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CFTC Considers FTX's Democratized Clearing Proposal

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On May 25, 2022, the U.S. Commodity Futures Trading Commission ("CFTC") conducted a public hearing to consider a request from LedgerX, LLC, d.b.a. FTX US Derivatives ("FTX"), to amend its order of registration as a derivatives clearing organization ("DCO") to allow direct clearing of listed futures contracts on Bitcoin and Ethereum and other digital assets by retail participants. This is a dramatic departure from a traditional clearing model where retail participants can trade and clear futures only through professional intermediaries – registered and heavily-regulated futures commission merchants ("FCMs").

This proposal follows the trend of democratization and disintermediation in crypto and digital assets markets to allow broader participation of retail traders, in contrast to participation by the traditional professional traders and hedgers, such as farmers, refiners, and financial institutions.

FTX currently offers clearing of futures and options on cryptos and other digital assets for retail participants only on a fully collateralized basis, while the proposal, if approved by the CFTC, would also allow FTX to clear margined products on a non-intermediated basis. For margined contracts (in contrast to fully-collateralized ones), a DCO collects only a portion of collateral to cover the risks of possible losses, which increases the risk of default. Normally, these increased risks are absorbed by the intermediaries – the FCMs and DCO's clearing members, albeit at a certain cost for customers.

To cover for the increased risks in a disintermediated model, the proposal includes several innovative features, such as (1) instantaneous risk management (every 30 seconds) and marking-to-market of customer futures positions 24/7; (2) posting of margin to cover open positions (the pay-as-you-go feature); (3) partial auto-liquidation of positions if collateral on deposit falls below the maintenance margin level (the go-as-you-pay feature); (4) full-auto-liquidation of portfolios through backstop liquidity providers if the value of position drops further below a threshold; and (5) the funding of FTX guaranty fund as further security.

FTX’s proposal raises fundamental questions of how U.S. derivatives market infrastructure should operate in the future, because, if approved, the disintermediated model of clearing will be used for futures on all other assets (such as energy, agriculture, interest rates, forex) and not only for cryptos. The CFTC has received numerous comments on the proposal. Regardless of how the CFTC will ultimately decide on the proposal, it is certain that the “retailification” and democratization of U.S. derivatives markets will continue.