



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and Risk

CFTC Letter No. 17-35
Exemption
July 24, 2017
Division of Clearing and Risk

Mr. Paul Chou
Chief Executive Officer
LedgerX
54 West 40th St. Ste. 819
New York, NY 10018

RE: Request for Exemptive Relief from Certain Derivatives Clearing Organization Regulations

Dear Mr. Chou:

This exemptive letter responds to your request dated May 23, 2017 (“Request”) for exemptive relief from certain provisions of Commodity Futures Trading Commission (“Commission”) regulations applicable to registered derivatives clearing organizations (“DCOs”).¹ According to the Request, LedgerX seeks exemptive relief from certain provisions of Part 39 of the Commission’s regulations due to the nature of LedgerX’s fully-collateralized clearing model. The specific provisions from which LedgerX seeks exemptive relief and the relief granted by the Division are discussed below.

I. Overview of LedgerX

LedgerX submitted an application for DCO registration on January 25, 2017.² Section 5b(c)(2)(A)(i) of the CEA³ provides that to be registered and to maintain registration with the Commission, a DCO must comply with the CEA’s core principles applicable to DCOs and with the Commission’s implementing regulations (*i.e.*, Part 39). LedgerX’s application did not address all of the Part 39 regulations, however, due to the nature of LedgerX’s clearing model.

¹ Under Regulation 140.99(a)(1), the Division of Clearing and Risk (“Division”), acting under delegated authority from the Commission, may issue a written grant of relief from the applicability of the Commodity Exchange Act (“CEA”) or of a rule, regulation or order issued thereunder by the Commission. Only the party requesting an exemptive letter may rely on the letter. Commission regulations referred to herein are found at 17 C.F.R. Ch. I (2017).

² LedgerX concurrently submitted an application for registration as a swap execution facility (“SEF”).

³ 7 U.S.C. § 7a-1(c)(2)(A)(i) (2017).

LedgerX is a fully-collateralized DCO, meaning that a participant must provide LedgerX with collateral sufficient to cover the maximum potential loss of the contract before the trade can be executed. LedgerX performs a pre-trade credit check to ensure each participant has sufficient collateral at Ledger X or a LedgerX-approved depository to cover the participant's maximum potential loss or delivery obligation.⁴ LedgerX accepts U.S. dollars and the commodity underlying the contract (*i.e.*, bitcoin) as collateral.

LedgerX is structured to allow participants to either self-clear or clear through a futures commission merchant ("FCM"), but anticipates that its initial participants will be self-clearing. Because LedgerX will initially clear only for its own SEF,⁵ LedgerX represents that all participants will be "eligible contract participants," as defined under Section 1a(18) of the CEA and Regulation 1.3(m). Participants must also satisfy other eligibility criteria before they can clear contracts through LedgerX.

II. Specific Provisions of Part 39

A. Financial Resources

Regulation 39.11(c)(1). Regulation 39.11(c)(1) requires a DCO to perform monthly stress testing in order to make a reasonable calculation of the financial resources it would need in the event of a default by the clearing member creating the largest exposure. LedgerX asserts that the monthly stress testing requirement in Regulation 39.11(c)(1) is not applicable to LedgerX because of its fully-collateralized clearing model. LedgerX indicates that by requiring participants to fully collateralize a position prior to execution, it ensures that it has enough funds on deposit to cover each participant's maximum loss. Because collateral sufficient to cover the maximum possible loss is already on deposit, LedgerX represents that it achieves the goal of the stress testing requirement in Regulation 39.11(c)(1), and any stress testing is therefore unnecessary. Thus, LedgerX seeks an exemption from the requirement to stress test its financial resources on a monthly basis pursuant to Regulation 39.11(c)(1).

Regulation 39.11(e)(1)(ii). Regulation 39.11(e)(1)(ii) requires a DCO to have financial resources sufficiently liquid to enable the DCO to fulfill its obligations as a central counterparty during a one-day settlement cycle. It further requires that a portion of those financial resources be in the form of cash, U.S. Treasury obligations, or high quality, liquid, general obligations of a sovereign nation, and sets forth the method for calculating that portion. LedgerX represents that it maintains sufficient liquidity by requiring that participants deposit collateral in the form of the participant's obligation, either cash or the underlying asset, prior to trade execution. LedgerX

⁴ Participants are fully collateralized in that they must post, on a pre-trade basis, the maximum amount that the clearing house would need to pay on a contract, with the exception of the amount that a long option holder would need to post if it later chose to exercise the contract. In this way, the clearing house is fully protected in the event that a contract is exercised; full collateralization does not mean that the clearing house holds, on a pre-trade basis, all funds that would be transferred in the event a contract is exercised.

⁵ LedgerX may, in the future, clear for one or more designated contract markets.

further indicates that the calculation required by Regulation 39.11(e)(1)(ii) would demonstrate that it holds liquid collateral in an amount equal to its obligations as a central counterparty during a one-day settlement cycle, and that the result of the calculation would not change from day to day because it operates as a fully-collateralized DCO. As a result, LedgerX seeks an exemption from Regulation 39.11(e)(1)(ii).

Relief

Based on LedgerX's representations, it is the Division's understanding that LedgerX would not need to perform monthly stress testing, because it would ensure that 100% of any exposure on a trade is fully collateralized before the trade can be executed. Based on these representations, the Division exempts LedgerX from complying with the stress testing requirement in Regulation 39.11(c)(1). With respect to the calculation requirement in Regulation 39.11(e)(1)(ii), LedgerX indicates that even if it performed this calculation, the result of the calculation would not change from day to day because it is fully collateralized. Based on LedgerX's representations, the Division exempts LedgerX from complying with Regulation 39.11(e)(1)(ii) because it maintains sufficient liquidity by having funds on hand sufficient to meet daily obligations.

B. Product and Participant Eligibility

Regulation 39.12(a)(5)(i). Under Regulation 39.12(a)(5)(i), a DCO must require all of its clearing members, including those that are not FCMs, to provide the DCO with periodic financial reports that contain any financial information that the DCO determines is necessary to assess whether participation requirements are being met on an ongoing basis. The regulation further requires that the DCO require its non-FCM clearing members to make these reports available to the Commission upon Commission request, or for the DCO itself to provide the reports to the Commission. LedgerX seeks exemptive relief from these requirements for its non-FCM participants.⁶ LedgerX represents that its participants would present no credit or default risk to LedgerX because they must fully collateralize trades. In addition, LedgerX notes that participants will be individuals or entities that are not registered with the Commission.

Relief

The purpose of Regulation 39.12(a)(5)(i) is to ensure that a DCO has the means to assess its clearing members' compliance with the DCO's participation requirements. The Division's understanding is that LedgerX requires its participants to fully collateralize any trade before the trade may be executed; as a result, LedgerX's participants present no credit or default risk to LedgerX. Therefore, LedgerX would not need to receive periodic financial reports from participants in order to assess their compliance with LedgerX requirements. Accordingly, the

⁶ LedgerX has limited its request for relief in this regard to its non-FCM participants. To the extent it has one or more FCM participants in the future, LedgerX affirms that because FCM participants would handle customer funds, LedgerX rules require that FCM participants provide LedgerX with "statements of financial condition at such times and in such manner as may be required from time to time." See LedgerX Rule 3.3.K.8.

Division exempts LedgerX from the requirements of Regulation 39.12(a)(5)(i) with respect to its non-FCM participants.

C. Risk Management

Regulation 39.13(h)(3). Regulation 39.13(h)(3) requires a DCO to conduct stress testing on a daily basis with respect to each large trader who poses significant risk to a clearing member or the DCO, and on at least a weekly basis with respect to each clearing member account, by house origin and by each customer origin. LedgerX represents that because it is not a margined DCO and requires full collateralization prior to trade execution, it would not need to conduct stress tests with respect to large traders to achieve the intended risk management goals of the tests. LedgerX further represents that it intends to evaluate large trader reports primarily for market surveillance and trade practice purposes, but not for risk management purposes.

Relief

Based on LedgerX's representations, it is the Division's understanding that LedgerX would not need to conduct daily stress testing because it would ensure that 100% of any exposure on a trade is fully collateralized before the trade can be executed. Based on these representations, the Division exempts LedgerX from complying with Regulation 39.13(h)(3).

D. Treatment of Funds

Regulation 39.15(d). Regulation 39.15(d) requires a DCO to have rules providing that the DCO will promptly transfer all or a portion of a customer's portfolio of positions and related funds at the same time from the carrying clearing member of the DCO to another clearing member of the DCO, without requiring the close-out and re-booking of the positions prior to the requested transfer, subject to certain conditions. LedgerX has indicated that it will not have any FCM participants at the outset of its clearing operations, and it seeks exemptive relief from Regulation 39.15(d) so long as it has one or fewer FCM participants.

Relief

It is the Division's understanding that LedgerX will not initially have FCM participants, which means there will be no clearing on behalf of customers. Accordingly, the requirements of Regulation 39.15(d) do not apply to LedgerX under the present circumstances, as the purpose of the transfer provision is to permit a customer to move positions and funds from one FCM to another without having to close out and re-book those positions. Based on LedgerX's representations, the Division exempts LedgerX from compliance with Regulation 39.15(d) so long as LedgerX has one or fewer FCM participants. In the event that LedgerX adds only one FCM participant, then that participant would not have another FCM to which it could transfer the positions of its customers. In the event that LedgerX adds more than one FCM participant, however, the Division would expect LedgerX to comply with Regulation 39.15(d) as it pertains to those participants.

E. Daily Reporting

Regulation 39.19(c)(1)(i)(B). Regulation 39.19(c)(1)(i)(B) requires a DCO to provide to the Commission, on a daily basis, a report containing information on daily variation margin payments, separately listing the mark-to-market amount collected from or paid to each clearing member, by house origin and by each customer origin. LedgerX seeks exemptive relief from this requirement because it requires full collateralization prior to the execution of a trade and, therefore, will not collect or pay daily variation margin.

Regulation 39.19(c)(1)(i)(D). Regulation 39.19(c)(1)(i)(D) requires a DCO to provide to the Commission, on a daily basis, a report containing the end-of-day positions for each clearing member, by house origin and by each customer origin. LedgerX seeks exemptive relief from this requirement because it requires full collateralization prior to the execution of a trade.

Regulation 39.19(c)(1)(ii). Regulation 39.19(c)(1)(ii) requires that the reports discussed above include information regarding: (A) all futures and options positions, as applicable; (B) all swaps positions; and (C) all securities positions that are held in a customer account subject to Section 4d of the CEA or are subject to a cross-margining agreement. For the reasons stated above, LedgerX seeks exemptive relief from this requirement as it pertains to paragraphs (c)(1)(i)(B) and (c)(1)(i)(D) of Regulation 39.19.

Relief

LedgerX has indicated that it requires full collateralization and, therefore, will not collect daily variation margin. It is the Division's understanding that, due to the full collateralization, LedgerX's participants' positions do not pose any risk to the DCO or its other participants. Consequently, the Commission does not need access to end-of-day position data to monitor the risk at LedgerX. Based on these representations, the Division exempts LedgerX from Regulations 39.19(c)(1)(i)(B) and (D). By virtue of the exemption from these provisions, the Division also exempts LedgerX from Regulation 39.19(c)(1)(ii) as it pertains to paragraphs (c)(1)(i)(B) and (c)(1)(i)(D) of Regulation 39.19.⁷

F. Public Information

Regulation 39.21 (c)(3), (4), and (6). Paragraphs (c)(3), (4), and (6) of Regulation 39.21 respectively require public disclosure of a DCO's margin-setting methodology, the size and composition of the financial resource package available in the event of a clearing member default, and its default rules and procedures. LedgerX has indicated that, due to its fully-collateralized clearing model, it does not use a margin methodology and does not face the risk of a participant default. As a result, LedgerX seeks relief from complying with paragraphs (c)(3), (4), and (6) of Regulation 39.21.

⁷ Although this letter exempts LedgerX from certain daily reporting under Regulation 39.19(c)(1), the Commission retains the right to obtain reports upon request under Regulation 39.19(c)(5).

Relief

In a previous letter,⁸ the Division expressed its view that a DCO's full-collateralization requirement satisfies the requirements of Regulations 39.11(a) (1) (the requirement to have sufficient financial resources to withstand a clearing member default), 39.13(g) (the requirement to have a risk-based margin methodology), and 39.16 (the requirement to have default rules and procedures). In light of this, the Division interprets LedgerX's full-collateralization requirement as satisfying Regulation 39.21(c)(3), (4), and (6).

Regulation 39.21(d). Regulation 39.21(d) requires a DCO to make its rulebook, a list of all current clearing members, and the information listed in paragraph (c) (as discussed immediately above) readily available to the general public in a timely manner, by posting the information on the DCO's website. LedgerX requests relief from the requirement to make public a list of its participants, except for those that are FCMs. LedgerX anticipates that its participants will be individuals or entities that are not registered with the Commission, and consequently believes it is not appropriate to publicly disclose their names.

Relief

The Division understands that initially, LedgerX's participants will be individuals or entities that are not registered with the Commission. The Division notes that the purpose of publishing a list of clearing members is to provide market participants with sufficient information to enable them to identify and evaluate the risks and costs associated with using the DCO's services. Because each LedgerX participant must fully collateralize its own trades, and LedgerX does not have a mutualized default fund, participants do not face the risk of needing to cover fellow participant losses. Therefore, based on these representations, the Division exempts LedgerX from complying with Regulation 39.21(d), except that LedgerX must make public a list of any of its FCM participants.

⁸ See CFTC Interpretative Letter No. 14-05 (Jan. 16, 2014) (responding to a request from North American Derivatives Exchange, Inc. for an interpretation of certain Commission regulations applicable to registered DCOs).

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III. Conclusion

This letter is based upon the representations of LedgerX, as well as applicable laws and regulations as currently in effect. The Division believes that granting the Request would not be contrary to the public interest or to the purposes of those provisions of the Commission regulations from which LedgerX has sought relief. However, any new, different or changed material facts or circumstances could change the Division's position and render this letter void. Moreover, this letter represents the position of the Division only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission. If you have any questions, please do not hesitate to contact Scott Sloan, Attorney Advisor, at (312) 596-0708.

Very truly yours,

John C. Lawton
Acting Director