would need to consider, and likely propose new rules, as to how the FTX as a DCO and DCM would comply with the supervision, training, fitness screening/statutory disqualification, sales practices and ethics trading obligation normally attached to Associated Persons of FCMs. The Commission would also need to consider how to apply other FCM requirements imposed by CFTC and NFA rules to FTX, in areas such as the role, responsibilities and reporting lines of an FCM's chief compliance officer; customer onboarding and screening; customer account statements; promotional materials and use of social media; handling of discretionary accounts; use of automated risk management controls to prevent placement of erroneous orders or orders that exceed pre-set thresholds; and risk management programs covering the elements in CFTC Regulation 1.11.

**FTX Proposals**

12) *When a participant's margin on deposit falls below the maintenance margin level, FTX is proposing to have an automated system immediately liquidate the participant's portfolio to the extent necessary to come into compliance with margin requirements. FTX's system will check margin levels, and when necessary liquidate positions, on a 24 hours a day/7 days a week basis.*

We note at the outset that CEA Section 5(d)(11) imposes on a DCM, as a statutory core principle, the obligation to establish and enforce rules and procedures to protect customer funds and assure the financial integrity of transactions entered into on its markets, including clearance and settlement of transactions through a DCO.

The proposed changes to FTX's clearing arrangements will put customer funds at risk and will erode the financial integrity of transactions occurring on FTX's DCM markets. In having their leveraged trades cleared directly with the DCO, market participants are denied the substantial protections they and their funds would receive under the strict segregation requirements that the CEA and myriad CFTC regulations impose on FCMs with respect to holding funds of FCM customers.[44] We highlight the important

[44] In 2000, Congress authorized a narrow "opt out" exemption from segregation requirements, limited solely to trading on exchanges registered as derivatives transaction execution facilities ("DTEFs"). Section 111 of The Commodity Futures Modernization Act of 2000 added Section 5a to the CEA, which created the DTEF exchange registration category. Trading on a DTEF was limited to persons that were eligible contract participants or that accessed the DTEF through a registered FCM. No board of trade registered as a DTEF, and Congress repealed

segregation protections market participants will lose under FTX's proposal in Section IV of the Overview of Specific Comments of this letter.

Moreover, instead of assuring market participants the financial integrity of their transactions, FTX will put market participants in jeopardy of needless liquidations and trading losses. As described in the FTX Request, FTX plans to recalculate a participant's margin level and mark position to the market once per second.[45] If at any point in time price moves result in a participant's account being under-margined, in lieu of issuing a margin call, FTX will use an automated system to liquidate the participant's portfolio (i.e., likely in 10% increments)[46] by placing offsetting orders on the DCM's central limit order book ("CLOB") until liquidation trades bring the account back into good standing (i.e., no longer under-margined). Liquidations will occur automatically (e.g., every six seconds)[47] and may occur at any point in time, 24-hours a day, 7-days a week.

This approach denies market participants any meaningful opportunity to post additional funds to keep their positions open. Instead of receiving margin calls and having a reasonable amount of time to deposit funds to meet such calls, participants must constantly monitor the margin levels of their accounts against FTX's liquidation trigger to keep pace with the constant recalculations. Participants on FTX's DCM markets will likely find that positions they want to keep open are automatically liquidated during times of temporary price swings or, even worse, when liquidations are deliberately triggered by abusive trading by others. Participants could face losses when their positions are forcibly liquidated that they would not otherwise incur if market prices then quickly rebound in their favor. Participants may also realize losses greater than warranted if their positions are liquidated at "fire sale" prices during periods when cascading auto-liquidations fuel rapid, artificial directional price moves.

Please also refer to Section II of the Overview of Specific Comments of this letter.

a) *Does liquidating positions without requesting additional funds from the participant present risks or concerns in a regulated market?*

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Section 5a in 2010 with the Dodd-Frank Wall Street Reform and Consumer Protection Act. Congress imposed a core principle on a DTEF similar to Core Principle 11, except that it did not mandate that trades be centrally cleared. Congress also authorized a framework under which an FCM could offer its customers trading on a DTEF the opportunity to opt out of segregation protections with respect to such trading, in former Section 5a(f). Notably, Congress narrowly limited the scope of this opt out to FCM customers that are eligible contract participants, i.e., to non-retail customers that could make informed decisions about foregoing the segregation protections. The FTX proposal goes far beyond Congress' carefully tailored experiment for segregation opt out when it considered the issue, in that FTX mandates that all of its participants—including its retail participants—must clear their trades directly without segregation protections.

[45] FTX Request, Letter from Brian G. Mulherin, Gen. Counsel, FTX US Derivatives, to Clark Hutchison, Dir., Div. of Clearing & Risk, at pg. 1 (Feb. 8, 2022) (Permissibility and Benefits of Direct Clearing Model under Commodity Exchange Act and CFTC Regulations), *available at* https://www.cftc.gov/media/7001/ledgerx_dba_ftx_ltr_direct_clearing_model2-8-22/download.

[46] FTX Request, Form DCO Exhibit G-Default Rules and Procedures, at pg. 3 (Feb. 2022), *available at* https://www.cftc.gov/media/6991/ledgerx_dba_ftx_formdco-exhibit_G_2-8-22/download.

[47] FTX Request, Form DCO Exhibit G-Default Rules and Procedures, at pg. 3 (Feb. 2022), *available at* https://www.cftc.gov/media/6991/ledgerx_dba_ftx_formdco-exhibit_G_2-8-22/download.

For those participants that can monitor their accounts around-the-clock and with the frequency that the FTX's proposal demands (i.e., once per second), they may well find that they are racing the clock to transfer funds to FTX before the FTX system starts automatically liquidating their positions, to keep the positions open when they expect prices to move favorably back. This can be a particular challenge if participants are attempting to transfer digital assets given the time latencies and system capacity constraints currently inherent in the underlying technology. This has in fact been a problem on spot exchanges for digital assets that use auto-liquidation functionality. Over the weekend of January 19, 2022, the token called Solana (SOL) experienced a significant downward price move. Reportedly, many market participants had their positions liquidated when they could not beat the clock to transfer additional SOL to their accounts to save their positions, further exacerbating the downward pricing pressure.[48]

*b) Given the real-time liquidation, are participant protections necessary beyond disclosures regarding the rules and liquidation process employed by FTX? If so, what other protections should be required?*

Yes. We question the fairness of using auto-liquidation on a 24-hours a day, 7-days a week basis when the means for participants to transfer additional funds in the form of cash to save their positions are severely constrained over the weekend, on holidays or during overnight hours when banks are closed. FCMs deploy significant risk management procedures to address weekends and bank holidays around the world that affect their customers in order to avoid unnecessary liquidations.

*c) Are there risks to a model that is designed to result in more frequent, but smaller, defaults than traditionally occur in cleared markets?*

Please refer to Section I.c.i of the Overview of Specific Comments of this letter.

*d) Are there concerns about an automated system's ability to liquidate a portfolio fairly and effectively? Are there additional concerns if multiple participants are liquidated at the same time, or if the automated liquidation results in price moves that result in a cascading effect of participants becoming under-margined and subject to automated liquidation?*

The auto-liquidation feature that FTX proposes to employ in its DCM markets raises concerns about FTX's compliance with the core principles set forth in CEA Sections 5(d)(4), (9) and (12), as well as under 5(d)(11). Under DCM Core Principle 4, FTX has the responsibility, and must have the capacity, to prevent manipulation and price distortion through market surveillance, compliance and enforcement practices and procedures. Under DCM Core Principle 9, it must provide a "competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process" of trading in its centralized markets. Under DCM Core Principle 12, FTX has an obligation to establish and enforce rules to protect its market participants from abusive practices committed by any party.

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[48] *See* Emily Nicolle, *Once billed as a rising star in crypto, Solana's sixth outage this month—and founder's 'lol' tweet—frustrates traders*, Fortune (Jan. 25, 2022) (noting, the SOL protocol has one of the higher throughputs at 65,000 transactions per second. The problem could be even more extreme on platforms with slower protocols.), *available at* https://fortune.com/2022/01/25/solana-founder-anatoly-yakovenko-crypto-crash-blockchain-instability/.

The auto-liquidation feature is anathema to these principles. Instead of protecting against pricing distortions and assuring integrity of the price discovery process, FTX may continually be placing liquidation orders into its CLOB, and at any point in time, creating artificial pricing pressures unrelated to supply and demand market forces. When liquidity is scarce, as often occurs during times of price volatility, spreads can become very wide leading to large price movements. Auto-liquidation may lead to even further volatility and price swings when customers are unable to deposit additional funds to save their positions given the rapid price swings.

Granted, many firms utilize auto-liquidation algorithms today. There is nothing innovative to this approach. However, in an intermediated model, those algorithms are inherently disparate applications that are not applying the same metrics with the same synchronization and harmony across all users of an entire marketplace. FTX's planned deployment of its auto-liquidation algorithm across its entire customer-base for its entire marketplace uniquely introduces significant risk to its customers and the market.

FTX's proposal will also be enabling opportunistic trading and enticing potentially abusive trading practices. If traders discern that significant amounts of positions will be auto-liquidated if prices breach a certain level, they could attempt to take advantage of the situation by placing orders that would profit them if the prices are indeed breached, allowing them to capture trades at favorable prices with orders on the other side of the market. The combination of the liquidating accounts coupled with the opportunistic orders could overwhelm natural supply and demand. On top of this, there is the risk that some with ill intent could be tempted to engage in abusive trading designed to trigger auto-liquidations that they could then opportunistically trade against. Has FTX developed rules preventing such activities, or trade monitoring programs to detect opportunistic or abusive trading practices when they occur? How will FTX protect its retail participants against potentially abusive trading practices designed to take advantage of them facilitated by the auto-liquidation functionality?

It is also fair to ask whether the auto-liquidation functionality in and of itself constitutes an abusive practice, contrary to the admonishment in Core Principle 12 that a DCM must protect its market participants from abusive practices committed by any party. As explained above, market participants may well find that positions they want to keep open are forcibly liquidated when they are attempting to transfer additional funds to FTX to save the positions but cannot complete the transfers by FTX's unrealistic calculation (e.g., once per second) deadlines.

The use of auto-liquidation has caused serious harm to DCM markets when employed by FCMs. CME Group Exchanges have disciplined firms using auto-liquidation to close out customers' futures positions in under-margined accounts, for causing extreme price movements, liquidity and volume aberrations, velocity logic events and significant market disruptions.[49]

e) *Are there concerns about whether there will be adequate liquidity for position liquidation on a 24 hours a day/7 days a week basis?*

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[49] *See* CME Group, Notice of Disciplinary Action, COMEX-15-0303-BC (Sept. 2020), *available at* https://www.cmegroup.com/notices/disciplinary/2020/09/COMEX-15-0303-BC-INTERACTIVE-BROKERS-LLC.html and CME Group, Notice of Disciplinary Action CBOT-15-0158-BC (Mar. 2017), *available at* https://www.cmegroup.com/notices/disciplinary/2017/03/CBOT-15-0158-BC-SAXO-BANK-AS.html.

Please also refer to Section II of the Overview of Specific Comments of this letter.

*f) What metrics or data should the Commission use to evaluate whether there is likely to be sufficient liquidity across a broad set of market conditions?*

Please also refer to Section II of the Overview of Specific Comments of this letter.

*13) If a portfolio's initial margin falls below the full liquidation threshold, FTX will liquidate the full portfolio by assigning the positions to predetermined backstop liquidity providers.*

*a) How should FTX determine the amount of capacity it needs from its backstop liquidity providers?*

*b) How should FTX determine the level of liquidation risk an individual backstop liquidity provider can take on?*

*c) What types of standards should FTX have for its backstop liquidity providers?*

*d) What risks are associated with a system that is dependent on outside liquidity providers in this way?*

As described in CME Group's response to Question 4, there is insufficient information provided in the FTX Request on FTX's planned use of backstop liquidity providers, which makes these questions challenging to answer. However, at a minimum, FTX must demonstrate that its liquidity providers can be relied upon to fulfil the obligation of their role and as such, these providers must meet minimum criteria (e.g., capital requirements and creditworthiness) to perform their role and must be subject to ongoing monitoring by FTX. The ability of FTX's backstop liquidity providers to perform their role should also be regularly tested, similar to the exercises current DCOs undertake with respect to testing their default management procedures.[50] Additionally, CME Group's response to Question 4 also outlines some of the challenges of FTX's substantial proposed reliance on liquidity providers.

FTX should also address potential conflicts of interest. The FTX Request is silent on whether FTX's affiliates may serve as backstop liquidity providers, but if they can, that raises conflicts of interests as to decisions on whether to use a backstop liquidity provider or which backstop liquidity provider to use, in particular in circumstances where the portfolio being transferred is valued favorably or includes transferred margin funds that will likely exceed any losses the backstop liquidity provider will realize in liquidating the positions.

Please also refer to Section II.c of the Overview of Specific Comments of this letter, which outlines CME Group's concerns with potential conflicts of interest arising from FTX's intended use of backstop liquidity providers.

**Market Impact**

*14) By reducing the number of people/entities involved in a transaction, does a non-intermediated model have an effect, positive or negative, on price discovery and efficiency?*

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[50] *See* CFTC Regulation 39.16(b).

As noted in Section II of the Overview of Specific Comments of this letter, the FTX Request and its disintermediated model have significant impacts on market integrity.

15) *By potentially expanding the number of people able to participate in derivatives markets, does a non-intermediated model have an effect, positive or negative, on price discovery and efficiency?*

A non-intermediated model does not necessarily expand the number of people able to participate in derivatives markets, unless of course that model engages in a race to the regulatory bottom and sacrifices proper risk management and other safeguards for the sake of increasing participation.