May 11, 2022

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
1155 21st St. NW
Washington, DC 20581

Dear Mr. Kirkpatrick,

The Futures Industry Association (“FIA”) welcomes the opportunity afforded by the Commodity Futures Trading Commission (“Commission” or “CFTC”) to provide comments on the proposal by FTX US Derivatives (“FTX”)1 to amend its revised order of registration as a derivatives clearing organization dated September 2, 2020 (the “Order”) to authorize it to clear margined derivative products for its participants on a non-intermediated basis (“FTX Proposal” or the “Proposal”).

FIA has a long history of supporting innovation in the derivatives industry and we believe the FTX Proposal has prompted a healthy dialogue within the industry. However, there remain significant open questions and a lack of critical public information on the model set forth in the FTX Proposal that make it difficult to analyze fully whether the Proposal, if adopted, would negatively impact the customer protections and the clearing process that lie at the heart of our futures markets.

Specifically, we are unclear whether various key principles of the derivatives regulatory oversight structure are adequately addressed by the FTX Proposal. These include principles of segregation of customer funds, conflicts of interest of those entrusted with market operations and customer funds, financial resourcing and capitalization of market operators, appropriately planned and sized default resources, and safeguards of key market operations. We urge the Commission to seek additional clarity from FTX on how these key principles are satisfied and to continue the public dialogue on this important, and possibly transformative, Proposal.

FTX’s Proposal draws on existing features employed in the derivatives industry today – including margined futures, as well as frequent, intra-day assessment of clients’ margin sufficiency and auto-liquidation of clients with inadequate margin coverage. However, FTX would uniquely combine all these features and deploy them in an integrated designated contract market (“DCM”) and derivatives clearing organization (“DCO”) without the benefit of futures commission merchants (“FCMs”) underwriting the risk of clients in any traditional manner. The combination of these features represents a material change from FTX’s current authorization that permits it to only clear futures, options on futures and swaps on a fully

1 Officially LedgerX, LLC d/b/a FTX.
collateralized basis. Although the Order does not currently allow intermediation, we note that FTX’s rulebook references the participation of FCMs, although how they would participate remains unclear.2

Furthermore, although FTX’s existing offering is based on digital assets and cryptocurrencies for retail traders, the clearing model as proposed by FTX would permit trading in derivatives on any underlying asset class transacted by any type of customer, including commercial hedgers. This requires us to view this Proposal with an eye towards the potential impact upon the core users of the derivatives markets: farmers, producers, refiners, pension funds, and the range of commercial participants who depend upon futures and related products to hedge price risk in the real economy.

We analyze this unique Proposal recognizing the CFTC’s long history of supporting innovation in the derivatives markets. In fact, the Commodity Exchange Act (“CEA”) explicitly states in the findings and purpose3 of the Act that the Commission should “promote responsible innovation and fair competition” among market participants. In promulgating the Commission’s purpose and mission, Congress was careful to ensure innovation was advanced responsibly and did not jeopardize the integrity or financial stability of the markets or the protections afforded to customers. The CFTC’s mission is structured around certain core tenets: In addition to the promotion of responsible and fair competition, the CFTC is charged with the protection of customer assets, ensuring the financial integrity of transactions, avoidance of systemic risk, and the prevention of manipulation.4 Congress’s insistence on promoting “fair competition” also suggests the CFTC needs to create a level playing field for market participants, which imposes a uniform regulatory framework upon similar activity with similar risks. FIA believes that these principles from the CFTC’s mission should drive the Commission’s analysis of the Proposal before us.

This letter further explores some preliminary issues and questions based upon FIA’s review of the material available along with the FTX Proposal. These issues include:

2 Under the Order, FTX may “not permit any FCM participant to clear on behalf of any customer.” FTX is permitted to accept FCM participants to clear on behalf of customers only if FTX first submits “all rules applicable to customer clearing to the Commission pursuant to Commission Regulation 40.5 or 40.6.” In private sessions with members of FIA, FTX has suggested that FCMs could fund their customers’ accounts at FTX; however, this Proposal may raise issues under CFTC Rule 1.30 prohibiting the loaning of funds by FCMs to customers on an unsecured basis.

3 In the Findings and Purpose of the CEA, the statute reads: “It is the purpose of this chapter to serve the public interests described in subsection (a) through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission. 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.” 7 U.S.C. § 5(b).

FTX’s proposed elimination of FCMs from the clearing model does not remove the need for the important customer protections and risk management functions that FCM clearing members currently provide. As agents for their customers, FCMs hold various regulatory responsibilities including vetting customers on the appropriateness of these leveraged products, policing clients for money laundering, segregating customer funds, guaranteeing customer trades, holding significant regulatory capital against those trades, contributing their own skin in the game capital to the central counterparty (“CCP”) default fund, and agreeing to further assessments should the CCP default fund need replenishment. Many of these responsibilities have been further strengthened post-financial crisis to provide important redundancies and checks in the clearing process to avoid not only a clearinghouse failure, but also losses to the customer asset pool.

The FTX Proposal indicates that many of these FCM-provided protections could be satisfied through the DCO core principles or may no longer be needed due to the model. However, it is not clear that this hybrid DCO model provides the same level of customer and market protections through a DCO registration, given FTX seeks to take on many of the same functions and activities of FCMs without FCM registration and the detailed regulatory requirements that ensue from registering.

FIA also believes there needs to be further analysis of the viability and adequacy of FTX capital as the default resource and appropriateness of tools (such as variation margin gains haircutting (VMGH)) proposed in the FTX risk model in extreme but plausible scenarios, especially for large commercial participants in other asset classes beyond retail digital currencies. Given the model relies on continuous liquid markets that are open 24/7/365, questions remain around the market impact of the auto-liquidation feature for the close-out of large positions in less liquid markets that are not continuously traded. Furthermore, more transparency is needed on the Backstop Liquidity Providers (“BLPs”), and how BLPs and other default resources are employed and governed during market distress while avoiding self-dealing.

We understand that the CFTC Request for Information is a first step in gaining more details on this unique market structure proposal that will help address some of the issues we have raised herein. We welcome FTX’s openness to engage with the industry on the merits and substance of the Proposal. We support FTX’s efforts to advance real-time risk management in clearing and bring greater competition to our markets. However, we do not believe there is sufficient information and analysis on the Proposal at this time to conclude that it should be approved by the Commission and, if so, under what conditions.
I. Relevant Background

A. FIA and its Members

FIA is the leading global trade organization for the futures, options, and centrally cleared derivatives markets. FIA’s mission is to support open, transparent, and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct. FIA’s membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry. FIA’s governance consists of firms that operate as clearing members in global derivatives markets, including firms registered with the CFTC as FCMs, and this letter principally represents their views.

Throughout its history, FIA has deployed its collective member expertise to provide comment and feedback on a range of suggestions and improvements to the derivatives clearing system, ensuring that the mission of the CEA is fulfilled. In evaluating innovative offerings, we bring several decades of experience managing well-functioning markets for the important risk management and price discovery purposes for which they were designed. We are pleased to work with the CFTC and with other regulators regularly to strengthen the clearing system, through embracing improvements and evolving rules to yield greater efficiencies for market participants and for customers. We provide these comments in the same spirit.

B. The FTX Proposal

We understand the FTX Proposal expands upon certain elements of existing direct clearing models in innovative ways: specifically, the efforts to incorporate more frequent margin adequacy assessments and to distribute low-cost or no-cost market data could yield enormous benefits to participants in our industry. We seek to better understand how the innovations that FTX has developed for the global cash and derivatives crypto markets could contribute to the evolution of the U.S. cleared derivatives market.

FTX’s Proposal seeks modification not only to an existing DCO order, but also to the fundamental paradigm of how the futures industry has historically operated, by relying primarily on the financial strength of FCM clearing members to buttress the financial solvency of clearing organizations who in turn ensure the performance of every cleared futures contract, option on a futures contract, and swap. Although the technical changes sought to the Order may not appear monumental on their face, we strongly believe that the changes could bring lasting effects, creating new sets of rules for certain participants, and therefore deserve detailed and thoughtful review.

Moreover, given the transformative changes that could potentially flow from the proposed amendment to the Order, we believe the CFTC must also carefully consider the public interest in potentially eliminating the traditional and essential buffer provided by FCMs in connection with margined products. This buffer serves not only as an integral part of the DCO waterfall in intermediated markets, but also as a critical front line in evaluating customer sophistication; ensuring customer education and suitability, customer protection, market integrity and
operational efficiencies; and supplementing or enhancing the self-regulatory roles of DCMs and swap execution facilities. Additionally, the Commission must carefully assess the adequacy of the current DCO risk management rules if applied in the context of the proposed framework. It also must evaluate whether any of its existing rules should be formally amended prior to approving FTX’s proposed margined-products disintermediated model. Indeed, it may be preferred that the CFTC consider FTX’s Proposal through a formal rulemaking process that would necessarily include, among other things, a holistic cost-benefit analysis.

We understand that retail disintermediated models already exist under the CEA structure but in a more limited way. We recognize that the FTX Proposal is innovative in its combination of disintermediation and margining of derivative products for retail participants, including how it proposes to substitute an alternative form of waterfall compared to the historic model backstopped by FCMs, relying on a 24/7/365 real-time margining system coupled with automatic liquidation of under-margined accounts, BLPs, and a guaranty fund from FTX’s own capital that apparently will be no less than $250 million. Although FTX’s Proposal draws on many existing features of the derivatives marketplace, it focuses solely on those offered by a stand-alone DCM/DCO and discards the symbiotic relationship that ensures checks and balances in the clearing system, which would be lost by eliminating FCMs in FTX’s proposed margined products disintermediated model.

Thus, because of the potential disruptive impact of FTX’s margined, disintermediated model on the traditional clearing and customer protection model, we urge the Commission to carefully consider whether FTX’s Proposal, for itself and for likely subsequent adopters of a similar model, adequately ensures:

- the financial stability of cleared derivatives markets;
- the financial integrity of clearinghouses;
- that participants of DCOs receive the same level of customer protection as they currently do as customers at FCMs; and
- market integrity.

We have invested significant time in reviewing this potentially transformative Proposal. We have reviewed the documents made public on the CFTC website in connection with this solicitation of comments and have also had several conversations with the FTX team and other

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5 For example, Kalshi is also a disintermediated retail model that does not have FCMs, but it offers only fully-collateralized binary options. NGX is also a disintermediated model, but its niche market has requirements that effectively preclude retail participation and is limited to commercial market participants and other institutional counterparties that are required to have the capability to make and take delivery of the underlying energy commodities.

6 For example, FCMs frequently examine CCP margin sufficiency and also can provide quick identification of clearing house errors and system problems. These functions help keep the entire system in check.
market participants. Particularly from those conversations, we gather that FTX continues to evolve its offering and seeks feedback on how it can be improved. We note that the FTX Rulebook continues to list certain product specifications that would likely be removed upon approval. We have also focused on other discrepancies between the rulebook made available by the CFTC and other documents and conversations detailing the model. We urge the Commission to review the Rulebook carefully to ensure the model is reflected as described. To that end, we highlight in this comment letter certain areas that we believe merit specific focus.

We understand that FTX engaged in conversations with FCMs and others to broaden the offering to institutional and other clients and we expect the platform will seek to list – as its Order currently permits – products outside of the current cryptocurrency and digital asset space. We, therefore, have analyzed both the current Proposal and the implications of expansion beyond the current Proposal. We urge the Commission to also consider the current Proposal with an eye towards a potential expansion into some or all of the markets under its regulatory authority. We believe that important commercial markets may be impacted and those hedging in these markets may be disadvantaged by certain features of the Proposal. Therefore, we suggest that the CFTC should not limit its review at this time to only certain users or participants. We look forward to working with the Commission as it evaluates the Proposal and its implications.

II. Analysis of the FTX Proposal in the Context of the Existing Regulatory Architecture

In considering the role that FTX seeks to fulfill by the FTX Proposal, it is important to note the longstanding regulatory framework in which it seeks to operate.

A. The Function and Role of Regulated FCMs

Some version of what is now known as an FCM has existed for centuries. Factor merchants were originally charged with interacting with customers directly. Since the passage of the Commodity Exchange Act in 1936, FCMs have been required to segregate customer funds, and their interactions with customers have been heavily regulated to ensure various customer and market protections. Although the regulatory structure has evolved significantly, these core protections remain entrusted to FCMs.

Currently, FCMs discharge several key functions independent of those discharged by DCOs. The clearing structure involves different, interdependent entities, each responsible for executing important and sometimes intentionally redundant system protections. Today, heavily regulated FCMs ensure that critical protections are met in the system, including those relating to customer protection, robust disclosures of risks, capital resources, and credit and collateral management. FCMs also provide a valuable buffer to ameliorate operational errors by DCOs on behalf of their customers.

FCMs are registered with the CFTC and are members of the National Futures Association (“NFA”). They assume obligations under the CEA, CFTC and NFA rules, and rules of any
exchange or clearinghouse of which they are a member or on which they facilitate trading. If FCMs maintain a presence or an activity in a foreign jurisdiction, they may also incur obligations under other foreign laws and regulations. In the United States, FCMs are regulated principally by the CFTC and their designated self-regulatory organization (“DSRO”), as well as episodically by their other self-regulatory organizations (“SROs”). Moreover, FCMs are obligated through an express rule (CFTC Reg. § 166.3) to ensure all customer accounts are supervised directly and indirectly through a robust oversight system.

These varied oversight sources contribute to a complex regulatory framework, including myriad requirements, designed to protect customers, customer funds, DCOs, and the financial system. We set forth below a number of these requirements, and highlight certain conceptual issues with the FTX Proposal to which we would direct CFTC’s attention:

- **Minimum capital requirements.** The minimum amount of capital that an FCM must have readily available is defined by rule, but constantly fluctuates. Generally, it is the greater of a number of amounts, including: $1 million; 8% of the margin requirement (as defined in CFTC Rule 1.17(b)(8)) for positions carried by the FCMs in customer accounts and noncustomer accounts; or the highest amount required by the SEC (for combined broker-dealers and FCMs) or any self-regulatory organization. Moreover, this defined amount is subject to certain caveats, including capital “haircuts,” or reductions, for no or late margin call satisfaction; and ongoing risk-reducing measures to help ensure capital is not impaired. FCMs risk-manage customers tick-by-tick as markets move, and may make margin calls intraday and in excess of DCM margins as a result, which would then impact regulatory capital requirement calculations. Due to regular fluctuations in the capital amounts required and regulatory penalties associated with capital deficits, FCMs typically maintain capital equal to at least 110% of the required amounts. FCMs are required to stand behind and guaranty 100% of customer trading. These capital requirements ensure that funding is available to backstop the trading of FCM customers and house accounts.
  - **Note Regarding FTX Proposal.** As it is not registered as an FCM, FTX is not subject to the same robust capital requirements. Moreover, given the lack of intermediation in its model, the FCMs’ capital and calculated buffers are not requirements in the FTX Proposal and, instead, the Proposal intends to liquidate rather than rely upon FCMs to evaluate and ensure adequate margin. We question whether the Proposal is robust enough in this respect.

- **Guaranty fund.** In addition to this capital buffer, the traditional DCO model allows the DCO to require FCM contributions to a guaranty fund and allows the DCO to require additional assessments from FCMs to shore up the guaranty fund if circumstances require.
Note Regarding FTX Proposal. It is not clear how the $250 million single-source “guaranty fund” that FTX proposes to satisfy capital shortfalls may be increased, or will be replenished if drawn down.

Customer funds protection and segregation. At an FCM, funds belonging to customers must be kept legally segregated from proprietary assets of the FCM. Customer funds are also protected by a robust FCM bankruptcy regime under Part 190 which, broadly speaking, ensures that funds of customers of a bankrupt FCM are directed back to the customer immediately. They do not pass through the bankruptcy estate and are, by statute, not subject to any claim by the FCM’s creditors.

Note Regarding FTX Proposal. Member funds at a DCO are not considered to be customer accounts and are not subject to legal segregation under the CEA or CFTC rules. Therefore, separation of funds by a DCO between clearing members and proprietary funds is not the same as legal segregation. Internal policies may not have the effect of offering the same level of protection imposed by statute and rule.

Prohibition of Guaranteeing Against Loss. FCMs are prohibited by Rule from guaranteeing against or limiting customer loss (or even making such representations). See CFTC Reg. § 1.56. In approving this rule, the CFTC sought to avoid FCMs becoming undercapitalized and to minimize the opportunity for the misuse of other customers’ funds. See 46 FR 62842 (Dec. 29, 1981). This rule then serves to ensure proper capitalization of the FCMs and to make sure customer funds are fully segregated.

Note Regarding the FTX Proposal. In Questions 4 and 5 of the RFI, the CFTC indicates its understanding that FTX limits its participants’ financial obligations and that participants will have no obligations to FTX other than posting initial margin. We read the FTX Rulebook to indicate that participants are obligated for losses beyond posted margin, and consequent attorney fees. See, e.g., LedgerX Rulebook Rules 14.2.B and 14.3.B. However, should FTX continue to maintain that participants have no obligations to FTX other than posting initial margin, and its Rulebook is updated to reflect this, we urge the Commission to consider why the principles of Rule 1.56 would not apply here to prohibit such a practice.

“Know Your Customer” obligations. Among other things, the Bank Secrecy Act (“BSA”) requires that “financial institutions” (including FCMs) engage in standardized due diligence procedures to verify customer identity and assess and
monitor potential, new, and existing customer risk. These Anti-Money Laundering screening requirements are essential duties performed by FCMs.

- **Note Regarding FTX Proposal.** FTX has undertaken to adopt and follow certain BSA-related obligations. We note that this undertaking to comply, as required by the CFTC, may not have the same force and effect of being required to comply under the BSA as a regulated “financial institution” thereunder. Already, principals of a firm, charged by the CFTC for allegedly acting as an FCM and not complying with the BSA, challenged a criminal complaint brought by the Department of Justice through a Motion to Dismiss, claiming that its activities were like those of a disintermediated DCO, and thus it had no BSA obligations.8

- **FCM customer-related obligations.** Registered FCMs must comply with numerous other obligations designed to protect customers and the markets in which they operate. These include, but are not limited to:
  - Firm-specific disclosures with ongoing obligations to refresh and update information to enable members of the investing public to select the FCM with which they do business.
  - Privacy notices that FCMs, as “financial institutions,” must provide.
  - Examination, registration, and disclosure requirements for public-facing FCM associates, including Associated Persons and Branch Office Managers.
  - Ethics examinations and other obligations for public-facing FCM associates who engage with customers.
  - As noted previously, significant requirements (which the CFTC has applied broadly) to adequately supervise all persons directly or indirectly handling customer interest accounts, with significant penalties for failure to do so. Adequate supervision includes the robust monitoring of customer accounts to help ensure market integrity, compliance with position limits, and other requirements imposed upon customers.

- **Note Regarding FTX Proposal.** Arguably, these important protections may not apply to DCMs/DCOs. That is, participants and members of these organizations are not traditionally viewed as “customers” with all the obligations that such a designation entails *vis a vis* an FCM.

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7 That is, in addition to the myriad regulatory requirements that FCMs are subject to, their status as a “financial institution” under the BSA requires them to be subject to the BSA regulations, with severe penalties for violations thereof.

8 See Memorandum of Law in Support of Defendants’ Motion to Dismiss, *United States of America v. Arthur Hayes, Benjamin Delo, Samuel Reed and Gregory Dwyer*, (USDC, SDNY (JGK)), filed December 21, 2021.
Other FCM obligations. FCMs are subject to other requirements that are designed to ensure market integrity. FCMs must comply with significant requirements to prepare, maintain, and retain appropriate books and records concerning their business, including recordings of certain telephone conversations. They are required to file daily segregation reports, periodic financial and risk reports, and a CCO Annual Report and certification.

Note Regarding FTX Proposal. Attention should be given to ensure that a DCO functioning like an FCM is subject to similar recordkeeping and certification requirements.

NFA Membership. FCMs are required to be members of the NFA, be subject to NFA audit, and comply with numerous NFA rules designed for customer protection. Their public-facing employees must also be members and pass requisite examinations, be fingerprinted and remain subject to background checks.

Note Regarding FTX Proposal. Disintermediated DCMs and DCOs do not have an entity in their system required to be a member of the NFA. Accordingly, these vetting and diligence requirements are never applied as they are to customer-facing FCM employees. Therefore, attention should be given to the role that NFA plays, and whether adequate assurances otherwise exist in the absence of NFA membership.

In short, this wide array of rules underscores the FCM’s important role as “gatekeeper” and one that supports market stability. We review the FTX Proposal with the understanding that the role of FCMs, and the consequent protective function entrusted to the FCM by the CEA and its regulations, are key to the proper functioning of the clearing system.

B. The Interdependent Existing Regulatory Framework Applicable to the Derivatives Clearing Business

As previously noted, the CFTC’s rules were written around a framework that separates key functions into different entities, or registration categories. Merely collapsing various entities into a single entity does not necessarily mean that the rules applicable to the surviving entity satisfy the wide range of protections embedded throughout the preexisting, multi-entity structure. The existing FTX DCO is certainly subject to numerous regulatory requirements. Having said that, the CFTC rule set governing DCOs and DCMs was written with the understanding that an FCM would inevitably discharge certain key functions within the DCO/DCM framework. This presupposition means that, even if a DCM observes all its requirements, it cannot be said that all necessary protections, presumably to be fulfilled by an FCM, will be in place. By way of example, the DCM rules (CFTC Reg. § 38.1101) require that a DCM that is also a DCO have “adequate financial resources.” However, this requirement does not include a methodology to determine what constitutes “adequate financial resources” for a DCM and a DCO that would also maintain responsibilities typically
discharged by an FCM. Moreover, FCMs supplement many protections today provided by DCMs and DCOs; they also act as a buffer for customers if DCMs and DCOs experience certain operational errors (e.g., by recognizing application of an incorrect risk array in computing firm margin requirements).

DCMs and DCOs frequently rely upon customer protection rules applicable to, and discharged by, FCMs. Indeed, a primary purpose of the FCM in the clearing system is to provide critical protections to customers. As the entities licensed to solicit directly from customers, FCMs are best positioned to provide a range of protections that are tailored to the customer in many instances. In addition to governing conduct involving direct interactions with the customers, FCM regulatory requirements are designed to protect the customer further from fraud, systemic failures, and malfeasance. To give just one example, NFA Rule 2-29 addresses FCM communications with the public and FCM promotional materials. The rule provides specific limitations on what FCMs may say about their business, about the future prospects of the business, or what could happen to customer funds designated for trading. These rules enhance customer awareness of the risks of trading and the limits of the markets. Such rules do not apply to a DCM or a DCO. In the absence of an FCM in the model set forth in the FTX Proposal, we urge the Commission to carefully analyze whether all of these important protections can be accommodated.

Today, the CFTC and DCMs expect FCM members to monitor trading and other activity by their customers, and routinely bring disciplinary actions against them when they believe they have not sufficiently safeguarded against improper conduct under certain facts and circumstances. FCMs are also subject to guidance regarding the handling of customer accounts and other financial matters by the Joint Audit Committee (“JAC”). Exchanges, such as CME Group, impose similar supervisory obligations upon their clearing members.

Given the presumed interdependence of entities functioning within the clearing ecosystem, we urge the Commission to review carefully the protections presumed and subsumed within the existing clearing model and to ensure that these protections are also incorporated, where necessary, into the proposed FTX model.

C. Unique DCO Risk Issues Raised by the FTX Proposal

We note that certain existing DCOs already operate without an FCM structure. Having said that, they are different from the FTX Proposal in key respects – most particularly, with regard to FTX’s unique combination of retail participation, the auto-liquidation mechanism and leveraged margin trading. Thus, we submit that the FTX Proposal requires a thorough analysis by the Commission, to the extent that the model might lack and thereby do away with certain of the protective elements built into the system. At a minimum, we submit that any approved model should provide at least the status quo level of customer protections and market integrity

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9 See, e.g., In the Matter of Advantage Futures LLC, et al., CFTC Docket No. 16-29 (2016).

10 See, e.g., CME Rule 950 (a clearing member must “adopt and enforce written supervisory procedures pursuant to which it will supervise in accordance with the requirements of [CME] Rules and the CEA and CFTC Regulations thereunder, each customer’s account(s)”).
protections as exist in the traditional clearing model, and may very well warrant a heightened level of protections, given both its unique market design and the likely participants in the market.11 We take this opportunity to consider some of these unique risk management features of the FTX Proposal and the FTX business model, to identify certain issues that we believe merit closer consideration.

1. Rulebook and Other Document Descriptions of FTX Default Procedures

Chapter 14 of the LedgerX Rulebook captures many of the unique features of the FTX model in its description of default procedures. First, Rules 14.1 and 14.2 define a default on the platform and authorize FTX to liquidate, terminate or suspend the open contracts of a participant meeting that definition of default. The Rule provides for liquidation except in certain cases, such as a participant-to-participant transfer, FTX auction, or if the Risk Management Committee determines that liquidation is not required to protect the financial integrity of FTX. It is not clear from the Rulebook or from discussions with FTX under what circumstances a liquidation would be avoided for these reasons. We note that in the event the company decides not to liquidate a position, it is permitted to enter into hedging transactions to reduce the risk to FTX of not liquidating.

Second, should the liquidation determination be made under 14.2, FTX has, at its discretion, several options to close out the position pursuant to Rule 14.3. As a first step, Rule 14.3.A permits the company to liquidate into the central limit order book. However, if the company determines that it is not “practicable or advisable under the circumstances in light of liquidity, open interest, market conditions, or other relevant factors” three options are available for close out:

- transfer of the positions to a BLP (Rule 14.3.B)
- partial tear up of positions of participants not in default, also referred to as the Secondary BLP (Rule 14.3.C)
- auctions pursuant to default auction rules in place at the time, or pursuant to other “alternative auction” rules determined appropriate by FTX.

The choice among these options appears to be entirely up to FTX.

Only if and after these four options (auto-liquidation and then the other three back up choices of transfer, partial tear up or auction) are determined to be “not practicable or advisable under the circumstances in light of liquidity, open interest, market conditions or other relevant factors,” can the company turn to the default resource of the FTX guaranty fund. (Rule 14.3.E). After exhausting the guaranty fund, FTX may elect, in the following order, Variation Gains Margin Haircuts and Full Tear Up. Finally, the rules make clear that regardless of

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11 As noted by Chair (then-Commissioner) Behnam at the March 11, 2021 GMAC meeting: “But certainly, as a general matter, whether it is clearinghouse risk or margin issues, and certainly today’s discussion around retail trading, these are the most ripe and important issues that I think we all care about in our market.” See https://www.cftc.gov/sites/default/files/2021/04/1618338631/gmac_transcript031121.pdf.
which method of closeout is utilized, the company may demand from the closed-out customer full payment for all losses, liabilities and expenses incurred in these steps. (Rule 14.4).12

FTX has also filed with the CFTC an “Exhibit G: Default Rules and Procedures.” The materials do not appear completely aligned with these Rule 14 steps. For example, Chapter 14 includes the use of auctions in the default process but Exhibit G does not. We assume the Rulebook will be updated to reflect the statements in Exhibit G and until we have clarity on the sequence of default procedures, it is difficult for us to fully assess the adequacy of the default process.

Nevertheless, we provide a few preliminary comments on the Rulebook. First, one of the key purported benefits of the FTX Proposal is that “FTX does not propose to mutualize losses among its participants in its default waterfall.” (See CFTC Request for Comment on FTX Request for Amended DCO Registration Order, March 10, 2022, at 2) (emphasis added). However, Variation Margin Gains Haircutting (“VMGH”) is listed as a default resource in both DCO Exhibit G and Rule 14.3.F. This tool conflicts with FTX’s assertion that it does not mutualize loss, insofar as VMGH is a form of loss mutualization. Further, we question the appropriateness of a tool like VMGH in the context of clearing for less sophisticated retail customers, who may not comprehend how it operates. Although traditional CCP rulebooks may include these tools, they reserve VMGH as the final step in recovery and there are guardrails around the use of these tools. For example, when VMGH is permitted, it is subject to regulatory oversight and strict limitations upon both the duration it may be used and/or the maximum dollar value of losses that can be imposed.

Furthermore, the use of Partial Tear Ups in Rule 14.3.C – also a loss mutualization tool—is ahead of the use of the FTX Guaranty Fund in the waterfall.13 That non-defaulting participants could be subject to Partial Tear Ups does not seem compatible with the FTX assertion that it does not mutualize losses. At the very least, participants should be made aware and rules on application of this tool should be further disclosed. Moreover, it is unclear whether FTX expects retail users to participate in the auctions, and whether such participants would require different procedures for a successful auction.

Given the business model and category of market participants targeted by FTX, we would strongly urge the CFTC to consider whether these tools are appropriately placed in the waterfall and whether they are appropriate at all for this model.

2. **Auto-Liquidation**

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12 As noted on pages 8-9 above, the CFTC indicates in RFI questions 4 and 5 that it understands FTX to be limiting participant financial obligations to margin posted. The Rulebook indicates, on the contrary, that participants are obligated for losses beyond posted margin, and consequent attorney fees. See, e.g., LedgerX Rulebook Rule 14.2.B and Rule 14.3.B.

13 One possible reading of Rule 14.3.C is that only Secondary Backstop Liquidity Providers, presumably parties who have executed Liquidity Provider Agreements, would be eligible non-defaulting participants for partial tear up. We submit that this is not clear in the rules and not referred to in Exhibit G. If this is the way the tool’s use is envisioned, the Rulebook and Exhibit G should be updated to reflect that.
FTX rests its model on the risk management benefits of its auto-liquidation feature. At the outset, we note that the FTX Rulebook makes clear that auto-liquidation is only one of the options available to FTX in dealing with a customer with insufficient margin. As detailed above, Rule 14.2 would permit FTX to decide whether to conduct an auction, or to maintain defaulted accounts on its own book and to enter into additional transactions on its platform to hedge its own risk in those positions. Given that FTX may make its own determination as to whether or not to liquidate, we urge the Commission to seek more information on threshold circumstances that could result in risk being held by FTX itself.

Should FTX decide to proceed with a liquidation, FTX proposes to auto-liquidate the participant if there is insufficient Initial, Maintenance or Variation Margin. As we know, multiple defaults often happen during volatile markets. Although FTX has asserted that its offshore entities has successfully handled multiple defaults on volatile days, the model has not been tested with large institutional market participants.

The notion of auto-liquidation presumes a willing and able counterparty and thereby itself depends on sufficient liquidity. Even if an auto-liquidation model can operate effectively, it is not clear that the ten percent auto-liquidation model would be appropriate in all market liquidity scenarios. Thus, we submit that FTX should justify the decision to liquidate ten percent of a position automatically, as opposed to some other number based on market conditions.

As the Commission is well aware, there are both products and certain time periods when liquidity ebbs, sometimes significantly. Volatility in the markets can also exacerbate liquidity crunches. The 24/7/365 nature of the FTX model only heightens these concerns, as this will increase the probability that auto-liquidation will be triggered at times of low liquidity (such as nights, weekends and extended holiday periods). Amplifying these concerns about liquidity are the potential limitations on the ability to “top up” margin in accounts during off hours. Meeting a margin call in fiat currency requires banks to be open, notwithstanding that the market is open 24/7. This is not the world we live in today.

Furthermore, during market turbulence, immediately liquidating a large participant during cascading markets can be procyclical, add to market volatility and may cause further defaults. In other words, a directional market subject to an auto-liquidation model has a tendency to be very procyclical and, thereby, this model could exacerbate financial instability in a time of heightened market volatility. This impact could very well be worse in the retail context, in which retail participants often move in packs and the effect of liquidating hundreds of retail accounts at once could be enormous. For all these reasons (and others), an FCM and a DCO have a duty to consider market conditions before liquidations. The current clearing model requires establishment of a clearly defined default management strategy with provisions for hedging and portfolio splitting prior to liquidation to ensure that close-out happens at the best possible price. Expert judgment is relied upon with the default management group or DCO risk management staff in some cases implicitly evaluating market conditions prior to taking action to liquidate positions. This second line of defense may be even more important in the context of crypto products, which have shown significant intraday and overnight volatility. This would impact size of losses depending on when positions are closed. In contrast, in an
objective, algo-driven automatic liquidating model, no such consideration can be given. Without this subjective requirement, a wholly automated function could in fact exacerbate market turbulence and create systemic risk.

Moreover, FTX’s model – which marks-to-market every 30 seconds and uses real-time auto-liquidation if a participant does not maintain sufficient margin – raises additional questions regarding possible unintended consequences. FIA recognizes that maintaining required margin on deposit with FTX along with an auto-liquidation mechanism can limit FTX’s exposure to client default risk, but submits that this structure interjects different risks that should be fully evaluated to ensure that market integrity is not compromised. For example, does auto-liquidation pose different or additional risks for market manipulation that are not present outside of this proposed model? Given the retail participation in the digital assets markets, we suggest that the CFTC should consider whether market manipulators will be able to trade on directional information affecting such assets and the expected retail reaction. Recognizing that other intermediated exchanges or those that allow only fully collateralized contracts currently list cryptocurrency futures, we suggest further that the CFTC should consider whether approving this disintermediated, margined model might create unwanted arbitrage, information asymmetry, market manipulation or instability scenarios with respect to those other markets.

For all these reasons and others, we submit that the CFTC should consider whether FTX’s proposed auto-liquidation feature would potentially cause market disruption not found in other models. SROs have sanctioned members for issues raised by similar auto-liquidation models:

- **Saxo Bank:**

- **Interactive Brokers:**

We suggest that FTX explain how its model can be distinguished from these cases, and how it would enforce its own rules prohibiting conduct by participants that constitutes a “disruptive trading practice.” See Rule 8.3(N).

We also note that the model relies heavily upon the execution of algorithms. From the information provided, we are unclear what controls exist with respect to automated algorithms integral to the risk management program of the FTX Proposal. Given the algorithm’s importance, we believe the CFTC should provide guidelines and resources to assess its dependability.\(^{14}\)

\(^{14}\) For example, after years of market review and debate on how best to address risks associates with electronic trading, the CFTC adopted CFTC Rule 38.251 as part of its Electronic Trading Risk Principles, which requires DCMs to implement rules to prevent, detect and mitigate market disruptions associated with market participants’ electronic trading as well as to subject all electronic orders to the exchange’s pre-trade risk controls. This rule,
The efficacy of FTX’s risk management framework hinges on its ability to automatically liquidate under-margined customer positions. We believe that the CFTC should consider whether the auto-liquidation feature warrants additional disclosures so that participants, particularly retail participants, understand the risks involved with participating at FTX as a member. We submit that, among others, the risks about which member/retail participants should be made clearly aware are:

- Upsetting planned risk management, hedging, or arbitrages if positions are closed out unexpectedly and without warning.
- Effect of delay in providing additional maintenance margin because of banking closures (normal weekend, or even extended holiday period considering the 24/7/365 nature of operations, for example) or delays in transmittal, including those not the fault of the customer.
- Effect of failure to pay maintenance margin.
- Possible adverse results of a forced auto-liquidation, including responsibility for any losses resulting from auto-liquidation, and liability for resultant legal fees.
- Possible irreversible auto-liquidation prompted by an FTX operational error caused either by FTX or due to a fat finger error entered by a market participant.

3. **Liquidity Providers**

FTX also contemplates the use of a BLP Program to provide flexibility to close out customer positions that are under-margined. The FTX Rulebook defines a Liquidity Provider as one who enters the Liquidity Provider Agreement, a document which is not provided for review with this RFI. Rule 4.3 makes clear that Liquidity Providers may receive incentives and benefits, but it is not clear what the Liquidity Provider is obligated to do in exchange for those benefits.

The Close-Out Rules provide further explanation about the Liquidity Providers and divide them into two types: “Backstop Liquidity Providers” and “Secondary Backstop Liquidity Providers.” It appears from the Rulebook that both types of Liquidity Providers will enter into a participant agreement. We gather generally from the rules that BLPs are those that accept customer defaulted positions through transfer and Secondary BLPs are those that agree to partial tear up of offsetting positions.\(^{15}\)

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\(^{15}\) However, it is not clear to us from the Rulebook that Partial Tear Ups would be limited to those parties who have signed a Liquidity Provider Agreement. We note that Partial Tear Ups are used in Rule 14.3.C with reference to Secondary Backstop Liquidity Providers, suggesting possibly that only those parties would be eligible for a non-defaulting position tear up; but the rule does not explicitly limit the tool to those parties.
We lack information we consider necessary to an adequate assessment of the effectiveness of the Liquidity Provider program. The terms of the agreements with the BLPs are highly relevant to an effective determination of key matters, including: the conditions under which these back-up providers would act; the volumes that they would be able to support and whether there are explicit limits on size of positions that they would liquidate; and the price at which liquidation will be undertaken, i.e., whether it is a price determined by the BLPs based on their perception of market conditions and positions to be absorbed, or whether it would be a price determined by FTX itself and the incentives in place to ensure the BLPs would act in the best interests of the market.

Furthermore, neither Chapter 4 nor Chapter 14 of the FTX Rulebook seem to adequately address the process for assigning positions to BLPs. At the very least, we would expect transparency on the minimum number of BLPs necessary; the minimum requirements to become a BLP; and whether the BLPs are obligated to accept positions. Furthermore, it is not clear from the public documents how FTX will ensure at all times that BLPs are available and have committed resources sufficient to support the model. Additionally, BLPs are allotted positions based on margin on deposit. What ensures that BLPs won’t remove margin or reduce it just during the time the DCOs may need to assign positions of a defaulted member, when liquidity is needed most? Further, while it appears that FTX may require the BLPs to accept trades at a haircut to current market price, this raises the concern that liquidation of large volumes at a discount to the market price could itself lead to a further downward spiral of prices such that the liquidation process would effectively only stop when the participant is fully liquidated.

Finally, we understand that at least one entity owned by FTX would participate in the Liquidity Provider Program. The Commission should carefully consider whether to permit an entity owned by FTX to serve as a BLP, which could create the potential for wrong-way risk and conflicts of interest.

We lack the clarity on the Liquidity Provider Program to evaluate whether it can mitigate the shortcomings of an algorithmically-driven auto-liquidation program. We urge the Commission to seek additional information on the use of the Liquidity Provider Program before it concludes that the close-out procedures envisioned sufficiently protect customers and the market itself.

4. **Financial Integrity of the FTX Clearinghouse**

As noted above, critical to the functioning of futures markets is the financial integrity of the clearing house. Most DCOs have their own financial requirements and, when a clearinghouse processes margined products, the DCO’s capital is “backstopped” in waterfalls by its FCM clearing members. These backstops may include guaranty fund contributions and special assessments levied upon the FCMs. These financial resources are designed to comply with the Principles for Financial Market Infrastructure, (“PFMIs”) jointly issued by the Committee on Payments and Market Infrastructure (“CPMI”) and the International Organization of Securities Commissions (“IOSCO”), which require (in relevant part) “rules and procedures [ensuring] that FMI’s… replenish any financial resources that the FMI may employ during a
stress event, so that the FMI can continue to operate in a safe and sound manner.” See Principles for Financial Market Infrastructure, April 2012 at 37, Principle 4, Key Consideration 7.

In its Proposal, FTX submits that its combination of automatic liquidations, BLPs, conservative margin requirements (for the initial referenced products, derivatives based on BTC and ETH), and a $250 million minimum self-funded guaranty fund provides an adequate and appropriate substitute for the financial requirements set forth in the traditional clearing model (See CFTC Reg. § 39.11). The CFTC either should disclose details about this to the public, or conduct its own analysis to satisfy itself that the relevant math supports this proposition. We submit that the chart and accompanying explanation in the February 8, 2022 FTX letter to DCR Director Clark Hutchison and the April 15, 2022 article posted on FTX’s website, https://www.ftxpolicy.com, entitled “Understanding FTX’s Guaranty Fund Sizing” (“FTX Letter”) does not provide sufficient quantitative analysis, including assumptions behind such analysis, to verify the proposition.

Although FTX, in the FTX Letter, suggests that it will increase its guaranty fund over time, there is no requirement that it do so, and the formula pursuant to which this would presumably occur is not clear. Thus, while FTX has stated privately it will restore its guaranty fund if it decreases below $250 million, we ask the Commission to consider how FTX’s commitments can be mandated, if at all, by the CFTC, whether FTX should be required to maintain segregated resources to support such replenishment, and if so, how large these segregated resources should be. Furthermore, the guaranty fund is placed ahead of VMGH, a loss mutualization tool and, finally, full tear up, in the default waterfall. In light of the representations made by FTX that it has funds sufficient to support a clearing model without loss mutualization tools, we query why the guaranty fund is limited to $250 million. We urge the Commission to carefully consider the appropriate levels of capitalizations for FTX to ensure it has the ability to continue to operate in a safe and sound manner.

We also seek clarity on the capitalization for the higher risk of non-default losses (“NDLs”) at FTX. The algorithmic manner in which positions are proposed to be liquidated suggests high technological reliance and potential vulnerability to cyber-attacks. It is therefore imperative that FTX provides greater disclosures around the framework to manage technology and cyber risk and its approach to mitigating risk related to NDLs. More broadly, the framework suggests a need for significantly higher levels of CCP capitalization levels to address default and non-default losses – in the absence of robust capitalization levels, there is a significantly higher risk that FTX may run out of resources. We would urge the CFTC to require a meaningful capital framework that aligns incentives and ensures adequate capitalization to address all aspects of both default and non-default losses.

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16 FTX is well aware of the potential of crypto trading platforms to be hacked. In August 2021, Liquid Group Inc. (“Liquid”), a crypto trading platform, announced that FTX Trading Ltd. (FTX Trading”) would provide $120 million in debt financing after Liquid was reported to have sustained a $100 million hack; this deal apparently closed in April 2021: https://blog.liquid.com/liquid-ftx-dept-financing. In February 2022, Liquid announced FTX Trading would acquire Liquid and all of its operating subsidiaries: https://blog.liquid.com/acquisition-liquid-ftx.
5. Traditional DCO Default Resources

The proposed model is distinctly different in its scope of default resources than the current DCO models that exist. Accordingly, analysis of the default resources requires more than just a straightforward calculation, and instead merits close consideration of the size and the purpose of resources available. As compared to currently existing DCO models, the proposed model is more concentrated and built on certain assumptions that are thus far untested in the United States. We urge the Commission to evaluate whether the proposed model includes the necessary protective layers for margined derivatives contracts. More broadly, we note that the PMFIs require that “[a]n FMI should establish explicit rules and procedures that address fully any credit losses it may face as a result of any individual or combined default among its participants with respect to any of their obligations to the FMI.” Principles for Financial Market Infrastructure, April 2012 at 37, Principle 4, Key Consideration 7 (emphasis added). Therefore, the standard for default resources should not just be to check for a sufficient default fund in comparison to the traditional model, but should holistically evaluate the adequacy of resources to cover tail risk.

Whereas FTX is proposing to fund all of the available default resources itself, existing DCOs rely on several independent and diverse sources. Consistent with the regulatory approach of distributed responsibility, the default resources are also built on a framework of distributed responsibility for loss absorption and deflection. We urge the Commission to fully consider the implications of the concentration risk created by FTX’s unique approach.

Traditional DCOs include several layers of resources, namely, contributions to the default fund and limited assessments for replenishment, that appear not to be accounted for in the proposed model.

With respect to the sizing of its default fund, the Proposal raises several questions. First, FTX has proposed to size its default fund to cover a default by up to three participants (Cover-3) that create the largest exposure for the DCO if Cover-1 or Cover-2 does not collectively account for 10% of the initial margin on deposit. Its Guaranty Fund will be funded by $250 million of its own capital, and purportedly would cover any losses incurred on positions beyond those accepted by BLPs and to reimburse those providers if necessary. However, the proposed framework does not set a minimum coverage requirement as a percentage of the cleared market share.

We note that in the traditional model, the default resources are not limited to the contributions of the clearinghouse itself. That amount is supplemented by contributions by the clearing members. In fact, the member contributions far outweigh the so-called “skin in the game” money contributed by clearinghouses. For example, CME’s “base” service which covers all of its futures and options, has three layers of protections: $100 million in skin in the game, $5.9 billion in member contributions and we estimate $25 billion available through members assessments. Even smaller exchanges with more concentrated product ranges have amounts...
that dwarf the FTX Proposal: Nodal Clear has $20 million in skin in the game, $204 million in members contributions, and we estimate $838 million via assessment authority.\textsuperscript{17}

6. FTX Default Resources

We understand that FTX’s proposed model is extrapolated from CFTC Reg. § 39.11(a)(1)’s requirements for sizing obligations, based upon the traditional default scenarios used by DCOs that have clearing members carrying customer business, suggesting a large size for a defaulting “member.” To account for the possibility that its members may be smaller in size, FTX would size its resources using a similar scenario that purports to be more conservative. From the materials provided, it is not clear that the derived formula pursuant to which FTX would size its resources is adequate.

Under Rule 39.11, sizing a Cover-1 default includes the largest clearing member including all of its house business and customer business. This proxy of the largest 1 or 2 clearing members defaulting in a traditional CCP is not comparable to the largest 1 or 2 direct participants failing. The Cover-1 or 2 model was not developed for the failure of single clients or retail participants but is designed for the failure of FCMs (including the required close out of their clients). Effectively, the sizing of the default resources in a non-intermediated retail market based on loss of its largest three participants will be significantly smaller. In contrast, the assumptions around the default of an FCM, generally including its house and its client positions, yields a significantly higher loss that must be absorbed by the resources of the CCP. We therefore worry that covering only one or two defaulting participants in the FTX scenario would be woefully inadequate.

Furthermore, the entities considered in this Cover-1 or Cover-2 default scenario are purposefully well funded and highly regulated. In other words, the current system is built to prevent a default in the first place given the capital requirements imposed on the clearing members. Most FCMs are required to hold capital equal to 8\% of the total risk margin requirement for positions it and its customers carry. As of December 2021, FCM capital held amounted to $175 billion dollars.\textsuperscript{18} We urge the Commission to consider the embedded protections in the current model that ensure well capitalized participating clearing members in the first place in determining whether the Cover-1, Cover-2 or Cover-3 default

\textsuperscript{17}FIA estimated the assessment amounts based upon a worst-case scenario in which two of the five largest members defaulted at the same time and the losses were so large that the clearinghouses applied the maximum assessments to replenish the default fund. In such a scenario, the assessment powers would be applied only to the surviving members of the clearinghouse, and the amount would be capped at a multiple of the pre-default contributions of those surviving members. That multiple is 5.5 at both CME and Nodal Clear.

\textsuperscript{18}This includes FCMs Adjusted New Capital and Excess Net Capital reported on the CFTC’s Financial Data for FCMs report for the end of December 2021. See infra, discussion of FCM capital requirements at p. 6. CFTC Reg. § 1.17(a)(1) requires the higher of: $1 million (or $20 million for an FCM swap dealer); 8\% of its risk margin requirements (plus 2\% of its uncleared swap margin, if the FCM is a swap dealer); net capital required by any registered futures association; or, for FCMs that are securities broker/dealers, the net capital required by SEC Rule 15c3-1(a).
arrangements are even relevant to the FTX model which assumes very different direct participants.

In markets where positions are highly correlated, we believe that failures may have a cascading effect that should be assumed in market design. The effect of underestimating this potential cascading effect is that the modeling is neither extreme nor plausible. “Cover-3” is based on an assessment that the default of the three largest clearing members is highly unlikely. What analysis exists to determine how many retail FTX participants are likely to default simultaneously during a catastrophe? We urge the Commission to consider whether the proposed reference to covering up to three participants in the proposed model is really a plausible proxy for the types of losses that could be incurred.

We further invite the Commission to make public several additional pieces of information to help the market understand the appropriateness of the Proposal, including:

- How often will the size of FTX’s Guaranty Fund contribution be recalibrated?
- How does FTX intend to replenish its resources in case the Guaranty Fund has been used in part, and according to what schedule?
- Does FTX maintain a reserve fund ensuring additional and dedicated funding, assuming any replenishment would come from FTX’s own capital?
- Given the lack of ability to make assessments, what other resources are available in the FTX waterfall should the Cover-3 resources be insufficient?
- How will FTX monitor the use of the Default Resources across closeout providers to ensure the default resources are not exceeded while performing the closeout(s)?

The CFTC has spent years of time, attention, and thought upon CCP resilience, recovery, and resolution since the enactment of the Dodd-Frank Act. So have other U.S. financial regulators, and the international financial regulatory community through the CPMI-IOSCO and FSB. They have established principles and guidance, by which even many non-systemically important U.S. DCOs voluntarily abide. We ask the CFTC to ensure these principles are applied to this Proposal.

Given the interconnectedness of global markets, and the fact that products covered by the FTX Proposal can potentially be extended to other, more traditional asset classes cleared at other CCPs, what happens on one DCO (or CCP) is often not limited to that particular clearinghouse, and can have broader financial stability consequences. See Sklar, Federal Reserve Bank of Chicago, Systemic Implications of Access to Central Bank Accounts for CCP (found at https://www.chicagofed.org/~/media/publications/working-papers/2020/wp2020-21-pdf.pdf). Thus, the underlying principles governing application of law and policy to derivatives clearinghouses are of widespread, fundamental importance to the markets.

7. Margin Calculations and Handling
Although FTX indicates it will use a VAR model with a minimum 1-day margin period of risk (MPOR), there is no modeling available for review. The regulatory minimum for margin requirements is a model that covers risk with a confidence interval of 99% based on a one day MPOR. We note that the information available on the FTX margin framework is fairly limited with no discussion of concentration margin and how it is charged. Furthermore, the Proposal does not state whether FTX would maintain position limits or charge additional margin to prevent positions from becoming outsized, or provide detail on the efficacy of the anti-procyclicality tools used by FTX. Considering the volatility of crypto products, anti-procyclicality tools are critical to ensure the integrity of the marketplace. We therefore submit that the CFTC should carefully consider FTX’s margin modeling with these questions in mind.

It is also worth considering that today, FCMs often challenge the adequacy of margin rates assessed by DCOs. When FCM proprietary models indicate that DCO margin rates inadequately cover potential market moves, FCMs may charge premiums to DCO margin rates, protecting themselves from a potential default by their customers and, thereby, also protecting the customer asset pool and the DCO. It is not clear who will similarly evaluate and mitigate against potential under-margining by FTX.

Finally, we note concerns about using customer’s margin to fund FTX’s business needs. The proposed FTX Rulebook includes a provision in Rule 7.G.5. that permits FTX to use participant initial margin and maintenance margin for meeting the Cover-1 liquidity needs of FTX. It is not clear how this rule is compatible with requirements that the DCO segregate customer funds from its own funds, and it merits closer consideration. Given the lack of margin calls, we expect that participants may want to overfund accounts in order to avoid liquidation. We believe it is crucial for the CFTC to make clear that excess participant funds are to be segregated at all times from the DCO’s funds.

8. Event of Bankruptcy

FIA notes that it is also not clear what would happen should FTX go bankrupt. For instance, pursuant to Subpart C of applicable bankruptcy rules (CFTC Reg. § 190.11 et seq.), all property in this model is member property. Thus, if there is a shortfall in the member account, all Kalshi collateral (100% collateralized products cleared by FTX) and all FTX leveraged products will be in the same class. The impact of the single member account class in the Part 190 Regulations is that fully collateralized Kalshi customers would subsidize the losses of FTX margined customers in an FTX bankruptcy.

Given that participants would likely wish to overfund the account to avoid auto-liquidation, we question what would happen to those funds in a bankruptcy. With these apparent gaps and

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19 The CFTC Bankruptcy Regulations have different subparts for an FCM bankruptcy (Part 190, Subpart B) and a DCO bankruptcy (Part 190, Subpart C). Various parts of the CFTC Bankruptcy Rules have different definitions for FCMs and DCOs. For example, the definition of “non-public customer,” “public customer,” and “customer” all differ between an FCM and a DCO. Thus, being a customer of an FCM versus being a direct member of a DCO may have important implications in a bankruptcy scenario. The Commission should investigate and fully understand these potential implications of the FTX model.
potential issues, we urge the Commission to consider whether the Part 190 Regulations fit and accommodate the proposed expansion of the DCO offering pursuant to the FTX Proposal.


The FTX Proposal raises a fundamental concern about governance. As the CFTC knows, the cleared market is intentionally set up with checks and balances within the system. The DCOs have an oversight function of the FCMs; the FCMs participate in checking the risk management of the DCOs; regulatory authorities take feedback from both on proper risk management of the system as a whole; and a comprehensive, principled regulatory regime emerges and functions. Given the expected initial makeup of its member base (i.e., primarily retail participation), we would recommend greater clarity on how FTX expects to obtain meaningful input on its risk management, legal and operational practices, and governance from its market participants. Further, we query how FTX will avail itself of market expertise which, at intermediated models, is often provided through default management committees represented by FCMs/brokers.

FIA believes that the oversight plans for the proposed model also need more clarity. For example, it is not clear which entity or entities at FTX will act as the Self-Regulatory Organization (“SRO”). The Rulebook defines SRO as “includ[ing] a DCO,” but DCOs are not themselves SROs, see CFTC Reg. § 1.3. We urge the Commission to further consider whether FTX could effectively and fairly perform all the functions of an SRO, including whether it could audit its own entity, and whether it would adhere to and participate in the Joint Audit Committee and its standards.

A related concern is the frequency of defaults of participants, and FTX’s subsequent market activity in its own market. In all likelihood, both the average number of defaults, and the average number of simultaneous defaults, will be higher than under a traditional clearing model. The resulting position liquidations, whether algo-driven or not, will cause FTX itself to become a substantial market player in the market it operates. This level of active market participation by the CCP would be unseen not only with respect to CCPs under the traditional market, but also with respect to any traditional broker/retail aggregator. This raises concerns with regard to the market structure.

One of the primary sources of transparency for CCPs is the PFMI’s Public Quantitative and Qualitative Disclosures. We strongly encourage FTX to issue Public Quantitative Disclosures as set forth in IOSCO’s PFMI. This might seem a logical step in ensuring the integrity of the FTX market.

10. Ownership

FTX shares common ownership with large trading firms doing business in the cryptocurrency markets. This is not unique to FTX. In fact, many trading venues are partly owned by market participants that have a direct interest in helping the venue grow. There are, however, some potential conflicts of interest in these arrangements and it is important to establish protections to ensure a level playing field. There is a lack of transparency into how the firms with common ownership with FTX participate in the markets that it operates and what advantages they might receive relative to other trading firms that do not share common ownership. There is also a lack
of information into how these firms participate in the liquidation process and the backstop liquidity program.

As the CFTC considers this issue, we urge the Commission to look to the precedents set in the agency’s implementation of the Dodd-Frank Act. During that process, the CFTC devoted entire sets of rules to both internal and external risk management with respect to entities that participate within the clearing portion of the business on the one hand, and within the dealing portion of the business on the other. At a minimum, we would expect that similar protections be required to ensure that the model does not create embedded advantages for certain participants. Additionally, the CFTC may want to consider conditions that prevent conflicts.

11. Impact on Non-Crypto Markets

As noted above, the FTX model as submitted to the Commission could apply to any type of future, option, or centrally cleared derivatives product. The simultaneous availability of both the existing DCM/DCO model and the proposed model for the same products could create unique issues that we urge the Commission to evaluate. For example, the 24/7/365 nature of the FTX model, compared to the current model of regular trading hours during weekdays, creates the potential for disparities among the exchanges and potential impacts to price formations, trading behaviors, including disruptive trading behaviors. In addition, the FTX model contemplates liquidating positions in a manner different from other models which could have wider market impacts. This could create opportunities for unwanted and possibly disruptive arbitrage between an auto-liquidated market and traditional markets listing the same products. The Commission should consider what consequences the simultaneous running of these different models could have on the system as a whole.

III. Conclusion

We appreciate the opportunity to provide the foregoing comments on the FTX Proposal. We hope it is clear from this letter that FIA strongly believes in the fundamental regulatory principle: same business, same risks, same rules, used most recently in President Biden’s Executive Order on digital assets and cryptocurrencies. FIA believes that that principle is appropriate here and its implementation will lead to ensuring a level playing field to those providing services in the market, and will protect customers by ensuring they receive all the components of a robust regulatory framework.

Thank you again for the opportunity to comment. Please contact Allison Lurton, Senior Vice President and General Counsel, at 202-466-5460, if you have any questions about this letter.

Sincerely,

Allison Lurton
General Counsel and Chief Legal Officer