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Commodity Futures Trading Commission Staff
Roundtable on Non-Intermediation
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Provided by:

DeltaStrategy Group

OVERVIEW

Today, the Commodity Futures Trading Commission (CFTC) held a roundtable to consider the implications of a non-intermediated direct clearing model for digital asset derivatives.

PANEL I SUMMARY

David Murphy, Professor
Clearing has continued to develop over time and has always been driven by market participants. Innovations have been adopted to accommodate market events and new technologies. FCMs bring governance and oversight into the system. We must consider whether we need the FCMs and, if we do, whether there are other ways to source those activities.

Sam Bankman-Fried, FTX
A non-intermediated model could still have intermediaries. It just means that the capital is held at the central counterparty. Margin should be posted with the DCO prior to positions being put on. This model will not require intermediaries to be the first line of defense in risk situations, because the DCO is holding the risk capital.
This model is valuable for asset classes that are open 24/7, but this is not essential. This could also work in asset classes that trade 24 hours a day during the week but go offline all weekend. This would require just posting initial margin to avoid any risk that might accumulate over the period that the asset is not trading.
This is best suited for digitally settled markets. Assets like wheat and corn are traded completely differently, and it would require more thought before I would be comfortable deploying in these markets. We are disintermediating the risk management process, but there is still a role for intermediaries to play in this model.

Sean Downey, CME Group
This model has an inherent assumption that an algorithm can replace capital. Margin and capital are completely different things in financial markets. When you deposit margin, it is no longer capital, and it is designed to cover market moves, not fail risks. In the current market structure, fail risks are covered by capital held in the market and FCMs holding capital as margin. The model's challenge is that it places reliance on margin and eliminates the role of capital reserves through an algorithm. Our concern is that there is insufficient capital in the system and an algorithm cannot make up for that. We have not seen any market moves that demonstrate that the current model is not functioning.

Mariam Rafi, **Citi**
We have been considering how the controls in place are different from those traditionally provided by an FCM. We are concerned about customer protection controls that may be lost. FCMs are responsible for absorbing many layers of risk that do not exist in a direct clearing model. The auto-liquidation model also poses concerns that customers are exposed to further risks.
Markets are becoming more digitized, and the current system is working to keep up with this innovation. Our concern is that an algorithm cannot replace the many risk controls in the current model. We need a level playing field for the responsibilities of various players in the current system.
Margin should be sufficient to cover losses without going into guarantee funds. Instantaneous liquidation does not cover this.

Tom Wipf, Morgan Stanley
When we think about these things, we agree that reduction in settlement cycles reduces risk exposure. We need to consider the basic market structure questions, as this is a significant departure from the traditional system. We need to consider how this will function in real-time markets.

Dennis McLaughlin, Risk Management and Clearing Expert
Clearing and settling systems come down to a legal concept of settling, but there is no legal settling of crypto assets. Digital assets do not have a set settlement structure in place, and the actual settlement of these assets takes several days despite the instant movement of the assets.

Demetri Karousos, Nodal Clear
Innovation does not need to replace an existing structure for it to be useful. We offer traditional risk management controls in innovative markets. I do not see much innovation in this proposed model. This is a rehash of existing models and failed ideas. Many FCMs already do real-time risk management checks.

Todd Phillips, Center for American Progress
Most crypto exchanges settle transactions off the blockchain, so everything happens on the exchange's own ledger, not the blockchain. I am not sure what the legal final settlement issues are. It is important for a financial intermediary to help to guide investors, particularly retail investors that do not understand the market structure.

Tom Chippas, ErisX
Most of the spot activity on cryptocurrency exchanges happen in real-time. Settlement finality does take place at this rate already in the system. The key difference here is the auto-liquidation process.

Rob Creamer, Geneva Trading
This disintermediated model does have some innovations, but I want to ensure that we embrace it in a way that is not disruptive to the current models we all rely on. We cannot see this as a binary issue. Many people believe that we cannot embrace this model without completely disrupting the current system. We also should not rush into adopting this model.

Gerry Corcoran, RJ O'Brien
If markets move against our customers, we do not automatically liquidate them, because we understand their business and resources. We should not eliminate the FCM's credit buffer that protects market participants. In certain times of market stress, we would have had to close all open positions under this proposed model. FCMs play an important role in evaluating customer credit and balance sheets in a way that algorithms cannot replace.
The current model today is not T+1. We settle margin all day long. We never have outstanding market calls. There is latency, but it is not a full day. We know our customers in a different way than an algorithm ever could.

Neil Constable, FMR Co
We support innovation that would improve market structure. We should not have to decide between fully embracing this model or rejecting its existence. We may be able to extract some capital from this system and allocate it differently.

Nelson Neale, National Council of Farmer Cooperatives
We need to consider the difference between those who use these markets for speculation and those who use these markets to hedge against their physical inventory. Eliminating the position of a financial hedger would significantly impact their business and livelihood. FCM capital is vital for hedgers.

Reggie Griffith, National Grain and Feed Association
We have to consider this model in how it might be applied to ag markets. This multiplies market risks for hedgers. This would require hedgers to hold a significantly increased amount of capital at the DCO.

Dave Olsen, Jump Trading, on behalf of FIA PTG
This discussion has assumed that markets will revert and recover in times of market stress, but there is no guarantee that customers will be able to fully cover their positions.

Chris Perkins, CoinFund Management
Risk today is being socialized. Today, we have 24-hour markets that are only being collateralized once a day. FCMs do not have the capacity to include all possible participants. This has pushed crypto markets overseas. This is a great opportunity for competition, and it should not be expanded to agricultural markets.

Christine Parker, Coinbase
This conversation seems to conflate direct clearing and non-intermediated models. This model could accommodate some intermediaries in the system.

Sean Downey, CME Group
Participants in this model are not paying for tail risk. The only way to do this is to margin for stress.

Chris Edmonds, ICE
It is vital to have real decision-making in default scenarios, not an algorithm.

Michael Winnike, Blackrock
This model could lead to more efficient markets with broader market access for retail participants. We think it is great to bring more CCP skin into the game.

Graham Harper, DRW
24/7 market structure does seem to be a significant innovation. This could be an interesting alternative to traditional market structures.

Stephen Berger, Citadel
We believe that constant risk management requires careful consideration but could be a market innovation.

Andrew Smith, Virtu
This seems like a model that could support FCM involvement.

PANEL II SUMMARY

Sam Bankman-Fried, FTX

We have fared well during recent market volatility. We have seen billions of dollars in volumes flow through our market, and we have never had to mutualize losses. We have not needed to go into our guarantee fund. Our markets have remained orderly and liquid during this stress. This model allows us to escape the binary between liquidating positions to early and risking massive cascading market impacts.

It is unclear whether this model would work for physically settled ag products at this time. I would feel much more comfortable with this for digital settled products at this time. It is also unclear whether this would work for more illiquid assets.

Allison Lurton, FIA

It is worth considering whether or not we would need to develop new, prescriptive regulations for this proposed model. We believe that some specific regulations should be addressed. FCM's duty to guarantee losses has been addressed in rules in the past. This model would not have that same requirement. All of the existing rules were written for an intermediated model, so we need to consider how this fits with every rule that is currently applied in markets. There are direct models in place today, but they are typically fully collateralized.

Emma Richardson, JP Morgan

We need to consider the gating mechanisms for how new products are proposed, especially with this model's potential to be brought to new products.

Alicia Crighton, Goldman Sachs

We need to consider the implications of the self-certification model because we do not have sufficient protections in this model at this time. It is also important to consider how these models coexist.

Neal Constable, FMR

Maybe backstop liquidity providers should absorb some of the responsibilities and regulations that are typically placed on FCMs in the markets.

PANEL III SUMMARY

The following statements are in response to a theoretical stress-test for an event in which there is a margin breach problem and multiple market participants are unable to meet their margin variation calls in a timely way:

Chris Edmonds, ICE

When members default, we will assume their position and begin hedging their portfolios. This would all take place in our risk governance structure which has oversight by internal regulators. We would then begin an auction process where certain members act as default participants. If the auction is successful, we are off risk. If the auction is not successful, we would start addressing this through our waterfall funds. If we still cannot cure the tail risk, we will use a mutualized guarantee fund. If we still cannot address the risk after this, we will do a partial tear up or a variation margin haircut. This would only take place if we were facing the extinction of a clearinghouse.

This process on FTX happens very quickly. We've always needed more time to address crises, and there is a certain art that is not captured entirely by the science of an algorithm.

Sam Bankman-Fried, FTX

Our risk engine assesses margin requirements based off of risk profiles and notional position size. This would begin with a 50 percent margin posted directly at the clearinghouse. If they are long on a contract and markets begin to fall, the margin will fall in real-time. This prevents them from taking on any further risk. If markets continue to fall, we will begin to deleverage the position piece by piece as if the customer had decided to start closing down their position. We do this slowly and piece by piece so that we do not impact market liquidity. If the market kept crashing from this position too quickly for us to deleverage at this pace, backstop liquidity providers (BLPs) kick in. These sophisticated firms help us to close down this position at predetermined rates. The BLPs take on collateral and can do what they want with the positions.

Our risk engine has the goals of ensuring the orderly passing of risk and avoiding accounts going negative in value. We could use our guarantee fund to top off these levels to prevent account values from going negative. We would be tempted to sacrifice our company's entire funds to protect the sanctity of customer protections and funds. If we got below our company's worth, we would have to make haircuts. We would then be forced to tear up positions, but we would never want to get to this place. The DCO risk process does not consider intermediaries. Customers could access the market through an intermediary if they choose.

The BLP layer does provide more liquidity to the system, but it is not necessarily a part of this. We could just have order books closing down. BLPs allow us to address temporary illiquidity. These are standard, large participants. This is not an auction; these order fills are done automatically. These firms have a significant amount of liquidity. BLPs prefund collateral to take on these positions should there be a default. Guarantee funds make up for the loss in the value of the assets that BLPs take on.

We are seeing many retail participants that want access to these markets, and these retail participants know much more than many people in this room. There are already leveraged retail cryptocurrency futures products.

Sean Downey, CME Group
FTX haircuts are typically between 2-5 percent which is significantly less than we would expect.
There is not much discretion in our mode. There is discretion when we get to tear ups, but auto-liquidation does not have discretion. Regulators are always welcome to get involved in our processes. I will not speculate how a regulator will get involved, and this process would speed up the deleveraging process.

Michael Winnike, BlackRock
There is less transparency about BLP assets than we have in the current system with FCMs.

Dennis McLaughlin, Market Expert
There is traditionally discretion in handling customer defaults. The rapid nature of auto-liquidations seems to negate discretion on the DCO's behalf.

Gerry Corcoran, RJ O'Brien
The FCM would offer more protection than this system. This model highlights the significance of FCMs. It is not clear why a BLP would take on these positions.

Nelson Neal, National Council of Farmer Cooperatives
This system would work better as a full market auction.

Miriam Rafi, FIA
A lot of what is being said is not presented in the rulebook. For instance, there is nothing in the rulebook that would allow FCMs to participate in these markets.

Demetri Karousos, Nodal Clear
We need to recognize that this has a much larger chance to cause cascading impacts because auto-liquidations could happen in response to market changes, not just the default of the largest market participants.

Hillary Allen, Professor, American University
There is an argument that this offers inclusion to more market participants, but there is already plentiful predation in cryptocurrency markets. This seems like an opportunity for intelligent firms to exploit retail investors. We have heard that this is more efficient, but increasing efficiency leads to marginal returns. We need some friction in the system.

Todd Phillips, Center for American Progress
If your margin can be bitcoin and you can be long on bitcoin futures, you could have your margin devalued while your position moves against you. That is a bad idea. We do not want retail investors involved in margin cryptocurrency trading.

PANEL IV SUMMARY

David Murphy, Professor
We need to have a clear and transparent amount of BLP liquidity. This could work in extremely liquid markets, but we need to ensure that it can always be used even in worst-case scenarios. We should consider working on this incrementally.

Demetri Karousos, Nodal Clear
There is significantly more cushion in traditional markets than in this proposal.

Allison Lurton, FIA
I have heard some talk that this is a battle between innovation and traditional markets. I believe that there will need to be laws and regulations changed or eliminated to accommodate this model.

Tom Sexton, NFA
It is unclear how this would play out should FTX go bankrupt. We need to consider who will be regulating this entity. Without FCMs, this entity will be its own SRO and would make all governance decisions.

Nelson Neale, National Council of Farmer Cooperatives
There has not been a stress situation that has called for this type of change to market structure.

Neil Constable, FMR
We believe that this should happen, but we need more transparency in how this model would function in practice.

Tom Chippas, ErisX
We believe strongly in innovation in this space. Nothing I heard today has anything to do with technology innovation. All of this technology already exists in the markets. That means that the only questions have to do with market structure. Outcomes from international markets that have experimented with this structure have tangible data we should be looking at, but we should not conform to what others have done. We need a deep analysis of this market structure.

Sean Downey, CME
Margin is not the only thing necessary to cover future margin events. We need to understand that the current market structure is the best support the hedging needs of market participants.

Rob Creamer, Geneva Trading
We need innovation in our markets, and the only way to prepare for that is through careful and considered data analysis.

Sam Bankman-Fried
This has been helpful in our goal of working with this industry and taking in your ideas.

Graham Harper, DRW
We have not discussed the fact that there has been tremendous consolidation in the FCM world. This model can work side by side with the traditional model.

Stephen Berger, Citadel
This seems like a more capital-intensive system than the traditional system. This will only lead to more market concentration. We should not create incentives to avoid the cleared ecosystem because they do not want to deal with a specific clearing model.

Todd Phillips, Center for American Progress
What might be appropriate for institutional investors may not be appropriate for retail investors. It is important to have intermediaries involved with retail investors.