FTX US Derivatives

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https://derivs.ftx.us/

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: Financial Resource Requirements under Core Principle B and CFTC Regulation 39.11(a)(1) in the Absence of Clearing Futures Commission Merchants ("FCMs")

Dear Mr. Hutchison:

FTX US Derivatives ("FTX") seeks to clear derivatives products that are not fully collateralized through a direct access market for both retail and institutional participants. In doing so, FTX plans to leverage its experience offering exchange and clearing services directly to market participants. Instead of weighing the credit worthiness of chains of intermediaries, FTX will margin all products directly against each market participant, which enables FTX to know and manage the precise amount of risk held by each portfolio, as well as by all portfolios in aggregate, at any given moment. FTX deploys a sophisticated real-time risk management system to support derivatives on cash markets that are always open, and commits to $250 million in dedicated, unencumbered cash to cover any remaining risk to the clearing house or its customers.[1]

Historically, clearinghouses have sought to manage their counterparty credit risk, in part, by mutualizing that risk among a relatively small number of clearing futures commission merchants ("FCMs"), who in turn managed the direct relationships with their much more numerous clients. Naturally, this created a relationship of reliance on those clearing FCMs to support the resilience of the clearinghouse. As a result, clearinghouses have been required to hold reserves against the possibility that such clearing FCMs themselves may default on their obligations, thereby requiring the clearinghouse to intercede.

Section 5b of the Commodity Exchange Act ("CEA") sets forth various core principles in the regulation of derivatives clearing organizations ("DCOs"), which have been implemented by the Commodity Futures Trading Commission ("CFTC") in Part 39 of the CFTC regulations. One of those core principles, namely Core Principle B, describes the minimum financial resources required of a DCO to ensure its financial resilience. Those requirements, however, likely presuppose a relatively small number of large FCM clearing members. The following analysis, therefore, describes the standard in existing law for calculating minimum financial resources a DCO is required to maintain, and explores how

[1] As set forth in Exhibit G to the FTX application for an amendment to its Amended Clearing Order, FTX also relies on other default resources.

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those standards might be viewed with respect to a clearinghouse that utilizes a direct-access model without clearing FCMs, but that is nonetheless likely to have large direct-access clearing members.

A. Legal Standard

The Commodity Exchange Act ("CEA") establishes both general and specific financial resources requirements for CFTC regulated clearinghouses in DCO Core Principle B. Generally, each DCO is required to have "adequate financial, operational, and managerial resources, as determined by the Commission, to discharge each responsibility of the derivatives clearing organization." *See* CEA § 5b(c)(2)(B)(i). Additionally, a DCO is required to possess financial resources that, "at a minimum, exceed the total amount that would – (I) enable the organization meet its financial obligations to its members and participants notwithstanding a default by the member or participant creating the largest financial exposure for that organization in extreme but plausible market conditions . . . ." *See* CEA § 5b(c)(2)(B)(ii). This specific requirement is generally referred to as "Cover-1," and is memorialized in CFTC Regulation 39.11(a)(1). Additionally, CFTC Regulation 39.11(c)(1) grants DCOs "reasonable discretion in determining the methodology used to compute such requirements . . . ." By contrast, a systemically important DCO is required to cover the default of "the two clearing members creating the largest combined loss to the derivatives clearing organization in extreme but plausible market conditions", otherwise known as the "Cover-2" standard. *See* CFTC Reg. 39.33(a)(1).

B. Proposed Methodology for Computing FTX Guaranty Fund Requirements

Although FTX does not have clearing FCMs, it does nonetheless have large, institutional direct-access members. In an abundance of caution, FTX proposes to account for the possibility that FTX's largest direct-access clearing member could be smaller than the largest clearing FCM at a comparable clearinghouse. FTX proposes to calculate its minimum financial obligations under CFTC Regulation 39.11(a)(1) using the following methodology: FTX will calculate the amount needed to meet its financial obligations to members and participants notwithstanding the default of: (a) the single largest clearing member (*i.e.*, the Cover-1 amount); or (b) if Cover-1 is less than 10% of total initial margin ("IM") at the clearinghouse, then the two largest clearing members (*i.e.*, the Cover-2 amount); or (c) if Cover-2 is less than 10% of IM, then the three largest clearing members (*i.e.*, the Cover-3 amount).

FTX's Guaranty Fund (GF) minimum sizing methodology explicitly meets or exceeds the regulations in 39.11 and conforms with the CFTC's principles based regulatory framework. The method starts by calculating the regulatory standard Cover-1 requirement. The Cover-1 standard sizes the GF to allow the DCO to continue operations even if the largest single participant defaults in an extreme but plausible scenario. FTX's largest exposure may be smaller than what is envisioned by the regulations due to the absence of clearing FCMs; however, FTX's largest clearing members are still highly likely to be institutional, rather than retail participants. Nonetheless, to allow for the possibility that such institutional clearing members could possibly be smaller than the largest clearing FCMs, we compare the percent of

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Initial Margin (IM) the Cover-1 entity is required to post relative to the total IM required from all participants. If the largest FTX clearing member holds less than 10% of the total IM at the DCO, FTX moves to a Cover-2 standard. The Cover-2 standard is outlined in Subpart C of CFTC Regulations, specifically CFTC Regulation 39.33, and requires that certain important or complex DCOs can absorb the joint default by the two clearing members creating the largest combined financial exposure, again in an extreme but plausible scenario. As yet another layer of protection for the clearinghouse, if the Cover-2 entities combined hold less than 10% of the total IM at the DCO, FTX will then move to a Cover-3 standard, which is more conservative than current CFTC regulations.

C. <u>Appropriateness of FTX's Cover-1 Proxies</u>

FTX is taking an innovative approach to determine the minimum size of the GF to meet the letter and the spirit of CFTC regulations. The regulations balance the severity versus the likelihood of default scenarios on DCO operations. Regulation 39.11 specifies Cover-1 as the standard requirement for a DCO's GF sizing. Cover-1, which assumes the largest exposure defaults in an extreme but plausible scenario, is a reasonable and conservative benchmark; if the DCO can cover the largest single default in an extreme event, any lesser default will not threaten the DCO's ability to operate.

Increasing the number of the largest participants that are assumed to default at the same time makes a scenario more extreme but naturally decreases the plausibility of such a scenario. If a DCO is large and/or complex as specified in Sub Part C, a Cover-2 standard may apply which further increases the conservativeness of the GF size. Here the CFTC has determined that, while the likelihood of the largest 2 entities defaulting at the same time in the worst case scenario is even less than Cover-1, this exceptional coverage is warranted if the DCO is important enough.

FTX's GF methodology considers not only Cover-1 and Cover-2 but also allows for a highly conservative Cover-3 sizing. The regulations do not explicitly consider Cover-3, likely because of the low probability of such a default event in a traditional, intermediated-clearing model. FTX's adoption of a Cover-3 standard for sizing the GF is conservative and exceeds the regulations, given the low probability of such a scenario. Note that the largest participants on FTX are highly unlikely to be retail participants, but instead large institutional participants.

To determine whether FTX should consider additional participants in the GF sizing calculation (*e.g.*, moving from Cover-1 to Cover-2 to Cover-3), we consider how much IM the participants are required to post relative to the total IM at the DCO. This metric proxies what a Cover-1 might look like at a more traditional DCO operating with an intermediated-clearing model.

The following analysis shows that 10% of IM is a conservative estimate of the percent of IM that a Cover-1 participant might post at a traditional DCO. The analysis uses information from the CPMI-IOSCO Quantitative Disclosures for major Central Counterparties (CCPs), which is a more generic term that includes DCOs, in Q3 of 2021.

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FIELD	IM ACCOUNTS	CME[2]	ICUS[3]	ICEU[4]	OCC[5]
6.1.1	House Account IM (mm USD)	$32,027	$8,129	$11,978	$24,451
6.1.1	Client Gross IM (mm USD)	$132,135	$15,445	$61,348	$2,518
6.1.1	Client Net IM (mm USD)	$0	$0	$17,114	$88,078
6.1.1	Total IM (mm USD)	$164,162	$23,574	$90,440	$115,047
18.1.1.1	Clearing Members	40	30	65	107
	Clearing Member Margin %	20%	34%	13%	21%

For each clearinghouse shown above, all the clearing members' house positions combined represent between 13% and 34% of the total margin posted. This is determined by taking the House Account IM and dividing it by the Total IM at the relevant CCP. What might reasonably be considered the largest 40 accounts combined at CME only hold 20% of the total IM at that clearinghouse. Similar ratios are seen at the other relevant clearinghouses presented. Thus, it is not likely that the largest single participant at any of these clearinghouses holds 10% of total IM. This analysis suggests that the 10% threshold selected by FTX is an appropriate and conservative measure to determine if additional coverage participants are warranted.

FTX's proposed approach to calculate the minimum GF size will meet the Cover-1 requirement at a minimum and likely exceed it. The above analysis shows that covering 10% of IM is a conservative proxy for what could be considered a large clearing member at a traditional DCO and may represent a larger percentage than any current clearing member at the DCOs discussed above. Further, sizing the GF to cover up to the 3 largest simultaneous exposures is more conservative than current regulations require. FTX believes, therefore, that its GF methodology is appropriate and innovative and in the spirit of the CFTC's history of principles based and prudent risk management.

Thank you for considering our proposed methodology, and we would welcome any questions or comments the CFTC may have in that regard.

Sincerely,

JLSchoening

JLSchoening (Feb 8, 2022 23:12 EST)

Julie L. Schoening, Ph.D.
Chief Risk Officer, FTX US Derivatives

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[2] *See* https://www.cmegroup.com/clearing/cpmi-iosco-reporting.html.
[3] *See* https://www.theice.com/clearing/quarterly-clearing-disclosures.
[4] *See id.*
[5] *See* https://www.theocc.com/Risk-Management/PFMI-Disclosures.

FTX Letter re FInancial Resource Requirements 2022-02-08

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