American Cotton Shippers Association
88 Union Avenue, Suite 1204
Memphis, TN 38103
United States

P +1 901 525-2272
F +1 901 527-8303
www.acsa-cotton.org

House Agriculture Committee Hearing
"Changing Market Roles: The FTX Proposal and Trends in New Clearinghouse Models"
May 12, 2022
Provided by:

HOUSE AG COMMITTEE HEARING

OVERVIEW

Today, the House Agriculture Committee held a hearing entitled "Changing Market Roles: The FTX Proposal and Trends in New Clearinghouse Models." The hearing focused on FTX's proposal to offer margined derivatives products in a non-intermediated model. The hearing witnesses were:

- Terrence Duffy, Chairman and CEO, CME Group
- Sam Bankman-Fried, CEO and Founder, FTX U.S. Derivatives
- Walt Lukken, President and CEO, FIA
- Christopher Edmonds, Chief Development Officer, ICE
- Christopher Perkins, President, CoinFund Management

Below is a summary of the hearing prepared by Delta Strategy Group. It includes several high-level takeaways, followed by summaries of opening statements and witness testimonies and a summary of the Q&A portion of the hearing.

Key Takeaways

- The following is a summary of some of the topics explored in today's hearing. Each is discussed in further detail in the Discussion section below.
- Committee Chairman David Scott (D-GA) said that FTX's proposal could pose serious threats to derivatives markets and could disrupt international equivalence agreements that have been vital for the growth and resiliency of U.S. markets.

- Committee Ranking Member GT Thompson (R-PA) said that this conversation must be seen as a market structure issue and that it is not limited to digital assets. Thompson commended Commodity Futures Trading Commission (CFTC or Commission) Chairman Rostin Behnam for his thoughtful approach to this issue and for seeking widespread public input.
- Sam Bankman-Fried said that the proposed model would incorporate all of the risk management controls typically offered by derivatives clearing organizations (DCOs), designated contract markets (DCMs), and futures commission merchants (FCMs), and he noted that even less conservative versions of the proposal currently before the CFTC already operate internationally and have withstood major market events.
- Bankman-Fried said that FTX has no intention of using this model to launch products for ag or energy commodities in the near future, and he said that he would be willing to amend the proposal to set a time period that FTX could not offer such products in.
- Terry Duffy and Christopher Edmonds said that the FTX proposal would constitute a shift in market structure that includes fewer risk management controls and could have a negative impact on other markets.
- Duffy said that the decision to allow such a model should come from a CFTC rulemaking process, not simply the approval of a single company's proposal. Duffy said that nothing is stopping FTX from offering products in traditional asset classes with this model, and, if this proposal is approved, CME would begin adopting this model for other asset classes to maintain a competitive advantage.

SUMMARY

Opening Statements and Testimony

Chairman David Scott (D-GA)

This proposal could be a serious threat to our clearinghouses, derivatives markets, and cross-border dealings. We must ensure that our derivative markets remain the best and most stable in the world. The CFTC has recognized the novelty of this proposal, and I have heard a number of concerns about the risks that this proposal could pose.

I am glad that the CFTC is working thoughtfully and taking widespread public comment on this issue, as this deserves long and proper consideration. While this proposal is limited to a select few digital asset contracts, we must view this as a potential for this model to expand into other derivatives markets and be adopted in some form by other clearinghouses. This proposal could also upset international equivalence agreements that the CFTC and Congress have worked hard to secure for many years.

Ranking Member GT Thompson (R-PA)

This is a similar market change to the change from open outcry pits to electronic trading. The benefits of electronic trading have been enormous in deepening liquidity, narrowing spreads, reducing transaction times, and creating new hedging opportunities. Our markets have not remained static since the change to electronic trading, with groups like CME moving their business to the Cloud which could reduce costs and increase market participation.

This proposal is worthy of balanced consideration. CFTC Chairman Behnam has committed that the Commission will consider this proposal publicly. Chairman Behnam also agreed to hold a public roundtable on this issue to continue to hear from the public on this issue. The most interesting part of today's testimony will be a broader conversation about changing market structure and the ever-evolving nature of derivatives markets.

Terrence Duffy, Chairman and CEO, CME Group

Risk management is a hallmark of CME Group and all derivatives markets. Under false claims of innovation that are little more than cost-cutting measures, FTX is proposing a risk management-lite clearing regime that would inject significant systemic risk into our financial systems. Their model comes at the expense of proven risk control practices, market integrity, and ultimately financial stability. This proposal would significantly increase market risk by removing up to $170 billion of loss-absorbing capital from the cleared derivatives markets, eliminating standard credit due diligence practices, and destroying risk management incentives by eliminating stakeholder capital requirements and mutualized risks.

The FTX proposal to auto-liquidate any customer that is under margin at any moment jeopardizes market stability. Auto-liquidation can exacerbate volatility and create dramatic price moves during times of turbulence. This could lead to a repeated pattern of price declines followed by additional liquidations. This will build losses on top of losses and drive prices down further.

FTX's market maker and backstop liquidity provider plans raise serious questions about the conflicts of interest embedded in FTX's model. This proposal also eliminates critical customer protections. Under this model, customers lose customer fund segregation protections and could be exposed to increased collateral losses. Non-defaulting customer positions could be terminated at the discretion of the first line of defense against any reason under any market condition.

If the Commission approves this proposal for cryptocurrency products, it will not be able to keep FTX or others from expanding into other asset classes. To suggest otherwise would put all market participants at an extreme disadvantage. Market structure changes will impact the entire industry, not just FTX.

Sam Bankman-Fried, CEO and Founder, FTX U.S. Derivatives

We are seeking to operate with margin as every other major exchange does. We have worked closely with the CFTC and respect the detailed process the Commission has used to approach this issue. While our proposal does combine ideas in a way that would bring great innovation to this space, each of the elements we incorporate does already exist in CFTC licensed derivatives exchanges. The amendment we have put forward would promote healthy markets through fair and equitable access.

The current structure charges for market data in a way that only allows the largest market participants to have full knowledge of the markets they trade in. We would distribute all market data for free. Traditional exchanges have separate models for the largest market participants such that only the largest participants have direct access with lower latency fees and market options. We seek to provide completely equitable market access to the most powerful tools.

We have strong customer protections under our safe and conservative model which would have alleviated recent market disruptions such as the London Metal Exchange (LME) collapse by having collateral prefunded at the clearinghouse rather than relying on credit and having a real-time risk engine. We also have enhanced customer protections including all of the customer protections that exist on current exchanges and at FCMs because we understand our responsibility to protect users. We also have further customer protections around suitability and transparency.

Our model would encourage competition, innovation, and liquidity. Bringing functional digital asset derivatives markets would increase U.S. international competitiveness. Digital asset markets need federal oversight to prevent systemic risk and compete against the rest of the world if they are going to be successful domestically.

Walt Lukken, President and CEO, FIA

This model would replace the traditional clearing model that distributes risk using FCMs with a more automated and centralized model. This model would combine margined futures with near real-time margining, 24/7 auto-liquidation of under-margined customers, and a self-funded CCP default fund without the benefit of FCMs managing, underwriting, and neutralizing customer risk. It is important to note that this could be introduced for any asset class transacted by any type of customer including commercial hedgers, so we must look beyond retail cryptocurrencies.

We believe the CFTC must analyze this proposal against the important customer protections and risk management functions that registered FCMs currently provide the marketplace. As agents for their customers, FCMs hold responsibilities including vetting customers, policing clients for money laundering, segregating customer funds, guaranteeing customer trades, holding significant capital against those trades, contributing to clearinghouse default funds, and agreeing to further assessments should central counterparty (CCP) default funds need replenishment. Today, FCMs contribute more than $15 billion to CCP default funds and hold additional regulatory capital. This backstops the potential default of customers and protects the broader financial system from a contagion event.

We believe FTX's risk model needs further analysis for extreme, but plausible scenarios, especially for participants in asset classes beyond retail cryptocurrencies. We must ensure that this model does not trigger a broader fire sale in the central price discovery markets that harms hedgers and exacerbates further market disruptions.

Christopher Edmonds, Chief Development Officer, ICE

We are fully supportive of using new technology to improve the efficiency of markets, but as we examine this application, we must remain mindful of the risks. All participants in the current market structure serve as important checks against excessive leverage, new products that are not well tested for widespread use, and the introduction of unexpected counterparty risk. Independent stakeholders like FCMs provide significant benefits to delivering market consensus. Market intermediaries increase customer confidence in fair markets, transparent pricing, and fully understood settlement processes.

FTX plays a leading role in markets for digital assets, and regulatory oversight will play a key role in responsibly expanding these markets. However, we have concerns with FTX's approach. Instead of following existing regulations and guidelines, FTX has requested a new set of rules not currently compliant with CFTC regulations or international standards. FTX raises significant questions about risk management, financial resources, and customer protections. We recommend that this committee consider the risks of the market implications of this proposal.

This proposal would force participants to lose their positions if markets move against them without the ability to bolster their stake with additional margin. The upshot of the differences between this and the traditional model has the potential to impact users of futures markets significantly.

Christopher Perkins, President, CoinFund Management

Our deep, liquid, and accessible markets are an important cornerstone of our economy and a pillar of our effective risk management. The arrival of Web 3 could transform the economy into a more inclusive and democratic ecosystem aligning with American values. With predictable, principles-based regulation, we can empower entrepreneurs to innovate onshore which will fuel our economy and catalyze job creation. Many Americans trade cryptocurrencies, and these markets are more inclusive than traditional markets. Despite this, these investors cannot hedge their risks because the legacy, intermediated market structure is unprepared to support the risk management realities of digital assets.

The FTX proposal promises to bring much needed innovation to digital asset derivatives markets. This proposal would reduce systemic risk through real-time collateralization and risk management, offer industry participants to more dynamically hedge digital asset risks, introduce incremental competition and choice, and revitalize U.S. digital asset derivatives markets at a time where leadership and innovation have migrated overseas. There are risks to deploying new technologies, and any proposal must meet the same fundamental risk management expectations as traditional exchanges. I support FTX's proposal.

Discussion

Scott (D-GA): How will this proposal to offer leverage not make an already risky asset much riskier for the customer, particularly in light of recent cryptocurrency volatility? How does this proposal stand up to international regulatory standards? *Duffy:* Most of the crypto markets are going overseas, but most of the losses in these markets are going overseas with them. These asset classes are completely different from traditional asset classes. This proposal is fraught with dangers, and the risks associated with these products, if not properly regulated, could be catastrophic for any asset that this model could be applied to; *Lukken:* FCMs have played a critical role in customer protections and fund segregation. We have many layers of protection in the current model that would be taken out in the FTX model. There is a reason that FCMs compartmentalize risks away from the CCP. Diversified risk is a helpful component of preventing a systemic event; *Bankman-Fried:* This proposal would reduce volatility in cryptocurrency markets and reduce risks. There is no federal oversight of digital asset markets today, which is a problem. That oversight would ensure that markets meet the safety standards we expect; *Edmonds:* The EU and the UK have made statements that they believe there should be the same rules for all products. We do not believe this can be approved in its current condition under the current rules, so this creates international concerns.

Thompson (R-PA): Why should markets deviate from the current, well-tested approach used by futures exchanges today? What aspects of FTX's approval should be adopted by traditional exchanges? What is the line between bad innovation and good innovation? *Bankman-Fried:* There should be a diversity of risk models so long as they are deemed suitable and consistent by the CFTC. Our application is consistent with the current rules and regulations of the CFTC, and it requires no additional rulemaking. Our proposal increases competition. In our risk model, collateral is held at the clearinghouses so the CFTC has oversight of the collateral at all times. A faster risk model is appropriate for digital assets. We have no plans to launch non-digital asset products under this model anytime soon; *Perkins:* In today's model, there is a mismatch between 24/7 digital asset spot markets and the way we collateralize in futures markets. Clients take on risk but have to wait until the following day to receive collateral back. It would be better for systemic risk if we met collateralization in real-time; *Edmonds:* The bright line test is whether or not innovation fits within the existing regulatory construct. Customers look for certainty. Having two standards creates uncertainty in the markets.

Adams (D-NC): What would be the impact of this model if applied to other asset classes? Will FTX be expected to shoulder the systemic risks that clearinghouses were traditionally responsible for? How would FTX protect consumers that use this platform? How should exchanges prioritize financial exclusion and equitable access to market data? *Lukken:* It would require further analysis before we understand how this model would work in other asset classes. In addition, this risk model may not function properly with large-scale commercial hedgers. Trying to auto-liquidate such positions could disrupt marketplaces. FTX has proposed to put skin in the game in its default fund to shoulder risk responsibilities. In doing so, however, they have wiped out a significant amount of FCM capital; *Bankman-Fried:* In our model, we have all the same customer protections found in DCOs and DCMs in addition to all the protections found in FCMs. We are also subject to KYC and AML protections; *Duffy:* We already have equitable access for any market participants.

Scott (R-GA): How would this proposal impact traditional markets used by hedgers? *Edmonds:* This model, if applied to traditional markets, would raise the costs for hedgers because they would have to prefund positions; *Bankman-Fried:* This model would require further analysis before we launched any products in the ag or energy spaces. We are not planning to launch these products anytime soon with this model. The CFTC does not want us to list non-digital asset proposals at this time. If you do not trust the CFTC to exercise their discretion, we would be willing to include a condition in our application that would not allow us to introduce such products for a period of time. We would not be willing to agree to a permanent restriction to list such products.

Delgado (D-NY): How do you respond to the assertion that the elimination of capital investment combined with your proposal to self-fund your guarantee fund would result in a lack of incentive for participants to mitigate their own risks? Is this model sufficiently secure for retail investors to build wealth? *Bankman-Fried:* It is important that we have protections against fraud and scams. This is typically provided by FCMs, so it is incumbent on us to have those same protections in place. Our platform would be entirely under CFTC oversight. In our model, initial margin for positions is posted to the clearinghouse; *Duffy:* It is difficult to predict success for retail investors. I am concerned about the overall proposal, because, despite what FTX says, it has the right to deploy products in different asset classes at any time. There are many problems with this proposal, but a primary concern is the lack of education being provided to retail investors.

Crawford (R-AR): Would the approval of this proposal incentivize other exchanges to introduce such a model for other asset classes? Do trends in cryptocurrency markets concern you as it pertains to market risk and asset volatility? *Bankman-Fried:* The CFTC will reject any proposals it deems inappropriate. This is not relevant to our application; *Duffy:* FTX says that it would be up to the CFTC to determine the viability of applications, but refuses to eliminate the potential to launch this into other asset classes. Even if FTX would not launch such products, other exchanges would. The risk of this going into other asset classes is extremely significant. The Ukraine crisis highlights the need for security and resiliency in markets that promote risk management for ag derivatives. I do not want to be forced into this lower-cost, higher-risk model, but I would have a fiduciary responsibility to launch such a model to remain competitive. The application put forward to the CFTC is completely different from some of the comments Mr. Bankman-Fried is making today.

Brown (D-OH): How does FTX balance innovation with consumer protections? *Bankman-Fried:* We have all the same customer protections as DCOs, DCMs, and FCMs. We will also work to educate all participants on market risks and functionality. We also disseminate data more equitably. It is important that customers are aware of what they are trading. Before you can access trading on our platform, we require you to walk through a tutorial on our platform and derivatives trading. We also require a test to ensure that customers understand the mechanics of our products and our platform.

Rouzer (R-NC): What problems was CME hoping to address when it introduced its direct clearing platform? Have other countries authorized such a model? *Duffy:* I am not opposed to a direct clearing model. I just oppose FTX's model because it does not conform to the Commodity Exchange Act (CEA). The CFTC had a problem with our direct clearing platform. Also, Basel III changed its policies which made it less necessary; *Bankman-Fried:* We have been authorized to offer this model in many other countries. We believe these countries are comfortable with our international model, which is less conservative than the model we are proposing in the U.S. today.

Kuster (D-NH): Would all moves towards disintermediation cause the same concerns as the FTX proposal? What considerations were put into this proposal to prevent crashes we have seen in digital asset markets? *Duffy:* The disintermediation model is a concern, but I am not inherently opposed to a direct clearing model. Intermediaries have additional risk management layers in place that help to manage risks; *Bankman-Fried:* Market crashes have not been limited to digital assets. Our model has similarities to models used all over the world. This is not an untried system and has weathered large market moves already. We would accept customers participating in our platform through an FCM through bespoke arrangements.

Davis (R-IL): Do you think that this would represent a piecemeal approach to market regulation? What impact would this proposal have on traditional hedgers? *Duffy:* Yes. This would set different standards for a single asset class. This would open the model up for all asset classes. This model is a cheap move around regulation, and I would be inclined to duplicate it for other asset classes to compete; *Bankman-Fried:* Unlike Mr. Duffy, I would consider whether this model was appropriate for all asset classes before proposing it. This is healthy for digital asset markets, but it might not be for all markets.

Maloney (D-NY): How does the auto-liquidation model function? How do we know these risk models are appropriate? *Bankman-Fried:* If markets move against a position and a customer is out of collateral, the position will be closed down so that they do not go net negative. If you do not have auto-liquidation, you either have to preemptively close positions that might not fully default or wait until a situation becomes systemic before addressing it as we saw with LME. This model is more conservative than the models we use overseas that have functioned in extreme market events; *Duffy:* I believe that there should be a formal rulemaking process to approve such a model. This cannot be just a cryptocurrency conversation; it has to be a rulemaking process for all markets. FTX's haircut on collateral for bitcoin is 5 percent. Their margin is 15 percent. This auto-liquidator will be running at extreme levels at those rates.

Mann (R-KS): How is this proposal different from the ICE NGX model? Is the FTX guarantee fund sufficient? *Bankman-Fried:* This is an example of an approved model similar to ours already on the market today. We are combining several of these models. In addition to our $250 million in the guarantee fund, we also require margin held for all open positions. We also have done extensive analysis of this model internationally, and we have never seen more than a few percent drawn from the guarantee fund; *Duffy:* This is a market structure change. This will bleed into other asset classes that are not prepared for such a model. This guarantee fund would never work for many of the markets that we currently use.

O'Halleran (D-AZ): Will collapsing the functions of various market participants create conflicts of interest? Will this increase the number of liquidations? *Lukken:* This is a key concern for us. We have distributed responsibilities, and, when you integrate this, it creates conflicts of interest; *Duffy:* I do not like to predict the future of markets. CME has never had to draw on our guarantee fund, and I am very concerned that this proposal will not have the considered input of all segments of derivatives markets.

Fischbach (R-MN): Why are derivatives markets key for risk management for ag producers? *Lukken:* Farmers have razor-thin margins, and they depend on derivatives markets to hedge risks appropriately. This proposal is open to any asset class. This is a market structure conversation, not a cryptocurrency conversation; *Bankman-Fried:* We are not planning to get into ag markets anytime soon, and we are open to making that assertion legally binding. Parts of this risk model could be helpful for ag markets, but it would also require some changes. One beneficial change for ag markets would be offering free market data instead of charging; *Duffy:* We never charged for market data until recently. We charge for some data primarily because you are paying for a constructed data set that requires effort and cost from CME. This is not just data on market pricing. We sell quality data that benefits participants, but this costs us money to create. It does not matter if FTX plans to go into other markets right now because this proposal would give them the right to do it. This is a nightmare for the ag community.

Khanna (D-CA): Do you have an understanding of blockchain technology and cryptocurrencies? *Duffy:* I am here to discuss market structure, not particulars of cryptocurrency markets.

Baird (R-IN): How would it benefit Americans for cryptocurrency trading to happen in America? *Lukken:* There has been an identified gap in regulation for cryptocurrency markets. We need a framework in the U.S. that allows industry to blossom; *Edmonds:* We do not know what regulator is responsible for various digital assets. There is no clear structure for commercial decisions to be made around; *Perkins:* Web 3 is here, and we cannot miss out on this innovation. We need a thoughtful derivatives regime for investors to hedge their risks. The FTX proposal is a perfect example of this; *Bankman-Fried:* Almost all digital asset derivatives volume is offshore, which prevents it from benefiting the U.S. or our investors; *Duffy:* I think markets are global in nature. Certain products move to different regions naturally.

Schrier (D-WA): How will FTX balance innovation with consumer protections? *Bankman-Fried:* We want to offer equitable access so consumers have a level playing field, but we have to have all the customer protections we expect in financial markets. We would work to educate any participant on our platform. We want to ensure there is complete transparency for any products we offer.

Johnson (R-SD): How would auto-liquidation disrupt markets indirectly? Could this model create more contagion in markets? *Lukken:* When there is a default in a marketplace, FCMs typically step in to ensure that risk is not simply dumped into the marketplace. When we have auto-liquidation, there is limited discretion or judgement. It could have an impact like a run on a bank. As positions default, it can lead to a cascade. It is hard to know if FTX's guarantee fund will be sufficient. We are trying to measure extreme but plausible scenarios that could occur. The Cover 3 model proposed may not be sufficient in such a scenario; *Bankman-Fried:* Our liquidations can be partial and piece-by-piece. If a position needs to be closed, it will be, but we have interim measures as well. It can be helpful to have an institutional party manage a position instead of liquidating it. The amount we put in the guarantee fund is more than will be necessary.

Carbajal (D-CA): How will you ensure that investors understand the risks of trading cryptocurrency on margin? How could the clearinghouse model better accommodate cryptocurrencies? *Bankman-Fried:* We will work to educate all consumers on the nature of our product offerings and the risks attached; *Duffy:* There are always ways to evolve clearing models to better accommodate risk. I am simply opposed to a proposal that would not allow all of us to participate equally. This should be done through rulemaking, not a single proposal. I am here to discuss market structure, not the benefits of particular cryptocurrencies or blockchain.

Cammack (R-FL): How does the current model benefit the largest players? *Bankman-Fried:* There needs to be complete equity for data transparency in these markets. Our model would have prevented market events like the LME crisis.

Spanberger (D-VA): What are your thoughts on the environmental impact of crypto mining? *Bankman-Fried:* While proof-of-work is energy-intensive, proof-of-stake blockchains have relatively low energy costs. These will be the systems that scale the largest.

Plaskett (D-USVI): Should there be a CFTC rulemaking process for this issue? *Bankman-Fried:* It would be highly unusual to have a rulemaking process to amend our margin order. It is also unusual to have hearings and roundtables for this issue. I think that this only shows increased transparency in our proposal.

Cloud (R-TX): What would you consider before moving this model into other markets? *Duffy:* This model needs to go through a rulemaking process because this is a market structure issue. If this went into approval, I would be forced to implement this model for markets around the globe. This model would create major issues in other asset classes; *Bankman-Fried:* The U.S. is the only developed country that cannot access liquid hedging for digital assets. We have far too little oversight and no clear regulation in these markets.