

May 11, 2022

BY ELECTRONIC TRANSMISSION

Christopher Kirkpatrick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21 Street NW  
Washington, DC 20581

**Re: Comments on FTX Request for Amended DCO Registration Order**

Dear Mr. Kirkpatrick,

The Options Clearing Corporation (“OCC”) appreciates the opportunity to comment on the proposal by LedgerX LLC, d/b/a FTX US Derivatives (“FTX”), to offer margined derivatives contracts on cryptocurrencies directly to participants without the benefits of clearing through a futures commission merchant (“FCM”). While FTX styles its proposal as a request for amendment to its order of registration as a derivatives clearing organization (“DCO”), FTX’s proposal may be more fairly characterized as a request for exemption from clearing transactions in the manner contemplated by the DCO Core Principles, CFTC Regulations and international standards set forth in the Principles for Financial Market Infrastructures (“PFMI Principles”) promulgated by the Committee on Payments and Market Infrastructures (“CPMI”) and the International Organization of Securities Commissions (“IOSCO”). OCC shares the concerns expressed in the comment letters submitted by the Global Association of Central Counterparties (“CCP12”) and the World Federation of Exchanges and writes separately to emphasize its concern that FTX’s proposal would “hard fork”<sup>1</sup> the proven central counterparty model in a manner that would lead to greater systemic risk and weaken investor protection.

**I. ABOUT OCC**

Founded in 1973, OCC is the world’s largest equity derivatives clearing organization. OCC clears all standardized options listed on the sixteen U.S. national securities exchanges that trade options subject to the jurisdiction of the Securities Exchange Commission (“SEC”) and commodity futures and commodity options for two U.S. futures exchanges subject to the jurisdiction of the Commodity Futures Trading Commission (“CFTC”). OCC also provides central counterparty clearing and settlement services for securities lending transactions. OCC is registered with the SEC as a clearing agency pursuant to Section 17A of the Securities Exchange

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<sup>1</sup> With respect to blockchain technology, a hard fork is a fundamental change in the blockchain’s protocol that effectively results in two branches that follow different protocols going forward.

Act of 1934,<sup>2</sup> is registered with the CFTC as a DCO pursuant to Section 5b of the Commodity Exchange Act,<sup>3</sup> and is designated by the Financial Stability Oversight Council as a systemically important financial market utility (“SIFMU”). As a SIFMU, OCC is also subject to oversight by the Board of Governors of the Federal Reserve System. OCC is owned by five options exchanges and operates as a financial market utility, returning or foregoing clearing fee revenue in excess of OCC’s expenses and capital needs. OCC is governed by a Board of Directors comprised of clearing member, exchange and public directors.

In its capacity as a DCO, OCC has cleared cash-settled futures contracts on cryptocurrencies. Previously, OCC provided clearance and settlement services for the first Bitcoin futures to be listed on a U.S. exchange by Cboe Futures Exchange, which was based on an auction price for Bitcoin. Currently, OCC clears and settles futures listed by Small Exchange on the Small Cryptocurrency Index, which groups together Bitcoin, Ethereum, and a number of equities in the cryptocurrency sector. As a clearing agency, OCC also clears and settles all listed options on equity securities, including ETFs in the cryptocurrency sector. OCC does not clear cryptocurrency contracts that settle in the underlying cryptocurrency.

## **II. BACKGROUND**

### **A. THE CCP MODEL**

A central counterparty (“CCP”) like OCC provides risk mitigation through counterparty substitution whereby the CCP becomes the counterparty to every trade—the buyer to every seller and the seller to every buyer. CCPs thereby guarantee performance of the cleared contract regardless of the default of one of the counterparties. CCPs also engage in multilateral netting, which reduces the risk in the overall system.

Risk management is at the core of how CCPs like OCC perform these critical functions. CCPs, clearing firms, exchanges, and market participants have a common interest in maintaining robust risk management so that defaults are rare, and that in the unlikely event that there is a clearing member default, the prefunded financial resources of the defaulting clearing member will, in most cases, cover its obligations to the CCP. This is the fundamental characteristic of a “defaulter pay” model, which OCC believes is the cornerstone of CCP resilience.

As a first line of defense against a default, CCPs manage credit risk by establishing and enforcing rigorous membership standards and monitoring the creditworthiness and operational reliability of their clearing members on an initial and ongoing basis. OCC’s clearing members consist of 107 broker-dealers and FCMs that collectively possess approximately \$200 billion in net capital available to absorb potential losses. OCC admits clearing members in accordance with the membership criteria set forth in its By-Laws and Rules and monitors ongoing

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<sup>2</sup> 15 U.S.C. § 78q-1.

<sup>3</sup> 7 U.S.C. § 7a-1.

compliance with those standards as provided in OCC's Third-Party Risk Management Framework.<sup>4</sup>

CCPs like OCC also manage their credit exposure to clearing members by maintaining margin to cover the expected period from the time of a default until the positions are closed out. Portfolios are marked-to-market, evaluated throughout the trading day, and settled at least once a day. In addition, CCPs establish default funds, typically funded by their members, to cover potential exposure to the non-performance of any member, thus mutualizing the risk of a member failure. For example, OCC maintains a mutualized Clearing Fund sized to provide a high degree of confidence that market integrity can be maintained in a wide range of stress scenarios that include the default of OCC's two largest clearing members and their participants—collectively involving tens of thousands of individual customer accounts—under extreme but plausible market conditions. In addition to a fixed amount required of all OCC clearing members, OCC allocates Clearing Fund deposit requirements to Clearing Members proportionately based on a weighted average of a clearing member's proportionate share of total risk, open interest and contract volume. These risk-based Clearing Fund deposits provide an additional incentive for OCC's members to manage the risks they present to OCC.

CCPs also have default management procedures and can draw on pre-funded resources, known as the "default waterfall," to assist them in managing a default. Pursuant to OCC's default rules and procedures, its default waterfall consists of the following resources in the following order:

- **Defaulting member's margin and Clearing Fund deposit:** As discussed above, the prefunded resources of the defaulting member, including margin and the defaulting member's Clearing Fund deposit, are the first resources that would be exhausted under OCC's default waterfall.
- **OCC skin-in-the-game:** Prior to charging the Clearing Fund deposits of non-defaulting clearing members, OCC would first contribute its own capital available as skin-in-the-game under OCC's Rules. This skin-in-the-game would include a minimum corporate contribution established by OCC's Board of Directors as well as any liquid net assets funded by equity in excess of 110% of OCC's regulatory capital requirement at the time of the default.
- **Clearing Fund deposits of non-defaulting members and OCC executive compensation:** After exhausting a defaulter's resources and OCC's skin-in-the-game, OCC would allocate any remaining loss proportionately to the Clearing Fund deposits of non-defaulting members and the unvested funds held in respect of OCC's Executive Deferred Compensation Program Trust.

Finally, CCPs also have in place recovery and wind-down plans. OCC has access to recovery tools under its By-Laws and Rules, including additional Clearing Fund assessments,

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<sup>4</sup> See Third-Party Risk Management Framework, available at <https://www.theocc.com/Company-Information/Documents-and-Archives>.

voluntary payments, voluntary tear-ups, and partial tear-ups. Notably, these recovery tools would come into play only after OCC exhausted the default waterfall described above.

## **B. SUCCESS OF THE CCP MODEL**

The success of the CCP model was perhaps best demonstrated when handling the Lehman Brothers bankruptcy during the financial crisis of 2008. As one former journalist and author observed, “Within a week of the Lehman bankruptcy, most outstanding open positions relating to these trades had been neutralized or ‘hedged’ . . . Within two weeks, most of Lehman’s customers were transferred to other investment companies. By late October 2008, CCPs in most leading financial markets had reported success in managing the biggest default in financial history without cost to their member companies.”<sup>5</sup>

On the heels of the financial crisis, international policy makers expanded the prevalence of, and reliance on, the CCP model as a part of their efforts to support the stability of the financial system. Perhaps most notably, in 2009, the G-20 committed that “all standardized OTC derivative contracts should be . . . cleared through central counterparties by end-2012 at the latest.”<sup>6</sup> It was clear to policymakers that the risk management enhancements provided by CCPs were preferable to the post trade practices of the bi-lateral OTC derivative markets. The G-20’s mandate led to a number of subsequent proposals and guidance from international policymakers, including the PFMI Principles. In addition, the Financial Stability Board (“FSB”)<sup>7</sup> and CPMI-IOSCO<sup>8</sup> have published important framework documents concerning standards for CCP resiliency, recovery, and resolution.

Many jurisdictions have incorporated these international standards into laws, rules and regulations that are tailored to the specific characteristics of their local market, legal framework and the CCPs subject to their authority. In the U.S., new standards for CCPs were implemented pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act and have been incorporated into the SEC’s Standards for Covered Clearing Agencies (“CCA Standards”) and the CFTC’s DCO Core Principles. Specifically, the CFTC adopted Subpart B of Part 39 of the

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<sup>5</sup> Peter Norman, Risk Controllers: Central Counterparty Clearing in Globalised Financial Markets, at 26-27.

<sup>6</sup> G20 Leaders Statement: The Pittsburgh Summit (September 24-25, 2009), available at <http://www.g20.utoronto.ca/2009/2009communique0925.html>.

<sup>7</sup> See FSB, Guidance on Financial Resources to Support CCP Resolution and on the Treatment of CCP Equity in Resolution (November 2020); FSB, Guidance on Central Counterparty Resolution and Resolution Planning (July 2017); FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2014).

<sup>8</sup> See CPMI-IOSCO, Recovery of Financial Market Infrastructures (revised July 2017); CPMI-IOSCO, Resilience of Central Counterparties (CCPs): Further Guidance on the PFMI (July 2017).

CFTC Regulations, which codifies eighteen core principles and related regulations with which DCOs must comply to obtain and maintain its registration status.<sup>9</sup>

### **III. FTX'S PROPOSAL LACKS SUFFICIENT INFORMATION FOR MEANINGFUL COMMENT**

As a general matter, meaningful comment on FTX's proposal to depart from the CCP model described above is hampered by the absence of information on its risk management practices and overall governance. In particular, the proposal, which seeks to extend clearing to margined products, lacks information on FTX's margin and credit and liquidity stress testing methodology. FTX's filing does not include information on its margin models or how FTX will comply with the margin requirements of CFTC Rule 39.13(g), including margin coverage requirements that meet an established confidence level of at least 99 percent, backtesting processes, any proposed spread and portfolio margins, the pricing data that is utilized, and independent validation of the model. This lack of information on its margin methodology is inconsistent with the level of transparency market participants have come to expect and that the CFTC requires under CFTC Rule 39.21(c)(3). This lack of information extends to other aspects of FTX's proposed operations, including its collateral haircuts and investment management policies, liquidity risk management, and default management testing procedures, among others. By comparison, since the adoption of the SEC's CCA Standards and the CFTC's DCO Core Principles, OCC has filed with the SEC and CFTC rule changes concerning its margin methodology, Risk Management Framework Policy, Margin Policy, Model Risk Management Policy, Collateral Risk Management Policy, Liquidity Risk Management Framework, Third-Party Risk Management Framework, Board of Directors and Board-level committee charters, and other governance arrangements, to name a few.<sup>10</sup>

### **IV. SYSTEMIC RISK POSED BY FTX'S PROPOSAL**

FTX's proposal seeks to depart from key risk management practices that are the cornerstone of the CCP model. As discussed below, FTX's proposed disintermediated model would pose risks for the financial system as a whole.

Absent from FTX's proposed disintermediated model are the types of credit due diligence and risk-based membership requirements that serve as the first line of defense against a default. DCOs are currently required under CFTC Rule 39.12 to establish and maintain procedures to monitor compliance with participant requirements that, among other things, require members to maintain sufficient financial resources to meet obligations arising from participation in the DCO in extreme but plausible market conditions (including capital requirements that are scalable to the risks posed by clearing members) and to have adequate operational capacity to meet such obligations. As noted above, OCC's clearing members, which include both broker-dealers and

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<sup>9</sup> See Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69334 (Nov. 8, 2011), as amended by 85 Fed. Reg. 4800 (Jan. 27, 2020).

<sup>10</sup> See CFTC.gov, Clearing Organization Rules, <https://sirt.cftc.gov/sirt/sirt.aspx?Topic=ClearingOrganizationRules> (select OCC under Organization).

FCMs, have approximately \$200 billion in capital available to absorb potential losses to the financial system. FTX's proposal does not seek to impose any capital requirements on its non-FCM members. In addition, CFTC Rule 39.13(h)(5) requires a DCO to have rules that require its clearing members to maintain risk management policies and procedures that address the risks the member may pose to the DCO, make those policies and procedures available to the CFTC upon request, and review those policies and procedures on a periodic basis. With respect to FCMs, such policies and procedures would include how an FCM manages and monitors credit exposure to its customers, providing another layer of credit due diligence. Eliminating this dual layer of credit exposure monitoring would increase the systemic risk posed by direct clearing between individual participants, who may lack the capital and operational capacity to meet obligations during stressed market conditions. Accordingly, a large number of simultaneous participant defaults under stressed market conditions is a very real possibility, especially under FTX's proposed auto-liquidation policy.

Perhaps most significantly, FTX's proposal does not explain how it will size its financial resources to cover "extreme but plausible market conditions." For context, in addition to initial margin, OCC maintained over \$16 billion in Clearing Fund deposits as of March 31, 2022 to satisfy its Cover 2 standard based on stressed scenarios in accordance with CFTC Rule 39.11(c). OCC sizes the Clearing Fund using daily stress testing of clearing member exposures based on changing prices, volatilities, and positions conducted pursuant to CFTC Rule 39.19(h)(3), amongst other factors. In lieu of a member-funded guaranty fund, FTX proposes to establish its own corporate contribution of \$250 million. FTX does not offer any insight into how it arrived at that static corporate contribution, nor does it propose to re-size that amount in a risk-based manner based on stressed scenarios or otherwise. In addition, FTX's proposed rules do not provide whether or how those skin-in-the-game funds would be replenished if charged. While FTX proposes to move to a Cover-2 or Cover-3 standard if the Cover-1 entity represents less than 10% of total initial margin, the defaulting clearing member's percentage of total resources available to a CCP like OCC in a Cover-2 scenario is well in excess of 10%. FTX's proposal to cover three individual accounts is simply not comparable to a CCP that covers financial institutions that can be comprised of tens of thousands of individual accounts.

FTX's proposal also departs from the default rules and procedures of established CCPs in ways that are likely to increase systemic risk. It is unclear how the proposed auto-liquidation function would perform in volatile conditions with possible reduced liquidity. Auto-liquidations could move the market further and triggering more auto-liquidations resulting in a feedback loop or "flash crash." Potentially to mitigate this result, FTX's proposed default waterfall relies heavily on the intervention of a "Backstop Liquidity Provider." However, there is no information in the proposal about who this Backstop Liquidity Provider may be, what expertise it may have, the financial resources at its disposal, the percentage of those financial resources committed to this function, the liquidity it has available to it, and what obligations it has to perform this function. Unlike with respect to the CCP model, under which clearing members have incentives to submit bids at a default auction to avoid mutualization of a loss, there is no information in the proposal to suggest that the Backstop Liquidity Provider would have an incentive to achieve a reasonable price. The same is true for a voluntary auction amongst participants under FTX's disintermediated model. Finally, FTX's proposal undermines the

nature of a CCP guarantee by incorporating partial tear-ups not simply as a recovery tool after the default waterfall has been exhausted, but as part of the default waterfall itself. Significantly, partial tear-ups are placed in FTX's default waterfall before FTX is obligated to apply any of its \$250 million skin-in-the-game. Accordingly, FTX's proposal goes against the many years of discussions between clearing members, clients, CCPs, and regulators that recovery tools such as partial tear-ups should exist at the end of the default waterfall process.

## **V. WEAKENED INVESTOR PROTECTIONS**

FTX's proposed disintermediated model would circumvent well-established customer protection regimes with respect to the regulation of FCMs, including regulatory and self-regulatory organization oversight. Perhaps recognizing this, FTX proposal seeks to adopt certain of those practices, including know-your-customer ("KYC") and anti-money laundering ("AML"). However, FTX does not offer any transparency into how it would staff these functions for so large a participant base—*i.e.*, in the absence of FCMs, FTX would be performing these functions for the entire industry's worth of investors. Moreover, FTX's proposal to by-pass the FCM regulatory regime raises other investor protection concerns.

FTX proposes to auto-liquidate participants' positions that are under-margined at any point in time. The proposal places the burden on participants, including retail investors, to closely monitor the value of their margin assets (to make sure they do not become under-margined), which would be especially challenging for individual investors in volatile markets and in the absence of transparent information about FTX's collateral management procedures (*e.g.*, collateral haircuts). In addition, the stated purpose of FTX's skin-in-the-game is to cover any remaining risks to non-defaulting participants. At variance with this, the FTX proposal also allows it the discretion to implement partial tear-ups, which may result in losses for the non-defaulting participants before FTX accesses its skin-in-the-game. In addition, under the CCP model, customer account portability is an important customer protection in the event of the default of a clearing firm, which would be lost under the disintermediated model.

If FTX were itself to fail, investors would be exposed to unique risks under FTX's proposal. For example, FTX has proposed authority to use initial and variation margin of non-defaulting participants to meet temporary liquidity needs. Such use of margin is inconsistent with the purpose of margin under the CCP model, which is limited to addressing losses of the defaulting member. In the likely event that FTX had, prior to its failure, exercised that authority, the loss of non-defaulting members' margin collateral would compound the complexity of FTX's resolution, especially in the absence of an established customer protection insolvency regime for cryptocurrencies.

## **VI. CONCLUSION**

The CCP model has served the financial industry well through periods of high market volatility during the 2008 financial crisis and the Covid 19 pandemic. The volatile nature of cryptocurrencies makes them a poor choice for a hard fork in the CCP model, particularly one that represents a weakening of proven risk management practices and investor protections, has greater potential for systemic risk, and does not meet the DCO Core Principles. In any event,

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such a departure would be inconsistent with the directive in the March 9, 2022 Executive Order on Ensuring Responsible Development of Digital Assets, which provides that intermediaries for digital assets “should, as appropriate, be subject to and in compliance with regulatory supervisory standards that govern traditional market infrastructures and financial firms, in line with the general principle of ‘same business, same risks, same rules.’”<sup>11</sup> As a CCP that is registered with both the SEC and the CFTC, OCC is also concerned about a fundamental change in the regulatory regimes that apply to different asset classes, especially for a class of assets for which it is yet unsettled which products fall within the respective regulatory regimes of the two regulators. If the amendment is approved, it is not clear on what principled basis the CFTC could deny a future request to extend this disintermediated model to other products within the CFTC’s jurisdiction. Of particular concern is the impact that a departure from the PFMI Principles could have on equivalency determinations with respect to the CFTC’s regulatory regime and those governing European and UK derivatives markets. If a departure from the PFMI Principles caused European and UK regulators to rescind or deny equivalency determinations, the foreign parent companies of certain OCC clearing members may be subject to additional capital charges under their own prudential requirements, which could in turn impact the business of the domestic clearing members and their customers. For the foregoing reasons, OCC believes the CFTC should deny FTX’s application to amend its DCO registration as proposed.

Very truly yours,

A handwritten signature in black ink that reads "John P. Davidson III". The signature is written in a cursive, flowing style with a prominent initial "J" and a long, sweeping underline.

John P. Davidson  
Chief Executive Officer

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<sup>11</sup> Executive Order No. 14067 (Mar. 9, 2022).