# Commodity Futures Trading Commission
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# Request for Comment on FTX Request for Amended DCO Registration Order

The Commodity Futures Trading Commission (Commission) has received inquiries from derivatives clearing organizations (DCO) or potential DCO applicants seeking to offer clearing of margined products directly to participants, such that participants would not clear through a futures commission merchant (FCM) intermediary (non-intermediated model). LedgerX, LLC d.b.a. FTX US Derivatives (FTX), has submitted a request to amend its order of registration as a DCO to allow it to modify its existing non-intermediated model. FTX currently clears futures and options on futures contracts on a fully collateralized basis. FTX proposes to clear margined products while continuing with a non-intermediated model.

## Current DCO clearing models

Fifteen DCOs are currently registered with the Commission. The majority of DCOs operate under a model that includes three characteristics that are significant for present purposes: margined products, intermediated clearing, and mutualized losses.

A margined product is one for which the DCO only collects a portion of the possible losses the counterparty could incur while holding the position. Therefore, a DCO that offers margined products is exposed to the risk that a counterparty will default, leaving the DCO to cover its obligations to the counterparty holding the other side of the position. To ensure it has sufficient resources, a DCO employs a margin model to determine initial margin requirements and maintains financial resources to be used in a predetermined order (default waterfall) to cover any losses from a default. Currently four DCOs, including FTX, clear only non-margined, fully collateralized trades. In a fully collateralized trade, the DCO holds as collateral 100 percent of the potential losses a counterparty could incur and the DCO is thus not exposed to the risk of a counterparty default.

At an intermediated DCO, only FCMs (and potentially some large proprietary traders) are direct clearing members of the DCO. Most market participants are customers of an FCM that is a clearing member and guarantees the customers' obligations to the DCO. This model provides DCOs with additional protections against a customer default and relieves customers of some of the operational and financial costs of being a clearing member. At a non-intermediated DCO, all market participants are clearing members. Currently, the four DCOs clearing fully collateralized products operate a non-intermediated model. Additionally, ICE NGX Canada Inc. (ICE NGX), operates a non-intermediated model for margined products.[1] ICE NGX has minimum financial standards for clearing members that limit membership to individuals or entities with a high net worth or that own substantial assets.[2]

When a DCO mutualizes losses in its default waterfall, the risk of loss from a default is shared by all clearing members. Typically, the default waterfall includes funds from all clearing members in the form of a guaranty fund that can be used to cover default losses that exceed the defaulting clearing member's resources. Guaranty fund

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[1] *ICE NGX Clearing and Settlement*, https://www.theice.com/ngx/clearing-settlement (last visited. Feb. 25, 2022)

[2] *ICE NGX New Customer Sign-Up*, https://www.theice.com/ngx/new-customer-sign-up, (last visited Feb. 25, 2022); Specifically, ICE NGX limits its participants to those with a net worth exceeding CAD $5,000,000 or total tangible assets exceeding CAD $25,000,000. This differs from the "Eligible Contract Participant" standard contained in the Commodity Exchange Act, *see* 7 USC § 1a(18), but is similarly used to exclude retail participation.

contributions are used even when the contributing clearing member is not in default. These funds are usually required to be on deposit at the DCO before a default happens. Some DCOs are able to call for additional funds, through clearing member assessments, to cover losses in excess of the prefunded resources. Of the DCOs that offer margined products,[3] only ICE NGX does not mutualize losses among its clearing members in this way.[4] Instead, ICE NGX covers losses in excess of the margin it collects by holding a portion of its own capital in reserve and maintaining a line of credit backed by a default insurance policy.[5]

## FTX proposal

FTX has requested an amended order to permit it to clear non-intermediated, margined products. FTX intends to offer its products to retail participants, and its financial and operational requirements for participants only require that the participant be able to post the margin required for a given position.

FTX's model does not contemplate receiving any funds from a participant not on deposit when the trade is executed. FTX has two margin requirements for its participants, the initial margin requirement and the maintenance margin requirement. The initial margin requirement is the amount of margin the participant must post to open a position. Maintenance margin is a set minimum percentage of the notional value of the portfolio that the margin on deposit must exceed. A participant's margin level is recalculated every 30 seconds as positions are marked to market, and if the collateral on deposit falls below the maintenance margin level, FTX's automated system will begin to liquidate the portfolio. The automated system will liquidate 10 percent of a portfolio at a time by placing offsetting orders on the central limit order book. Once the liquidation process results in collateral on deposit that exceeds the maintenance margin requirement, the liquidation will stop. Because the liquidation is done automatically and positions are marked to market every 30 seconds, these liquidations can occur at any time, on a "24-7" basis.

Below the maintenance margin threshold, FTX will also set a "full liquidation" threshold based on a set percentage of the notional value of the positions. If the margin on deposit falls below that threshold, FTX will liquidate the remainder of the portfolio. To fully liquidate a portfolio, FTX intends to enter into agreements with backstop liquidity providers who agree ahead of time to accept a set amount of positions if a portfolio needs to be completely liquidated, and who will receive the remaining margin for the position once the full liquidation threshold is hit. FTX will also fund a guaranty fund with $250 million of its own capital to cover any losses incurred on positions beyond those accepted by the backstop liquidity providers. FTX will also use its guaranty fund to reimburse the backstop liquidity providers when the participant's margin does not cover the value of the portfolio acquired by the backstop liquidity providers. FTX does not propose to mutualize losses among its participants in its default waterfall.

## Questions

### DCO rules

1) The Commission's regulations require a DCO to hold enough financial resources to meet its obligations after a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions (Cover-1 standard).[6] The Cover-1 standard was calibrated based on the assumption that the DCO will be intermediated and that the clearing member creating the largest exposure will represent a significant amount of the risk a DCO faces. In a non-intermediated model where retail participants are direct

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[3] Because fully collateralized DCOs do not face the risk of a clearing member default, there are no losses to mutualize and the concept does not apply.

[4] *ICE NGX Clearing and Settlement*, https://www.theice.com/ngx/clearing-settlement.

[5] *Id.*

[6] 17 CFR § 39.11(a)(1).

clearing members, the significance of a default by the single participant presenting the largest exposure will likely be much smaller.

a) What standard, other than Cover-1, would be appropriate to meet the requirement in Core Principle B that a DCO "shall have adequate financial … resources, as determined by the Commission," to meet its responsibilities in extreme but plausible market conditions in a non-intermediated model?[7]

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

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

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

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

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

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

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

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

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

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

[7] 7 USC § 7a-1(c)(2)(B).

**FCM rules**

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

7) Due to the absence of FCMs, the participants' collateral in a non-intermediated model is not required to be segregated under section 4d of the CEA.[8] The orders of registration for DCOs offering a non-intermediated model require the DCO to hold funds of its participants as member property, as that term is defined by the Bankruptcy Code.[9] Is this protection sufficient for participants' funds if a DCO begins to offer margined products?

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

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

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

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

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

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

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

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

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

9) Should a DCO offering a non-intermediated model be subject to the capital requirements applied to FCMs in addition to, or as an alternative to, DCO and DCM financial resources requirements?

[8] 7 USC § 6d.

[9] 11 USC § 761(16).

a) Would the Commission's risk-based capital requirement for FCMs in Regulation 1.17 be the most appropriate financial resources requirement for a DCO offering a non-intermediated model if it is approved to be a DCO that directly clears margined products for retail participants without an FCM guarantee?[10]

b) If a DCO offering a non-intermediated model is subject to a risk-based capital requirement based on the risk margin amount of its participants' accounts, should the percentage be higher than eight percent to reflect that the DCO will only hold margin for its listed products and not diverse positions across multiple exchanges?

c) Regulation 1.17 requires FCMs to maintain a sufficient amount of unencumbered liquid assets (after application of haircuts) that are in the possession or control of the FCM to cover each dollar of the FCM's obligations. If this type of financial resources requirement is applied to a DCO offering a non-intermediated model, should that requirement also consider the composition of the DCO's capital?

d) For FTX's proposal, if a risk margin amount threshold is applied to FTX's minimum financial resources requirement, should the percentage of risk margin required be set at a higher percentage than eight percent, given that FTX's participants would not be required to contribute financial resources to the DCO beyond their required initial or maintenance margin amounts?

10) FTX's current order of registration requires it to comply with anti-money laundering laws and regulations as if it were a covered "financial institution" under applicable law.[11] Do FTX's proposed changes present any additional risks that would require additional anti-money laundering requirements?

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

**FTX proposals**

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

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

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

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

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

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[10] 17 CFR § 1.17.

[11] Specifically it must comply with the Bank Secrecy Act (31 U.S.C. § 5311 et seq.), the International Emergency Economic Powers Act (50 U.S.C. § 1701 et seq.), the Trading with the Enemy Act (50 U.S.C. § 4301 et seq.), and the executive orders and regulations issued pursuant thereto, including the regulations issued by the U.S. Department of the Treasury and, as applicable, the Commission, as if [FTX} were a covered "financial institution" within the meaning of 31 C.F.R. § 1010 et seq.

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

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

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

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

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

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

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

**Market impact**

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

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