DATE: 5/20/2022
FOR DISCUSSION ONLY

Commodity Futures Trading Commission
Staff Roundtable Discussion on Non-intermediation

Wednesday, 25 May 2022

Washington, DC

STYLIZED FACTS FOR DISCUSSION

The **Commodity Futures Trading Commission ("CFTC" or "Commission")** has received a request by **LedgerX, LLC, d.b.a. FTX U.S. Derivatives ("FTX-US")** for an amended order of registration as a Derivatives Clearing Organization ("DCO") that would permit FTX-US to offer clearing services for certain margined products to market participants on a direct, non-intermediated basis, utilizing a highly automated, near real-time risk and default management system. CFTC Request for Comment (2022).*

For purposes of the discussion, roundtable participants will be asked to consider how a **hypothetical clearinghouse ("DM-DCO")** that faces its participants directly, without intermediation by a Futures Commission Merchant ("FCM"), might operate if approved to do so by the Commission. This feature (non-intermediation) is useful as a starting point – together with other operational and risk management attributes – for distinguishing the clearing service for margined products that DM-DCO would provide, if approved to do so, from clearing arrangements currently provided by other CFTC-regulated DCOs.

The stylized facts relating to DM-DCO set forth below – including general descriptions of the financial resources available to the clearinghouse, its operational process, risk and default management procedures, and other features – are based on key attributes of the clearing service that FTX-US has described in its application for an amended order of DCO registration.

The roundtable discussion, however, is intended to give participants an opportunity to discuss issues that may have broad significance, extending beyond the Commission's review of the FTX-US application. In particular, the purpose of the roundtable discussion is to consider the potential costs and benefits of a direct model of clearing that utilizes a highly automated, near real-time risk and default management system, not to focus on issues that are specific to the FTX-US application. The stylized facts outlined below are intended to assist in that effort.

However, it may be helpful to refer on a limited basis to certain aspects of how the FTX-US clearing service is intended to operate in order to illustrate certain points and facilitate a better understanding of the key characteristics of the hypothetical DM-DCO clearing service.

* As noted in the CFTC's Request for Comment, "FTX-US 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." The stylized facts do not include any specific reference to the provision of such a service by DM-DCO.

In addition, the stylized facts may be supplemented or revised during the course of the discussion as may be considered desirable, depending on how the roundtable discussion proceeds.

It may also be helpful to refer to certain requirements of U.S. law relating to market and customer protection in the provision of clearing services for margined products during the roundtable discussion. Nevertheless, roundtable participants should bear in mind that the purpose of the roundtable meeting is to consider broad policy, risk management, and legal issues, not to reach any conclusion regarding the Commission's review of the FTX-US application or to determine how statutory and regulatory requirements currently in effect might apply to that application.

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Stylized Facts

- **General Background/Assumptions**

DM-DCO is a legal person under U.S. law (or other applicable law) and subject to regulation by the Commission and to registration as a DCO.

Like traditional DCOs, DM-DCO is generally expected to make adequate provision for both market and end-user (or customer) protection, as required under applicable law.[*]

DM-DCO also is assumed to have sufficient capital and liquidity to operate responsibly and satisfy relevant regulatory reporting requirements. The amount of capital and liquidity that might be sufficient to meet applicable legal and regulatory requirements may be subject to discussion by roundtable participants.

DM-DCO intends to interact with its users on a non-recourse basis. What this means, in the context of the proposed clearing service, may be subject to discussion by participants in the roundtable discussion.

- **Counterparty Substitution**

DM-DCO becomes a direct counterparty to all trades submitted for clearing by its users, eliminating bilateral credit exposure between pairs of users. As a result, DM-DCO faces each of its users on a principal-to-principal basis, without intermediation.

[*] Because DM-DCO intends to face its market participants directly, without intermediation by a FCM, the use of the term "customer" in this context presents some interpretative challenges that are not considered in the stylized facts. In particular, there appear to be important issues concerning the treatment of customer property (e.g., segregation requirements) in the context of the clearing service to be provided by DM-DCO.

- **Continuous Risk and Default Management Operations**

DM-DCO plans to operate on a continuous basis (24x7x365) in global markets for certain products. This necessitates continuous monitoring of market conditions and the ability to react to those conditions on a near real-time market basis.

To mitigate credit risk associated with the clearing service provided by DM-DCO, the clearinghouse will implement a collateral-based (or strongly “defaulter-pays”) risk management system that automatically recalculates margin requirements at high frequency as market prices change.

Unlike traditional clearinghouses for margined products, DM-DCO does not propose to issue calls for additional funding on the basis of mark-to-market changes. DM-DCO will, instead, rely on collateral deposited by and held on behalf of any participant to cover mark-to-market losses incurred in that participant’s account.

DM-DCO proposes to maintain a hierarchy of three levels of margin requirements for a given risk position:

- The level required at position initiation (initial margin);
- A lower level, below which automatic de-risking is triggered (maintenance margin); and
- A still lower level, below which full account termination and assignment to a third party is triggered, (auto-close margin).

Users of the DM-DCO clearing service may choose to deposit collateral in an amount that exceeds DM-DCO’s minimum margin requirements to mitigate against incurring losses that may trigger default management processes.[*]

The default management process, like the margining system to be implemented by DM-DCO, will be highly automated. In particular, if margin falls below the maintenance requirement in a user account, DM-DCO will immediately begin liquidating a portion of a defaulting user’s positions (or “de-risking”) in order to bring the account back into compliance with the clearinghouse’s minimum maintenance margin requirements. The liquidation process may continue in stages until the amount of collateral available to support open positions for a particular account exceeds the applicable maintenance margin requirement.

Any resulting losses, either from the de-risking process or from further mark-to-market losses, will be marked to the defaulting user’s account and be offset by collateral held by DM-DCO for the user. Among other things, roundtable participants may wish to consider how this process may interact with market pricing in the relevant market(s). As noted above, defaulting users will

[*] As noted above, DM-DCO intends to monitor credit risk on a continuous basis and automatically recalculate margin requirements and unrealized profit and loss as market prices change. In this context, “default” is defined as an under-margined condition.

not face any additional liability to the clearinghouse beyond the amount of collateral held by DM-DCO.

DM-DCO also will engage certain Backup Liquidity Providers ("BLPs") to support the liquidation process. This arrangement is intended to provide additional resources for default management in case market conditions in the relevant market(s) are illiquid and user positions cannot be quickly liquidated in accordance with the clearinghouse's auto-liquidation process. In particular, accounts are allocated to BLPs if collateral in the account falls below auto-close margin, including during the de-risking process.

How this feature of the DM-DCO proposal interacts with other risk management components, what qualifications BLPs should possess, and how they should be compensated, among other issues, may be subject to discussion by participants in the roundtable discussion.

- **Loss Allocation and Guarantee Fund**

DM-DCO will establish a guarantee fund funded solely by its own capital in an amount that is considered adequate to provide a source of financial resilience for the clearinghouse. Users of the DM-DCO clearing service will not contribute to the guarantee fund.

DM-DCO proposes to fund the guarantee fund in an amount intended to cover 10% of total margin held by the clearinghouse and will be recalculated periodically. Roundtable participants may wish to discuss whether this approach is adequate and, in particular, whether it provides satisfactory assurances of clearinghouse resilience in "extreme, but plausible, circumstances."

The guarantee fund is intended to cover these extreme contingencies, in part because DM-DCO's recourse is limited to assets posted to DM-DCO as collateral. Therefore, if losses assigned to an account exceed the amount of available collateral, any excess losses will be absorbed by the guarantee fund. In addition, positions may be allocated to the BLPs, if necessary, at a discount. This discount is funded by the guarantee fund.

- **Mutualization of Losses/End of Waterfall Procedures**

The primary BLP process described above continues until one of the following two events occurs: 1) aggregate BLP risk thresholds have been hit or 2) funds in the guarantee fund have been fully exhausted. Each of these individual events leads to unique adjustments in the position liquidation process outlined above.

As part of the process of becoming a BLP, the BLP is assigned a maximum level of risk that it can receive through the auto-liquidation process. Once this limit is reached, no further portfolio risk can be transferred to that BLP. As a result, auto-liquidation volume could become so high as to exceed the risk capacity of all available BLPs. In this event, DM-DCO will turn to the secondary BLP system, represented by the largest market participants with offsetting positions to the liquidated accounts (e.g. largest shorts if liquidated accounts are long). Positions will be assigned to these secondary BLPs on a pro-rata basis until no further position liquidation is needed (theoretically up to the full open interest of the product).

If the guarantee fund is exhausted, no further funds are available, at least temporarily, to offset additional account losses prior to position transfer (whether through the primary or secondary BLP system). In this event, those with unrealized gains will be subject to adjustment (which may be called "variation margin gains haircutting"), in proportion to their gains, up to the point where all accounts have been transferred and no unrealized, uncovered losses remain. At the point where the guarantee fund has been exhausted, DM-DCO would either need to replenish the guarantee fund or, in extreme circumstances, move to full tear-up.

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REFERENCES

U.S. Commodity Futures Trading Commission, 2022, Request for Comment on FTX Request for Amended DCO Registration Order (11 March), available at: https://www.cftc.gov/media/7031/CommentFTXAmendedOrder/download

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