BETTER MARKETS

June 16, 2022

The Honorable Rostin Behnam
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW Washington, DC 20581

Re: Concerns Regarding Process for Considering FTX Application to Amend DCO Registration to Allow Direct Clearing Access to Margined Futures Contracts

Dear Chair Behnam:

Thank you for your leadership in opening up the process for considering FTX's application to the Commodity Futures Trading Commission ("CFTC" or "Commission") to amend its derivatives clearing organization ("DCO") order of registration to allow it to offer direct clearing access to margined futures contracts ("FTX Application"). Putting the FTX Application out for public comment and convening a public roundtable to discuss it on May 25, 2022 (the "Roundtable") were important steps to ensure that the many complicated issues raised by the FTX Application were not only fully considered but done so in an open and transparent way. This, of course, is imperative given the momentous issues raised by the FTX Application.

However, we have some concerns about the process thus far and the as yet undisclosed process going forward that we would like to share with you. As we explained in our comment letter on the FTX Application,[1] and as others have observed,[2] FTX's Application should not just be considered as a narrow or limited change to one DCO's business model, but as a potentially very significant change to the structure of the entire futures markets. In particular, among other things, FTX's Application, if approved, would increase the participation of retail speculators in futures markets, which have historically been markets for physical producers and purchases to

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1 Better Markets Comment Letter on FTX Application (May 11, 2022), https://bettermarkets.org/wp-content/uploads/2022/05/BetterMarkets_Request_for_Comment_FTX_Request_for_Amended_DCO_Registration_Order.pdf.

2 Hilary Allen, Lee Reiners and Ryan Clements, Non-Intermediated Clearing of Crypto Derivatives on Margin is a Bad Idea, FinReg Blog (May 12, 2022), https://sites.law.duke.edu/thefinregblog/2022/05/12/non-intermediate-clearing-of-crypto-derivatives-on-margin-is-a-bad-idea/; *See also* CME Letter on FTX Application at 4 (May 11, 2022) ("In order to grant the FTX Request, the CFTC will be required to find that any Amended DCO Order complies the Core Principles, a finding that would have precedential value allowing other DCOs to implement this model in other markets.)

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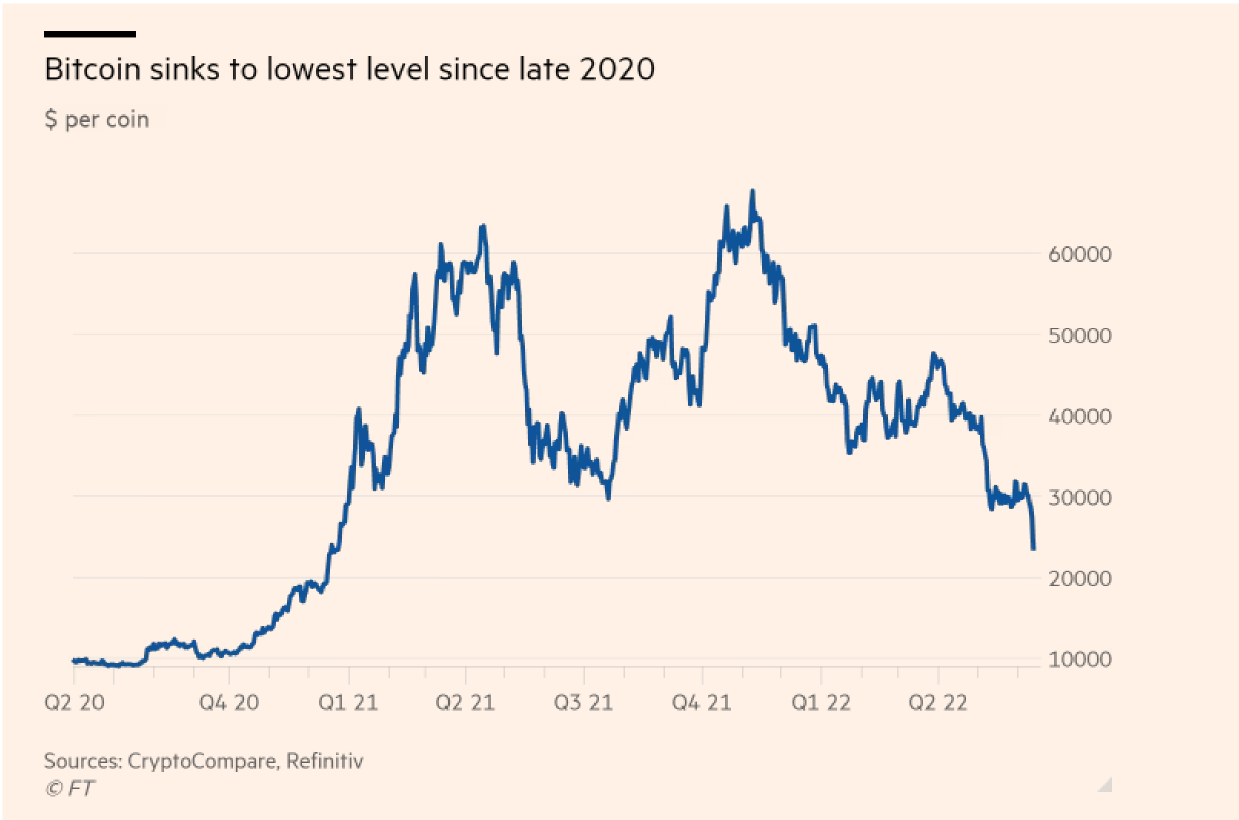
hedge price risk, almost always by institutional participants who have the financial resources and sophistication to protect themselves.[3] Considering this potentially dramatic if not historic change to the futures markets is all the more critical given the extreme price volatility of crypto, as illustrated over the last several weeks and months, if not years, as demonstrated by this June 14th chart regarding Bitcoin's historical price:[4]



As you know, the CFTC has broad discretion when considering a request to amend a DCO's order of registration.[5] As we explained in our comment letter, and as echoed a wide range of commenters, the potential for the fundamental transformation of the futures markets, and all of the uncertainties and risks this would entail, the CFTC's consideration of FTX's Application requires a deliberative, robust, transparent public process with significant opportunity for

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3 This risk relates to the entire futures markets and is not limited to crypto futures given that FTX and others have talked openly about expanding involvement in other ways as well. *See* CME Group Letter on FTX Application (May 11, 2022) ("FTX has made clear in public statements that it plans to expand the proposed structure to other centrally cleared derivatives asset classes."), https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=69466&SearchText=cme.

4 *See* Adam Samson, Eva Szalay, Scott Chipolina, Hudson Lockett and William Langley, "*Bitcoin tumbles after crypto lender Celsius blocks all redemptions*," The Financial Times (June 13, 2022), available at https://www.ft.com/content/25ac1667-9f50-4f16-b553-448ea4582613?shareType=nongift.

5 *See* 17 C.F.R. § 39.2(d),.

meaningful public comment. That's why we were encouraged by the Commission's initial responses to FTX's Application. However, the Roundtable could have been more effective as a meaningful forum for informing the public, and facilitating debate about, FTX's Application:

First, although it announced the Roundtable on April 27, 2022, the CFTC did not release a participant list until just before the meeting on May 24, 2022. Of course, the participants were identified, invited, confirmed, and even participated in planning calls all well in advance of the Roundtable. There was no reason not to disclose this to the public much earlier. The failure to do so made it impossible for the public to know ahead of the Roundtable which interests would (and would not be) be represented at the Roundtable.

Second, there was no advance public notice of the topics to be covered at the Roundtable. Instead, shortly before the Roundtable the CFTC released what it called an "agenda" that simply listed four modules, unhelpfully named "MODULE I," "MODULE II," "MODULE III" and "MODULE IV." This made it impossible for the public to know ahead of the Roundtable which topics would be discussed.

Third, although the CFTC avoided making the Roundtable specifically about FTX's application, opting instead to give participants a "stylized" set of facts relating to a fictitious DCO referred to as "DM DCO," it did not publicly release this hypothetical in advance of the meeting and indeed, as of the date of this letter has not yet released this hypothetical. Accordingly, when participants referred to assumptions or facts in this non-public hypothetical, members of the public were left to guess about what exactly was being referred to.

Fourth, the Roundtable was dominated by industry interests, with few independent voices or representatives of the public interest. Indeed, of the 31 participants in the Roundtable, only four were not representing an entity with a direct self-interest in the resolution of FTX's Application: one "independent risk management and clearing expert," two academics, and a representative from a public advocacy organization. As a result, the conversation was inevitably dominated by self-interested industry voices, limiting the Roundtable's utility to provide the public with a balanced presentation of the issues raised by FTX's Application.

In fairness to the CFTC, FTX's Application presents a host of novel issues, and the process for dealing with those novel issues has necessarily been somewhat *ad hoc*, particularly as the process has unfolded just as the Commission was onboarding four new commissioners. Missteps are certainly understandable, if not inevitable, and despite them we commend the CFTC on what was certainly a good faith attempt to provide a forum for initial discussion of the issues raised by FTX's Application, accompanied by what was clearly a significant amount of hard work by the Commissioners and staff.

Nevertheless, understandable as they may be, the end result of these missteps was that the Roundtable, while providing an interesting discussion and some useful information, failed to fulfill its potential as a forum where the public could get meaningful and fair presentation of the issues raised by FTX's Application. This is unfortunate because it is the American public that, after all, suffer the consequences if FTX's proposal – and the likely logical extensions of that proposal -- threatens the American financial system or economy.

Taken together, these missteps also could give the impression that approval of FTX's application is a foregone conclusion, a matter of "how" rather than "if." Indeed, that was a sentiment expressed by several Roundtable participants. Thus, although there was skepticism expressed about FTX's Application from some of the industry participants, the prevailing sentiment (expressly encouraged by the moderator, who we would have hoped would have been more neutral) was of finding common ground and compromise on the issues raised by FTX's Application, with many participants expressing confidence that there would be room for all industry participants to profit if FTX's non-intermediated model were approved.[6] This is unsurprising—while FTX's model may threaten the current business models of some in the industry, the financial industry is nothing if not creative in finding new ways to turn a profit, which too often takes the form of wealth extraction from Main Street Americans. To be sure, while some industry participants have raised self-interested, if often cogent, concerns about FTX's Application, they are also doubtless, and understandably planning ways they can compete and profit if FTX's Application is approved.

However, largely missing in all of this discussion of finding compromise or ways that FTX's Application can be approved while accommodating a variety of business interests is whether approval of FTX's application would serve the **public interest**. This includes retail traders who, as the CFTC itself acknowledges, futures trading is "rarely suitable" for.[7] Yet approval of FTX's Application would mean much easier access to high risk, leveraged futures contracts on cryptocurrency, itself a risky and volatile asset class, notwithstanding that retail traders tend to suffer significant losses when trading risky derivates contracts using leverage.[8] The public interest also, of course, includes the American taxpayer who could ultimately be on the hook for any risks to the financial system from FTX's Application. Yet, despite a few perfunctory nods towards the public interest from industry participants, the distinct impression given by the Roundtable was that approval of FTX's Application was overwhelmingly a matter of satisfying the concerns of various industry participants who see a potential threat to their bottom line, rather than addressing the serious concerns FTX's Application raises for the American public.

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6 Allyson Versprille, *Wall Street Traditionalists Spar With FTX Over Crypto Derivatives*, Bloomberg (May 25, 2022) ("Some raised the prospect of a compromise… It's possible that both models could co-exist, according to Jennifer Han, chief counsel and head of regulatory affairs at the Managed Funds Association, whose members include hedge funds. There's a lot of support for continued innovation and competition in this area'."), https://www.bloomberg.com/news/articles/2022-05-25/traditional-wall-street-spars-with-ftx-over-derivatives-plan?utm_source=google&utm_medium=bd&cmpId=google&sref=mtQ4hc2k.

7 https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/FuturesMarketBasics/index.htm.

8 Vildana Hajric, *Mom and Pop Investors Took a Bath Trading Options During Pandemic*, BLOOMBERG (Apr. 27, 2022), https://www.bloomberg.com/news/articles/2022-04-27/mom-and-pop-took-a-billion-dollar-bath-trading-pandemic-options?sref=mtQ4hc2k.

We are confident that the CFTC, and its dedicated staff, understand that its job is to ensure that FTX's Application is consistent with the public interest, and not just to ensure that the profit-motivated concerns of some in the industry are placated. Nevertheless, the unbalanced nature of the discussion at the Roundtable, almost entirely focused as it was on industry perspectives and concerns, could undermine confidence that the CFTC's consideration of FTX's Application appropriately took into account the risks to investors, including retail investors, the financial system, and the broader economy.[9] To ensure that this does not happen, as it continues to consider FTX's Application, the CFTC's process must be marked by greater openness, transparency, and accountability on the part of both the CFTC and FTX.

This means that future open meetings to discuss issues raised by FTX's Application must be accompanied by meaningful and granular transparency, ahead of the meeting, as to both participants and issues to be discussed (and any scenarios or hypotheticals around which the discussion is being organized). Moreover, the CFTC must ensure that discussion of the various issues raised by FTX's Application is balanced, which means the CFTC must do a better job of affirmatively including the perspective of those who do not have a direct pecuniary self-interest in the resolution of FTX's application. This means including more academics, more independent experts, and more representatives of organizations that represent the public interest, whatever their ultimate perspective may be on the issues raised by FTX's Application. And it means selecting a neutral moderator, one who although knowledgeable about the issues presented, has not picked a side in the debate and therefore can fairly explore a variety of viewpoints.

It also means ensuring that independent voices have ample chance to air their views, and have the valid concerns they raise taken seriously, not hostilely brushed aside, as occurred when the lone representative from a public interest organization raised the reasonable concern that margined Bitcoin futures contracts, accompanied by 24/7/365 margining and auto-liquidation that can blow them out of positions anytime, may not be suitable for retail investors. This perfectly credible concern, which is consistent with the CFTC's own assessment of the suitability of futures trading for retail customers, was unfortunately met by a dismissive, disrespectful, insulting and unnecessarily hostile response from FTX's CEO.[10]

The CFTC must also require that FTX submit significantly more public information about its proposed model. While the CFTC has a wide degree of discretion in handling an application to amend a DCO registration order, approving the application on the public record that exists at this point would almost certainly be considered arbitrary and capricious. FTX's Application

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[9] Importantly, this would be the case whether the CFTC approves or rejects FTX's application. If approved, the impression would be that the application was approved because various industry interests were placated, i.e. those industry participants were convinced that FTX's model did not pose an undue threat to their profit. If rejected, the impression would be that industry interests were not able to be placated, i.e. that FTX's application fell victim to entrenched, incumbent industry interests.

[10] Allyson Versprille, *Wall Street Traditionalists Spar With FTX Over Crypto Derivatives*, Bloomberg (May 25, 2022), https://www.bloomberg.com/news/articles/2022-05-25/traditional-wall-street-spars-with-ftx-over-derivatives-plan?utm_source=google&utm_medium=bd&cmpId=google&sref=mtQ4hc2k.

consists primarily of an 11-page letter, supplemented by a 5-page letter on financial resource, a total of 16 pages long. Unfortunately, those materials are largely conclusory, self-serving assertions, lacking detail or evidence to back up those assertions. FTX's public discussions of its application, including at a Congressional hearing and at the Roundtable, have provided very little additional information, with FTX primarily sticking to talking points that seem to be derived from the conclusory assertions made in its application. Indeed, while the utility of the Roundtable was compromised by some of the missteps highlighted above, what it demonstrated above all else is that FTX's Application raises significantly more questions than FTX currently has answers to, even for FTX itself.

An illustrative example of this occurred when a representative from the National Council of Farmer Cooperatives, and others, raised concerns at the Roundtable about how FTX's proposed model would impact producers using the futures markets to hedge price risk. That question prompted FTX's CEO to admit that the model might not work as well or, at the very least, would raise more difficult questions for futures on physical or agricultural products.[11] Yet, FTX's Application, by its terms, is not limited to Bitcoin futures contracts, nor to contracts that are "digitally settled." ***Indeed, it is not limited to any particular asset class, notwithstanding its CEO's admission that its model raises more difficult questions for other asset classes.***

As another example, FTX has asserted that "it intends not to rely on clearing FCMs or otherwise require that its participants mutualize risk to the clearinghouse."[12] But, as commenters have pointed out, FTX's Rulebook would appear to continue to allow it to deal with defaults, at its discretion, by engaging in partial tear up of positions not in default.[13] The unmistakable impression this raises is that FTX itself has not even thought through the implications of its application, and indeed has not even fully thought through what exactly it is asking for in its application, or even the nature of the model it is proposing. These are incredibly serious concerns that must be definitely and publicly addressed and resolved prior to any further consideration of FTX's Application.

Given the lack of information, detail, and evidence FTX has provided to support its application, the CFTC must use its broad authority to seek additional information from a DCO seeking to amend its registration order to get significantly more information from FTX.[14] Any additional information FTX presents must be made publicly available, and the public must be given ample time and a robust opportunity to comment on any submissions FTX makes.

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11 https://www.theblockcrypto.com/post/148786/cftc-roundtable-on-ftx-proposal-highlights-barriers-in-clearing-of-digital-vs-physical-assets.

12 FTX Proposal at 5.

13 FIA Letter on FTX Application at 12 (May 11, 2022), https://www.fia.org/sites/default/files/2022-05/FIA%20FTX%20Request%20for%20Amended%20DCO%20Registration%20Order%205.11.22.pdf.

14 17 C.F.R. § 39.2(d)(2).

At the very least, FTX must publicly provide the CFTC with credible, detailed answers to the following questions:

- How will the volatility associated with both cryptocurrency markets and futures trading impact investors?
  - In particular, the CFTC should require that FTX produce an analysis of how its proposed model would have fared over the last several weeks of extraordinary volatility in the cryptocurrency market assuming the accuracy of its future projections of customers and revenue flow. This analysis should address not just how the clearinghouse would have been projected to fare, but the impact on customers, particularly retail customers. Among other things, this analysis should show how much the average account was auto-liquidated, what percentage of accounts would have been totally liquidated, and how retail accounts would have fared relative to institutional accounts.

- How can investors be protected without the investor protections associated with FCMs?

- Will the online, app-based, check-the-box know your customer questions genuinely satisfy all legal requirements?

- How will retail traders be protected if they have easy, app-based access to trade futures contracts, particularly given such traders tend to perform poorly when engaging in speculative derivatives trading?

- How would retail traders' margined positions have fared over the last several weeks of volatility?

- How will the markets change as purely speculative retail traders become more active and make up a larger proportion of market participants, changing the balance between physical end users and speculators?

- How will the futures markets perform if all clearing houses are non-intermediated and enable direct margined retail participation, as seems to be the reasonable assumption if FTX's application is approved?

- How will more retail traders impact physical market prices, price discovery, hedging costs, and the other institutional participants in the markets?

- Will additional speculators in the markets lead to, cause, or exacerbate excess speculation?

- How will the compression of the waterfall from multiple shock absorbers to only a few impact the markets and systemic risk?

- What will the actual default waterfall be?

- Will FTX's platform increase systemic risk given the increased price volatility that may come with increased retail participation?

- What assumptions is FTX making about retail participation in its market following introduction of its direct access model, over the next one, three, and five years? What is the basis for those assumptions?

- Does FTX plan to market direct access to retail customers, as it has marketed its spot product to customers?

- What kind of cybersecurity protections does FTX have in place to ensure its automated liquidation systems are not compromised? What happens in the event of a system outage, malfunction, or glitch, even if for a single second, in a 24/7/365 auto liquidation system?

We would suggest that, after FTX provides responses to these questions and provides the data, all of which must be publicly released, that the CFTC put the information along with FTX's Application out for public comment. After receipt of those comments, the CFTC should convene another roundtable along the lines discussed above to ensure that it not only has the FTX information, but also the views of all stakeholders once informed by that information.

For its part, the CFTC must, after considering public comments received on FTX submissions, independently analyze those submissions and make a credible determination as to whether FTX has demonstrated that its proposal satisfies all applicable core principles and other legal requirements, and that it does not pose undue risk to the U.S. financial system or broader economy. Even after this, however, the CFTC's job will not be done because, as has been publicly stated by market participants, approval of FTX's application will lead to other DCOs seeking to emulate it and those requests that will be difficult if not impossible to deny once FTX's Application is approved.[15] Thus, the CFTC must operate on the assumption that FTX's model will spread, to other DCOs and other asset classes, and must consider that when evaluating FTX's Application.

The CFTC must, therefore, consider a framework that ensures that the spread of FTX's model does not pose undue threats to market participants including retail investors, commercial producers seeking to hedge price risk, the financial system, and the economy. Such a framework should also be subject to public comment, if not a formal rulemaking process. Only **if** these conditions are met (and it must be a matter of "if" not "when" FTX's Application is approved, i.e., approval simply cannot be assumed before obtaining and analyzing sufficient material information), can FTX's Application be approved.

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15 CME Letter on FTX Application at 4 (May 11, 2022) ("In order to grant the FTX Request, the CFTC will be required to find that any Amended DCO Order complies the Core Principles, a finding that would have precedential value allowing other DCOs to implement this model in other markets."), file:///Users/Jason/Downloads/69466KathleenCronin.pdf.

Thank you for your time and consideration of these issues. We know we don't have to tell you how important the decision on FTX's Application will be to investors, markets, the financial system, and the economy. Unlike many matters that come before regulatory agencies like the CFTC, history will likely closely scrutinize this one given the gravity of its implications.

Sincerely,

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