

May 11, 2022

VIA ELECTRONIC SUBMISSION ([Link](#))
Commodity Futures Trading Commission
Office of Public Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 2058

Re: The CFTC Request for Comment on FTX Request for Amended DCO Registration Order

The Global Association of Central Counterparties (“CCP12”) is the international association for CCPs, representing 41 members who operate over 60 individual central counterparties (CCPs) globally across the Americas, EMEA, and the Asia-Pacific region.

CCP12 appreciates the opportunity to respond to the CFTC Request for Comment on FTX Request for Amended DCO Registration Order¹ (“the Request for Comment” or “the RfC”). In our response, we would like to express our numerous concerns regarding FTX’s proposed clearing model (i.e., offering direct clearing to retail and other participants for margined derivatives products), as outlined in the RfC, and the many risks that stem from their proposal. If approved by amending FTX’s registration order, this would represent a radical change in the clearing landscape, which would have far-reaching consequences for many stakeholders, including other CCPs, market participants, end/retail clients and the economy as a whole.

Risk management is at the core of centrally cleared markets, which have demonstrated their resilience through numerous periods of stress. The effectiveness of the central clearing model was affirmed by G20 Leaders following the 2008 Financial Crisis with their commitment to centrally clear standardized OTC derivatives.² Based on a review of the materials provided in the RfC, the FTX proposal does not seem to meet the risk management standards to which CCPs globally adhere, including the *Principles for financial market infrastructures* (April 2012)³ (“PFMIs”), as described further below.

Simply put, FTX’s proposal appears to eliminate sound risk management practices and many customer protections for retail participants, which are key features of centrally cleared derivatives markets across the globe. In particular, retail participants would no longer be guaranteed the customer protections, including those at the level of the CCP, that they have traditionally been afforded when accessing centrally cleared derivatives markets through a CFTC-registered Futures Commission Merchant (“FCM”).

¹ The Commodity Futures Trading Commission, Request for Comment on FTX Request for Amended DCO Registration Order (March 2022), available at [Link](#)

² Group of 20, Leaders’ Statement, Pittsburgh Summit (Sept. 2009), available at [Link](#)

³ CPMI, IOSCO, Principles for financial market infrastructures (April 2012), available at [Link](#)

FTX's proposed structure ultimately creates incentives that may serve to increase, rather than reduce, the risk to market participants and the global financial system.

FTX's proposal appears to include a number of risk management shortcomings and inconsistencies when compared with the PFMI. A few examples are noted below:

- The absence of credit due diligence and the apparent lack of FTX's intention to monitor the credit quality of its clearing members⁴ (PFMI Principles 3 & 4) is very troubling, especially considering that FTX does not intend to apply any minimum capital requirements to its direct participants,⁵ nor does FTX propose to impose robust risk-based participation requirements (PFMI Principle 18). Risk-based capital requirements and other risk-based requirements act as a first line of defense for CCP risk management and, importantly, incentivize participants to actively manage their risks, given that as risk-taking increases, typically the required capital increases. These requirements are absent in FTX's proposal. To put this into context, CFTC-registered FCMs maintain over USD 173 billion in capital to backstop their customers' risk-taking, including retail participants,⁶ which under the FTX proposal would not be available. Additionally, since FTX's proposed participant requirements lack a risk-based component, we also question how FTX could have confidence in retail participants' ability to effectively manage their risks in a 24/7 market. The lack of participant requirements may also result in a significantly larger number of direct participants (as compared to traditional CCPs). The combination of such a broad participation and the lack of prudential requirements would most certainly create additional risk management challenges for FTX. This situation is exacerbated by the fact that FTX eliminates the potential for the mutualization of stress loss resources in the event of a participant's default that is traditionally adopted by CCPs. This lack of mutualized resources further disincentivizes participants from effectively managing their tail risks. Overall, the FTX proposal reduces participants' incentives to actively manage their risks, particularly in periods of stress.

This lack of participants' potential ability to manage risks should also be considered in the context of FTX's proposed auto-liquidation approach, where it would automatically liquidate participants' positions when price movements result in participants being under-margined at any point in time. Thus, if a retail participant was not able to successfully manage their risk in a 24/7 market (i.e., keep their account from being under-margined), his or her portfolio would be liquidated without the participant having the opportunity to cure the potential margin shortfall. From what we understand, FTX plans to assess participants' exposures once each second and conduct liquidations every six seconds, which provides for an extremely narrow, almost impossible, window for participants to attempt to avoid liquidation.⁷ Counterintuitively, auto liquidation could lead to first-mover advantages where those participants with small excess deposits are liquidated at prevailing market prices while those with higher excess margin deposits could face lower market prices post liquidation. The proposal also does not prohibit participation of individual persons, who, in fact, appear to be one of

⁴ FTX Letter, Permissibility and Benefits of Direct Clearing Member under the Commodity Exchange Act and CFTC Regulations (Feb. 2022), at pg. 5 (noting, "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.").

⁵ *Id* at pg. 8 (noting, "there is no need to establish minimum capital requirements for each participant.")

⁶ CFTC, Financial Data for FCMs (Feb. 2022) (noting, this includes adjusted net capital and residual interest), available at [Link](#).

⁷ FTX Request, DCO Exhibit G (Feb. 2022).

FTX's target participant bases. The auto-liquidation feature combined with a lack of appropriately stringent participation requirements does not meet best practices in risk management and creates additional risks that are not present in traditional central clearing models. In fact, the likelihood of default to FTX is inherently higher under FTX's proposal because of the auto-liquidation model and the fact that retail and other participants would be facing FTX directly. In comparison, today, these participants are guaranteed by clearing members, which are responsible for managing these participants' failures.

The application of FTX's proposal presupposes markets are always sufficiently liquid and efficient to conduct auto-liquidation, which is not likely the case. This is particularly concerning if auto-liquidation was applied to markets with non-crypto underlyings which could lead to unintended consequences – note, we understand that FTX's intention is to extend its offering more broadly. The proposed mechanism to close out futures positions through auto-liquidation is highly likely to leave the underlying positions unhedged. Moreover, the liquidation costs and potential participants' liabilities (in the form of commissions, fees, or other expenses) remain unknown and could exceed the margin on account, which could lead to additional losses for participants. Auto-liquidation could also cause a cascade of liquidations and defaults resulting from the acceleration of violent market moves. This in turn could increase overall systemic risk.

There could also be other negative financial ramifications should auto-liquidations introduce additional price dislocation and market manipulation risks. Certain markets with non-crypto underlyings are more susceptible to price dislocation due to the diversity of non-fungible contract specifications and bifurcated liquidity across OTC and on-exchange trading. Additionally, within crypto markets, in the absence of regulation and supervisory oversight at both national and international levels, crypto exchanges' auto-liquidation prices are open to manipulation risk by either the exchanges or their liquidity providers.

The auto-liquidation mechanism might also have a broader negative impact on the financial markets. Negative consequences have been observed in crypto markets in the past where liquidation led to mass sell-offs, such as during the turbulent days of May 2021 when bitcoin prices dropped by 30%, while traders liquidated approximately USD 12 billion in leveraged positions.⁸ Another bitcoin flash crash took place on the crypto derivatives exchange BitMEX in March 2020, triggering liquidations worth USD 702 million.⁹ A more recent example are the crypto futures liquidations amounting to USD 800 million in several crypto exchanges (including OKEx and Binance) in January 2022.¹⁰

- FTX's financial resources are not sized to cover "extreme but plausible market conditions"¹¹ (PFMI Principle 4) and broadly, do not provide coverage that is comparable to what CCPs have in place today. To put this into perspective, based on the CCP Public Quantitative Disclosures' ("PQDs") data,¹² 46 CCPs across the globe had a total pool of USD 132 billion at their disposal at the end of

⁸ CNBC, Bitcoin traders using up to 100-to-1 leverage are driving the wild swings in cryptocurrencies, available at [Link](#)

⁹ CoinDesk, Bitcoin's Crash Triggers Over \$700M in Liquidations on BitMEX, available at [Link](#)

¹⁰ CoinDesk, Bitcoin Falls Below \$43K, Leads to \$800M in Crypto Liquidations, available at [Link](#)

¹¹ FTX Letter, Financial Resources under Core Principle B and CFTC Regulation 39.11(a)(1) in Absence of Clearing Futures Commission Merchants ("FCMs") (Feb. 2022), at pg. 3.

¹² CPMI, IOSCO, Public quantitative disclosure standards for central counterparties (February 2015), available at [Link](#). See also, CCP12 Public Quantitative Disclosures, available at [Link](#).

Q3 2021. Notwithstanding the shortcomings with respect to coverage of “extreme but plausible market conditions,” as described below, both the proposed Cover 3 standard and the USD 250 million default fund are insufficient. This is particularly the case when participants, as FTX proposes, have no minimum capital or other risk-based requirements (and thus have higher default probabilities) and overall number of participants is significantly higher than those at traditional CCPs.

There is also a lack of clarity as to how the amount of USD 250 million for the default fund has been determined. There is no mention of credit stress testing, sufficiency analysis or how tail risks would be managed. In contrast to CCPs’ current practice, which is to consider a wide range of stress scenarios in sizing their default funds (or other similar resources), FTX states only that increasing the assumed number of participants defaulting is inherently extreme and naturally decreases the plausibility.¹³ FTX does not elaborate on what it considers to be “extreme but plausible market conditions” when determining potential losses that may arise from participant defaults. Additionally, should a default event occur and exhaust FTX’s default fund, FTX does not appear to have rules in place that detail how it will replenish these resources (PFMI Principle 13). Moreover, the FTX model in which the default fund covers at most 3 participant accounts (i.e., Cover 3 standard) seems far from robust when compared to the Cover 1 or Cover 2 standard applied by traditional CCPs, which in practice means that CCPs often cover hundreds, if not thousands of accounts. FTX fails to acknowledge that CCPs size their default funds considering not only their clearing members’ house exposures, but also the exposures they guarantee on behalf of customers.¹⁴ This illustrates why the Cover 1 or Cover 2 standard applied by traditional CCPs is not appropriate for FTX, nor for that matter is FTX’s proposed Cover 3 standard.

- There are no indications as to how FTX would manage its counterparty risk related to its liquidity providers, which it would rely on to execute its auto-liquidation approach and manage defaults. Managing this counterparty risk would, at a minimum, be necessary to give FTX a high degree of confidence that these providers would be able to fulfil their role in “extreme but plausible market conditions” (PFMI Principle 7). For example, it is unclear what types of entities these liquidity providers are, how their onboarding would be conducted, if they have committed to absorbing a certain amount of loss, or if there would be ongoing monitoring of these entities (this is unlikely to be the case since there is no plan to perform credit due diligence on clearing members). These counterparty risk management practices are of the utmost importance and without clarity around them it is impossible to determine whether FTX would be able to effectively rely on these counterparties under normal conditions, never mind in extreme but plausible ones. It must also be taken into account that the role of liquidity providers is particularly important in the FTX proposal, given their core role and the limited financial resources being proposed. In particular, FTX’s intended approach to managing risk exclusively relies on real-time monitoring of margin levels relative to exposures and auto-liquidation for which liquidity providers play a key role. A failure of a liquidity provider to perform its expected role in managing a participant’s default would expose participants to significant risks, particularly if FTX decides to use partial tear-ups as a first line of defense (discussed further below), as is contemplated under proposed FTX Rule 14.3. This is especially troublesome because FTX intends to have no

¹³ FTX Letter, Financial Resources under Core Principle B and CFTC Regulation 39.11(a)(1) in Absence of Clearing Futures Commission Merchants (“FCMs”) (Feb. 2022), at pg. 3.

¹⁴ Ibid., at pg. 4.

participant capital requirements so it is very likely that there would be no additional resources available to cure the default losses. When a liquidity provider fails to liquidate a participant's portfolio, this would also increase the risk of losses to FTX and prolong the time when FTX does not have a matched book, a core feature of a CCP's operations.

- There are no indications that FTX's governance arrangements reflect the obligations to support the stability of the broader financial system (PFMI Principle 2).

Additionally, FTX's application does not provide transparency into a number of risk management practices, which makes it a challenge to evaluate whether the proposal is sufficient to meet risk management standards, including those set forth in the PFMIs. This is inconsistent with the level of transparency that market stakeholders and the public have come to expect from CCPs and are provided with CCPs' public information, such as the PFMIs and PQDs, the CCP rulebooks, and other documents. For example, the proposal lacks information on FTX's margin and stress testing methodologies, collateral acceptance and management (e.g., haircuts and investment practices), liquidity risk management, settlement procedures, and its testing of default management procedures. These deficits combined with other important elements that are missing (i.e., back testing of margins and credit and liquidity stress testing results) make an assessment of many of the features of the FTX proposal (including the sufficiency of margins and default fund) impossible.

According to the very limited information provided on the calibration of the initial margin requirements in the FTX's application, participants shall at all times maintain sufficient assets in each account to satisfy 100% of the initial margin requirement and if they do not, FTX intends to subject part or all of their portfolio to auto-liquidation. Since market volatility cannot be precisely predicted, even by the most experienced market participants, such an approach is bound to lead to exposure gaps. The likely failure to be able to maintain sufficient collateral by all participants at all times and the potential inability of FTX to perform liquidation can result in unnecessary defaults. It seems that no prior notifications regarding the auto-liquidation actions undertaken by FTX – which would give participants the opportunity to react and remedy the margin insufficiency (e.g., through topping up collateral posted) – would be provided to the affected participants.¹⁵ This could expose participants to unnecessary losses, which could have been avoided if the FTX proposal had conformed with best practices in risk management.

The problems described in the paragraph above could be exacerbated by the FTX's apparent lack of intention to implement appropriate collateral haircuts; and notably, no proposed haircut levels are outlined in the RfC.¹⁶ According to the FTX Participant Agreement, it is the participants' responsibility to monitor the qualifying assets in their accounts and to ensure that there are sufficient assets to meet margin requirements.¹⁷ Particularly in the case of retail participants, it seems unrealistic to expect that they would be capable of fulfilling this role on a 24/7 basis, especially if liquidations do in fact occur every six seconds. This would result in the portfolio of these participants being subject to regular auto-liquidation. There is also no clarity as to how collateral would be invested or safeguarded. All of these features of the FTX proposal seem to put potential FTX participants at a considerable disadvantage when compared to

¹⁵ See proposed FTX Rules 7.1.C and 7.1.D.

¹⁶ See FTX US Haircuts: [Link](#) and FTX International Haircuts: [Link](#).

¹⁷ FTX Request, Participant Agreement-Margin Revisions (Dec. 2021), available at [Link](#).

clearing members of CCPs and their clients in more traditional models. For example, traditional CCPs conduct regular settlement cycles to call for initial and variation margin, apply prudent haircuts that are designed to address the potential diminution of the collateral value, engage in practices that are designed to protect the assets posted by members and invest these assets only in safe and highly liquid financial instruments, and broadly share the returns on collateral investments with the members.

In many cases, FTX's proposal inaccurately claims that it is providing "improvements on traditional risk management practices"¹⁸ provided by CCPs today. In reality, some of the supposed improvements cited (e.g., real-time risk monitoring and the collection of liquidity and concentration margin) are practices employed by CCPs today. In other instances, FTX fails to include traditional risk management best practices in its proposal. In addition to the examples provided above, FTX's proposal points to its auto-liquidation mechanism as an improvement on traditional risk management, when in fact this approach has been considered in the past and dismissed, at least at the market infrastructure level, as detrimental to retail participants. In particular, it will expose FTX's participants to additional execution pricing risks and present them with other risks (as described above).

In this context, CCP12 would also like to reiterate our concern about the lack of information on the liquidation agents (i.e., liquidity providers in the FTX proposal) and whether these agents would have any obligations, as described further above. In a liquidation, the absence of clearing members that guarantee customers exposures means that there are no incentives for liquidation agents to auction off the defaulter's portfolio at the best possible price. In addition, the risks would only increase when trying to perform liquidations resulting from multiple defaults.

Another example of one of FTX's proposals, which we deem to be potentially risky, is the intended ability, under FTX Rule 7.1.G, of FTX to use participants' assets posted as IM or VM to meet temporary liquidity needs, even when the participant is not in default. While FTX states that it would restore this IM or VM as soon as practicable, it is not clear what would happen if FTX was unable to restore the participants' assets. In our opinion, there would be an urgent need to disclose the risk of this potential margin mutualization to the participants. Another important question that this proposal raises is whether any such borrowing would cause the lending participants to be under-margined.

Whereas the proposal envisions partial tear-ups and variation margin gains haircutting to address losses beyond the default fund, we also note that the FTX Rule 14.3.C appears to provide for discretionary contract tear-up prior to the use of the default fund, liquidity providers, and potentially even the auto-liquidation process. This is a form of loss mutualization. This would mean that a participant, who is in good standing, would be exposed to counterparty risk (i.e., a counterparty defaults and the contract of a non-defaulting participant is torn up), without knowing the identity of the counterparty or being able to manage the risk. This situation is even worse than bilateral trading because at least in a bilateral trade the entity knows its counterparty and can try to manage the risk.

To elaborate more on the lack of protection for participants, CCP12 has strong doubts as to whether FTX's intended participant base would be able to, among other things, assess the risk associated with participating in FTX under the proposed model, appreciate the risk that mutualized margin and tear-up provisions present, or evaluate the sufficiency of the default fund and the impact that an undersized

¹⁸ FTX Letter, Permissibility and Benefits of Direct Clearing Member under the Commodity Exchange Act and CFTC Regulations (Feb. 2022), at pg. 5.

default fund might have. Today, clearing members maintain experienced legal and risk staff, which evaluate a CCP's risk models and rulebooks before connecting to the CCP and giving access to their customers. Under the FTX proposal, participants are now responsible for assessing these risks and most likely have little power, on an individual basis, to push for changes at FTX. Even if participants had the capability to assess the risks, FTX would need to improve its disclosures for them to be able to do so. For example, FTX materials appear to be misleading in their characterization of the risks when they describe the default fund as covering any remaining risk to customers.¹⁹ The default fund's function of risk reduction to non-defaulting participants is very limited, particularly since FTX has the discretion to exercise partial tear-ups prior to the use of the default fund. Under a partial tear-up scenario, non-defaulting participants would not have the opportunity to manage their risk and therefore would be penalized rather than protected. In addition, participants must understand that not only may their positions be closed out through auto-liquidation by FTX if they are under-margined, but that such a liquidation could result in the participant owing more if the liquidation costs exceed its margin.²⁰

As already alluded to above, the important role that clearing members play in the traditional CCP model must not be forgotten. They provide an additional layer of informed risk monitoring and risk absorption. They evaluate a CCP's risk models, rulebooks, and operations, among other things, and provide an independent check on the sufficiency of margin levels (and may increase those levels for given customers above the CCP minimums). All of these important features and functions are lacking in the FTX proposal.

If the CFTC permits the FTX proposal to move forward as currently constructed, it would give credence to a model that fails to meet PFMI and general risk management best practices, and could be a catalyst for other jurisdictions to adopt such models. This is even more troubling when considering a scenario where FTX's proposed structure is applied to derivatives with non-crypto underlyings (e.g., global benchmark products that are used by market participants to hedge their business risks). The proliferation of clearing entities that do not meet the PFMI and general risk management best practices could have negative implications for global financial market stability and the real economy.

Another important aspect to be considered would be the potential impact the approval of FTX's proposed clearing model could have on the CFTC's cross-border relationships with other jurisdictions. For example, there could be implications on the CCP regulatory equivalence decision between the CFTC and the European Commission and potential for the CFTC to reach an equivalence decision with HM Treasury. A question arises as to whether such an approval would jeopardize these equivalence decisions. This could result in the U.S. DCOs losing their recognition status in the European Union ("EU") and United Kingdom ("UK"), and thus no longer being able to effectively serve clearing members with EU- and UK-based participants and participants with parent companies in these jurisdictions.

¹⁹ FTX Letter, Financial Resources under Core Principle B and CFTC Regulation 39.11(a)(1) in Absence of Clearing Futures Commission Merchants ("FCMs") (Feb. 2022), at pg. 1

²⁰ FTX Request, Participant Agreement-Margin Revisions (Dec. 2021) (noting, Section VI.O-Q), available at [Link](#).

About CCP12

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CCP12 promotes effective, practical, and appropriate risk management and operational standards for CCPs to ensure the safety and efficiency of the financial markets it represents. CCP12 leads and assesses global regulatory and industry initiatives that concern CCPs to form consensus views, while also actively engaging with regulatory agencies and industry constituents through consultation responses, forum discussions and position papers.

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