FTX US Derivatives

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February 8, 2022

VIA EMAIL

Mr. Clark Hutchison
Director, Division of Clearing & Risk
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Permissibility and Benefits of Direct Clearing Model under the Commodity Exchange Act and CFTC Regulations

Dear Mr. Hutchison:

LedgerX LLC, d/b/a FTX US Derivatives ("FTX"), recently submitted an application requesting that the Commodity Futures Trading Commission ("CFTC") amend its Amended Order of Registration as a derivatives clearing organization ("DCO"), thereby allowing FTX to offer margin directly to customers. In support of that application, FTX offers the following explanation of how this approach, which would not rely on intermediation, is permitted by the Commodity Exchange Act (the "CEA") and CFTC Regulations. FTX will also demonstrate how its proposed risk management framework is comparable to the clearing-related requirements imposed on clearing futures commission merchants ("FCMs").

As set forth below, FTX plans to lead futures markets in the United States into the 21st century, without compromising traditional risk management, customer protection, or systemic risk mitigation expectations. With dramatic improvements in technological infrastructure over the past twenty years, companies such as FTX are now able to provide their customers with direct access to exchange and clearing services, as FTX has now done for several years. FTX aims to build on these technological advancements by offering margin directly to its customers.

FTX fully appreciates the risks that arise from offering margin and plans to implement the following risk management standards that will exceed historical expectations. First, instead of relying on traditional weekly margin calculations, FTX will assess its customers' abilities to meet their margin requirements approximately once per second. Second, by operating 24 hours a day, 7 days a week, 365 days a year, FTX can implement real-time market monitoring tools to immediately react to market changes and avoid major risks to clearinghouse stability. Third, FTX will remove friction, delay, and reduce operational risk in the assessment and timely de-risking of accounts, as appropriate, through direct interactions with customers. Finally, to support the resilience of our clearinghouse, FTX will rely on backstop liquidity providers and the $250 million in unencumbered cash it has contributed to its Guaranty Fund — one of the largest self-funded cash contributions for a derivatives clearinghouse in the United States.

While FTX understands that historical market practices envisioned an intermediated marketplace where brokers interfaced directly with customers, the CEA does not mandate a one-size fits all approach. As we look to the future of regulated derivatives markets, crypto-asset platforms and other nascent exchanges have pursued a direct-membership model where

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investors onboard directly to the trading and clearing platforms, and not through an intermediary or broker.[2] The traditionally manual modes of interacting with markets, intermediated or not, have largely been replaced with technology that provides immediate, direct access. These technological developments have enabled the use of automated or programmed strategies for faster and more efficient trading decisions. By utilizing this technology, FTX and others already directly provide services to customers who do not have the infrastructure or relationships to support the involved clearing mechanisms other firms require.[3] In other words, the direct-access model democratizes futures trading access.

Having operated a direct-access exchange and clearinghouse without intermediaries for several years now, FTX has already developed DCO operations that often exceed or are comparable to key FCM duties prescribed by CFTC Regulations, including: (a) maintenance of adequate financial resources; (b) safeguarding customer money, securities, and other property; and (c) implementing appropriate eligibility access criteria.[5] Additionally, other clearing-related functions traditionally performed by FCMs, including know your customer ("KYC") and anti-money laundering ("AML") functions,[6] are currently performed by FTX.[7] For other clearing-related requirements, the FTX clearinghouse is also already subject to an enhanced set of regulations relative to an FCM, such as the CFTC's rigorous systems safeguards regime related to cybersecurity and other operational risks[8] and recordkeeping requirements.[9]

With this application to amend its DCO registration, FTX seeks to build on its years of experience of offering direct access by offering margin directly to its customers, without clearing FCMs. For the benefit of the CFTC and the public, FTX provides the following summary of: (I) the risk management process for FTX's non-intermediated model; (II) how FTX intends to perform relevant clearing functions that an FCM traditionally undertakes; and (III) trading-related functions that an FCM may perform that FTX believes to be outside the scope of this request to amend its clearing order.

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2 *See* FTX's Key Principles for Market Regulation of Crypto-Trading Platforms, *available at* https://blog.ftx.com/policy/ftx_key_principles/.

3 *See* Eris Exchange, LLC, KalshiEx LLC, and Nadex.

5 While FTX is currently seeking an amendment only to its DCO order of registration, and the focus of this analysis is on clearing-related duties, a comprehensive list of both clearing and exchange-related FCM duties and requirements prescribed by both CFTC regulations and NFA rules may be found here: *NFA Regulatory Requirements for FCMs, IBs, CPOs, and CTAs* (August 2021), https://www.nfa.futures.org/members/member-resources/files/regulatory-requirements-guide.pdf.

6 *See* CFTC Regulation 42.2 and NFA Interpretive Notice 9045 – NFA Compliance Rule 2-9: FCM and IB Anti-Money Laundering Program; NFA Interpretive Notice 9070 – NFA Compliance Rules 2-9, 2-36, and 2-49: Information Systems Security Programs.

7 For example, both Eris Clearing LLC and FTX are required to comply with the Bank Secrecy Act, the International Emergency Powers Act, the Trading with the Enemy Act, and any Executive Orders and regulations issued thereto, as a condition of their DCO Orders of Registration. *See* Eris Clearing, LLC DCO Registration Order (Nov. 2, 2020) and LedgerX, LLC Amended Order of DCO Registration (September 2, 2020).

8 CFTC Regulation 39.18.

9 DCO Core Principle K and CFTC Regulation 39.20 set forth clearing-related recordkeeping requirements comparable to those imposed on FCMs through CFTC Regulation 1.36.

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I. <u>DCO Risk Management With A Direct-Access Business Model</u>

Building on years of experience offering exchange and clearing services directly to customers, FTX now also seeks to extend margin directly to its customers. Although the traditional clearinghouse model has resulted in the risk of margin mutualized among DCO clearing members, the CEA does not require this historical business practice. Rather, the CEA merely requires that DCOs manage their risks appropriately. FTX aims to manage such risks by monitoring its customers' positions in real-time and taking appropriate and timely action to de-risk accounts in default in the following manner. First, FTX will seek to liquidate a position on FTX's central limit order book ("CLOB"), which remains open at all times.[10] If that is not practicable, FTX will attempt to lay off positions with backstop liquidity providers. Finally, FTX will use its reserve of $250 million in unencumbered cash to cover any remaining residual risk to the clearinghouse or its customers. At the end of the waterfall, in the unlikely event the Guaranty Fund is exhausted, traditional DCO default management tools will be available.

A. DCOs are not required to mutualize risk among intermediaries

While many DCOs mutualize losses among clearing members (typically FCMs), this practice is not required by the CEA. Under Section 1a(15) of the CEA, "derivatives clearing organization" is defined as "a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that, with respect to an agreement, contract, or transaction" that satisfies one of the following three disjunctive prongs:

> (i) enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties;
>
> (ii) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the derivatives clearing organization; **<u>or</u>**
>
> (iii) otherwise provides clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such agreements, contracts, or transactions executed by the participants.[11]

Significantly, only the third prong refers to the mutualization of credit risk among clearing members. Because a clearinghouse only needs to satisfy one of the above three disjunctive prongs of the DCO definition, a DCO is not required to adopt a business model that mutualizes

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[10] An FCM's or broker-dealer's authority to liquidate a customer's account that is in default is well-established under federal securities and commodities laws. *See, e.g., In re MF Global Inc.*, 531 B.R. 424, 435-36 *(Bankr. S.D.N.Y 2015); Moss v. J.C. Bradford and Co.,* 337 N.C. 315, 326-27 (1994) ("In light of the fact that rules governing margin calls and account liquidation are for the protection of the merchant and commodities exchange itself, we interpret the federal regulatory scheme in the area of futures trading, including CME Rule 827, to permit the liquidation of a customer's account without prior demand or notice.").

[11] CEA § 1a(15)(A) (emphasis added).

default risks among clearing members. This is supported by the CFTC's own statements: "The Commission is of the view that each DCO should be afforded an appropriate level of discretion in determining how to operate its business within the legal framework established by the CEA, as amended by the Dodd-Frank Act."[12]

B. The FTX direct-access model offers an innovative means to monitor and manage risks more effectively

Section 5b(c)(2)(D) of the CEA, implemented through CFTC Regulation 39.13, requires each DCO to ensure that it possesses the ability to manage the risks associated with discharging the responsibilities of the DCO through the use of appropriate tools and procedures, including written policies, procedures, and controls that establish an appropriate risk management framework, and is approved by the DCO's board of directors. At a minimum, the framework must clearly identify and document the range of risks to which the DCO is exposed, address the monitoring and management of the entirety of those risks, and provide a mechanism for internal audits.

CFTC Regulation 39.13 gives DCOs discretion, within specified limits, in setting, modeling, validating, reviewing and back-testing margin requirements.[13] In implementing the risk management framework, a DCO must appoint a chief risk officer to make appropriate recommendations to the DCO's risk management committee or board of directors regarding the DCO's risk management functions. Accordingly, "a DCO should adopt a comprehensive and documented risk management framework that addresses all of the various types of risks to which it is exposed and the manner in which they may relate to each other."[14] A sufficient risk management framework should include a daily assessment of the DCO's adequacy of its initial margin requirements, valuation of the initial margin assets, back-testing of products that are experiencing significant market volatility, and conducting of stress tests with respect to each large trader who poses significant risk.

Additionally, FCM risk management requirements are very similar to those imposed on DCOs. CFTC Regulation 1.11 requires each FCM to establish, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the FCM. The FCM's risk management unit must give quarterly risk exposure reports to senior management and the CFTC. For FCMs that act as clearing members of a DCO, the CFTC adopted Regulation 1.73. Under CFTC Regulation 1.73, a clearing FCM is required to: (i) evaluate its ability to meet initial and variation margin requirements at least once per week; (ii) evaluate its ability to liquidate positions in an orderly manner at least once per quarter; and (iii) test lines of credit once per year.

When comparing the risk management standards imposed on DCOs and FCMs, FTX believes that a direct clearing participant of a DCO will receive comparable protections to an FCM's customers. Notwithstanding the comparability of DCO and clearing FCM risk management requirements, in practice, FTX proposes to monitor and manage customer risk in

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[12] *Derivatives Clearing Organization General Provisions and Core Principles ("DCO Final Rule")*, 76 Fed. Reg. 69334, 69,335 (Nov. 8, 2011).
[13] *Id*. at 69,365-76.
[14] *DCO Final Rule*, 76 Fed. Reg. at 69,363.

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a more stringent fashion than is required by either regime, as described in the proposed default rules and Exhibit G.

In addition to the traditional risk management functions that FTX will be performing, the following are some noteworthy examples of improvements on traditional risk management practices that FTX will implement:

- FTX will rely only on collateral deposited with FTX when evaluating its risk exposure, as opposed to holistic credit checks that rely on information, such as a person's worth, occupation, credit score, and other information that may be stale at any particular point in time.
- FTX will measure all participant account values in real-time, as opposed to periodic snapshots.
- Settlement variation margin will be exchanged on a near real-time basis to avoid the accumulation of large losses over time.
- FTX will factor concentration and liquidity risks into initial margin requirements.
- FTX will stress test liquidity needs daily to ensure adequacy of resources.
- When participant positions fall below the maintenance margin threshold, FTX will liquidate positions rapidly, intra-day on the CLOB.
- If FTX is unable to liquidate a position on the CLOB, FTX will resort immediately to agreements with backstop liquidity providers who agree to accept a pre-negotiated volume of liquidation orders over a specified timeframe.
- If the backstop liquidity providers cannot cure a participant's shortfall, FTX will draw from its $250 million reserve fund capitalized by unencumbered cash to cover any remaining risk to the clearinghouse or its customers.

C. To reserve against defaults by participants, FTX will utilize backstop liquidity providers and $250 million of its own capital

As FTX intends not to rely on clearing FCMs or otherwise require that its participants mutualize the risk to the clearinghouse, FTX does have resources beyond liquidating positions on its CLOB to manage margin risk.

Following reasonable efforts to liquidate positions on the CLOB, FTX proposes a "backstop liquidity provider program," which will effectively mutualize a portion of the clearing risk among a select group of professional traders who can absorb and lay-off risk that may be temporarily difficult to resolve in the open market. To serve as a backstop liquidity provider, a trader will need to meet certain criteria. For example, the trader must agree to provide a certain minimum amount of backstop liquidity to be available on a 24/7 basis, and to provide initial and variation margin payments within a short period of time. In addition to these providers, other holders of large positions will be able to serve as secondary backstop liquidity providers. In the event clearing member defaults result in account deficits, however, FTX will then rely primarily on $250 million of its own unencumbered capital to manage margin risks.

II. Having Successfully Operated A Direct-Access Exchange and DCO for Several Years, FTX Has Already Proven Its Ability To Perform Many Functions Traditionally Undertaken by FCMs

A. FTX maintains considerable financial resources and reports to the CFTC routinely

The financial stability of a DCO, or an FCM, is based upon the premise that the entity has and maintains adequate financial resources to remain operational, and to meet its obligations to customers, clearing members, and operational costs. Pursuant to Section 4f(b) of the CEA, an FCM must meet certain minimum financial requirements prescribed by the CFTC. Furthermore, CFTC Regulation 1.17 sets forth adjusted net capital requirements for FCMs. For an FCM that is not a broker-dealer, a security-based swap dealer, or a security-based major swap participant, the FCM must maintain adjusted net capital equal to, or exceeding the greater of: (i) $1 million or (ii) the FCM's risk-based capital requirement (*i.e.*, 8% of the total risk margin requirement for positions carried by the FCM in customer accounts and non-customer accounts).

Similarly, for a DCO to meet Section 5b(c)(2)(B) of the CEA and CFTC Regulation 39.11, the DCO must have adequate financial, operational, and managerial resources "as determined by the Commission" to discharge each responsibility of the DCO. A more quantitative metric of this requirement is that the DCO must possess financial resources that exceed the total amount that would enable the DCO to meet its financial obligations to its clearing members notwithstanding a default by its largest member, based on the value of the DCO's own capital, guaranty fund deposits, default insurance, and certain assessments of additional guaranty fund contributions. The DCO must also possess financial resources, limited to its own capital, that exceed the total amount that would enable the DCO to cover operating costs for one year. Notably, the Commission declined to adopt a minimum capital requirement for DCOs. Instead, the Commission emphasized that it is appropriate "to provide flexibility to DCOs in designing their financial resources structure so long as the aggregate amount is sufficient."[16]

To this point, as described above, FTX has committed $250 million of its own unencumbered capital to meet its obligations as a DCO in the event of a participant's default. Although some clearinghouses rely upon guaranty fund deposits and assessments from clearing members to meet their financial resources obligations, the Commission has provided DCOs flexibility with meeting the financial resources requirement, so long as the resources are permissible. For example, ICE NGX, which operates a direct clearing model, relies upon participant collateral, a guarantee fund in the form of a letter of credit, cash, and default insurance to meet its financial obligations under DCO Core Principle B.[17]

Furthermore, as a registered Designated Contract Market ("DCM") and DCO, FTX is also subject to robust systems safeguard requirements.[18] To satisfy these requirements, FTX has adopted a comprehensive system safeguard program designed to identify and minimize

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[16] *Id.* at 69,347.
[17] *See* https://www.theice.com/ngx/clearing-settlement.
[18] CFTC Regulations 38.1050-51; Regulation 39.18.

operationalize risk. FTX has also implemented controls relating to information security, including controls related to: access to systems and data; user and device identification and authentication; vulnerability management; penetration testing; business continuity and disaster recovery processes; and security incident response and management, among others.

B. FTX has a track record demonstrating protection of customer money, securities, and property

One of the CEA's fundamental components is the protection of customers, and the safeguarding of customer money, securities or other property pledged to margin, guarantee, or secure trades or contracts. Section 4d of the CEA directs FCMs to segregate customer money, securities, and other property from its own assets. Section 4d(a)(2) of the CEA requires an FCM to treat and deal with futures customer funds as belonging to the futures customer, and prohibits an FCM from using customer funds to margin or extend credit to any other person. Further, CFTC Regulation 1.20 requires that an FCM must separately account for all futures customer funds and segregate such funds as belonging to its futures customers. Account names must clearly identify customer funds as the futures customer funds and show that such funds are segregated as required by sections 4d(a) and 4d(b) of the CEA and by CFTC regulations. An FCM may deposit futures customer funds, subject to the risk management policies and procedures of the futures commission merchant required by CFTC Regulation 1.11 with: (1) a bank or trust company; (2) a DCO; or (3) another FCM.

DCOs are subject to other comparable obligations to those set forth in Section 4d of the CEA; namely, CFTC Regulation 39.15 requires the DCO file rules for CFTC approval related to the commingling of DCO and clearing member customer positions, as well as rules on money, securities, or property received by the DCO to margin, guarantee, or secure such positions. The DCO's rules must, for example, identify the products that would be commingled, analyze the risk characteristics of the eligible products, and analyze the liquidity of the respective markets for eligible products.

Under FTX Rule 7.3, FTX separately accounts for and segregates all participant funds used to purchase, margin, guarantee, secure, or settle Company Contracts from FTX's proprietary funds. In doing so, FTX maintains a proprietary account that will be credited with fees or other payments owed to a participant that are debited as a result of trades and settlements of Company Contracts. FTX maintains a record of each participant's account balances and Company Contracts, and is prohibited from holding, using, or disposing of except as belonging to participants.

C. FTX has implemented eligibility criteria that promote free and open access and protect against undue risk

Section 5b(c)(2)(C) of the CEA requires a DCO to have appropriate admission and continuing eligibility standards (including sufficient financial resources and operational capacity) for members of, and participants in, the DCO. CFTC Regulation 1.3 defines "clearing member" as "any person that has clearing privileges such that it can process, clear and settle trades through a derivatives clearing organization on behalf of itself or others. The derivatives

clearing organization need not be organized as a membership organization."[19] Under this definition, all of FTX's participants will qualify as "clearing members."

CFTC Regulation 39.12 requires these participant eligibility criteria to be objective, publicly disclosed, and risk-based. Specifically, CFTC Regulation 39.12(a)(2) requires that clearing members have access to sufficient financial resources to meet obligations arising from participation in the DCO in extreme but plausible market conditions. The DCO must also maintain appropriate standards for determining the eligibility of agreements, contracts, or transactions submitted to the DCO for clearing. Furthermore, the DCO must have procedures to verify, on an ongoing basis, the compliance of each participation and membership requirement of the DCO.

The CFTC explained that the participant eligibility requirements in CFTC Regulation 39.12(a)(1) satisfy "the dual Congressional mandate to provide for fair and open access while ensuring that such increased access does not materially increase risk."[20] The CFTC emphasized that the rule provides a DCO with discretion to balance restrictions on participation with legitimate risk management concerns.[21] In this regard, the CFTC found that the DCOs are "in the best position in the first instance to determine the optimal balance."[22]

FTX's membership criteria for participants are fully aligned with the Congressional mandate to provide for fair and open access to clearing services in a manner that is consistent with prudent risk management. FTX's real-time monitoring of participant positions enables it to determine, at all times, whether a participant's account has sufficient cash and collateral to meet its margin obligations to the DCO. In the event an account does not have sufficient financial resources, FTX will immediately begin to liquidate the participant's position until the amount of funds in the participant account is equal to its margin obligations to the DCO. Because FTX monitors participant accounts 24/7 and liquidates underfunded positions in real-time, there is no need to establish minimum capital requirements for each participant. Instead, FTX's risk management framework enables it to ensure at all times that each participant has sufficient financial resources to meet its current obligations arising from participation in the DCO.

In addition, FTX's membership requirements will advance many of the policy considerations underlying CFTC Regulation 39.12, including promoting competition and liquidity. FTX anticipates that its participants will be diverse, encompassing traders and investors with varying investment objectives, risk tolerances, and portfolio sizes. Diffusing the risk of defaults across numerous participants also greatly reduces the likelihood that the default of any one or two large members will seriously jeopardize the clearinghouse, thereby strengthening the DCO's financial stability.

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[19] 17 CFR § 1.3.
[20] *DCO Final Rule*, 76 Fed. Reg. at 69,353.
[21] *Id.*
[22] *Id.*

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III. FCMs Also Perform Certain Trading-Related Functions That Are Independent of Clearing Functions

FCMs are subject to certain obligations related to trading on an exchange that are unrelated to clearing positions, such as: (i) providing disclosures to customers regarding, *inter alia*, the risks of trading;[23] (ii) order and transaction recordkeeping obligations;[24] (iii) minimum trading standards;[25] (iv) trading authorization requirements;[26] (v) requirements to produce monthly statements and confirmations;[27] and (vi) conflict of interest and trading standards.[28] These FCM requirements primarily focus on the FCM customer's execution of transactions on the exchange. As these functions are trading-related, rather than clearing-related, FTX believes they are outside the scope of FTX's request to amend its clearing order. It should be noted, however, that FTX acting in its capacity as a DCM (which is a category of self-regulatory organization) would handle many of these requirements in accordance with Part 38 of the CFTC's rules, and has already been providing direct-access to its exchange for years now, as have others.

* * *

[23] CFTC Regulations 33.7 and 1.55; NFA Interpretive Notice 9073 – Disclosure Requirements for NFA Members Engaging in Virtual Currency Activities. FTX is also subject to exchange trading related public disclosure requirements as set forth in DCM Core Principle 7, and CFTC regulations 38.1400 and 38.1401.

[24] CFTC Regulation 1.35. FTX is also subject to exchange trading related recordkeeping requirements as set forth in DCM Core Principle 18, and CFTC regulations 38.950 and 38.951.

[25] CFTC Regulation 155.3. FTX is also subject to exchange trading related requirements to protect its markets and market participants as set forth in DCM Core Principle 12, and CFTC regulations 38.650 and 38.651.

[26] CFTC Regulation 166.2.

[27] CFTC Regulation 1.33. FTX provides IRS Form 1099s to customers, trade history is available to each customer.

[28] *See* CFTC Regulations 1.56, 1.71, and 155.3. FTX is also subject to exchange trading conflicts of interest requirements as set forth in DCM Core Principle 16, and CFTC regulations 38.850 and 38.851.

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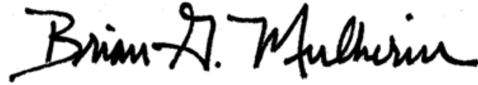
FTX appreciates the opportunity to present its views on these important issues and would value the opportunity to discuss these matters further, at your convenience.

Sincerely,



Brian G. Mulherin
General Counsel, FTX US Derivatives

cc: Eileen Donovan