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CFTC Staff Advisory No. 18-14

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Division of Market Oversight

Division of Clearing and Risk

To: Designated Contract Markets, Swap Execution Facilities, and Derivative Clearing Organizations

Subject: Advisory with respect to Virtual Currency Derivative Product Listings

Virtual currency derivatives products and the underlying spot markets are new, rapidly evolving, and global. Commodity Futures Trading Commission (“CFTC” or “Commission”) staff believes it is important to encourage innovation and growth in these products, but within an appropriate oversight framework that enables exchanges and clearinghouses to operate within the confines of the core principles. To this end, Commission staff continues to monitor developments in these products and discuss the risks and challenges they present with industry and market participants. Most recently, Commission staff worked collaboratively with Chicago Mercantile Exchange (“CME”) staff and Cboe Futures Exchange (“CFE”) staff to conduct a review of bitcoin futures contracts listed pursuant to Commission Regulation 40.2.¹

This Commission staff advisory provides guidance to exchanges and clearinghouses on certain enhancements when listing a derivative contract based on virtual currency pursuant to Commission Regulations 40.2 (self-certification) or 40.3 (voluntary submission for Commission review and approval).² This advisory reflects staff’s current thinking based on experience with virtual currency derivative products to date. The exchanges and clearinghouses have self-regulatory obligations for the markets they operate. As front-line regulators, they should be proactive, flexible, and ensure proper surveillance and oversight of the trading and clearing of virtual currency contracts given the risks noted below.

This advisory is not a compliance checklist; rather, it clarifies the Commission staff’s priorities and expectations in its review of new virtual currency derivatives to be listed on a designated contract market (“DCM”) or swap execution facility (“SEF”), or to be cleared by a derivatives

¹ See 17 CFR §40.2 and CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets, January 4, 2018, http://www.cftc.gov/idx/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

² See 17 CFR §40.2 and 17 CFR §40.3.

clearing organization (“DCO”). Certain elements (*i.e.*, DCO risk management or monitoring the cash-settlement process) addressed in this advisory may not be relevant for certain virtual currency contracts depending on their terms and conditions. Further, as new products are brought forth (*e.g.*, uncleared or physically-settled derivatives), staff will reevaluate and revisit the advisory, as necessary, to address any new or heightened concerns raised by these products and not covered under this advisory.

Commission staff generally believes that this advisory should help exchanges and clearinghouses effectively and efficiently discharge their statutory and self-regulatory responsibilities, while keeping pace with the unique challenges of emerging virtual currency derivatives.

I. Background

In 2015, the CFTC found that bitcoin and other virtual currencies are properly defined as commodities.³ The Commission interprets the term “virtual currency” broadly, to encompass any digital representation of value that functions as a medium of exchange and any other digital unit of account used as a form of currency.⁴ Virtual currencies may be manifested through units, tokens, or coins, but do not have legal tender status. Virtual currency transactions are generally validated and logged through a network of computers on a distributed ledger, commonly known as a blockchain.

Virtual currencies are unlike any commodity that the CFTC has dealt with in the past. To date, virtual currencies have gained prominence as they are bought and sold for investment, speculative, or financial purposes. Those transactions greatly predominate over commercial uses of virtual currency – such as to purchase goods and services – which are still developing. Thus, virtual currencies differ from commodities like oil and gold where commercial uses predominate or at least provide points of comparison.⁵ At the same time, virtual currencies differ from financial indices and other commodities for which robustly-regulated markets facilitate price verification and provide insight into the reasons for price changes.

Because of these differences from other commodities, it is more difficult to provide context or a frame of reference for the prices of virtual currency that are quoted on the spot markets. While prices and transactions on those spot markets can be observed, the connection of these prices to any commercial market, intrinsic value, or supply and demand is less clear than for other commodities. This connection may become clearer as markets for virtual currencies mature.

³ See *In re Coinflip, Inc.*, CFTC No. 15-29, 2015 WL 5535736 (Sept. 17, 2015); see also *CFTC v. McDonnell*, No. 18-CV-361, 2018 WL 1175156, at *1 (E.D.N.Y. Mar. 6, 2018) (“A ‘commodity’ encompasses virtual currency both in economic function and in the language of the statute.”).

⁴ See Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60,335, 60,338 (proposed Dec. 20, 2017) (noting that the Commission “does not intend to create a bright line definition at this time given the evolving nature of the commodity”). This interpretation of the term “virtual currency” is similar to one set out by the Internal Revenue Service. See IRS Notice 2014-21, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

⁵ Staff understands that serious, good faith efforts are underway to implement many *potential* commercial uses of virtual currencies. Also, it may be possible to value virtual currencies that reward validators with newly issued units of the virtual currency (*e.g.*, “mining”) according to the cost of “mining.” But to date, the commercial uses of virtual currencies have not developed to a point that there are readily verifiable, independent points of comparison to spot market prices.

The significant risks associated with virtual currency markets justify close scrutiny by both CFTC staff and registered entities. For example, virtual currency platforms present heightened concerns about potential impacts on CFTC-regulated markets, including potential market manipulation, because they lack the transparency and robust regulation as U.S. derivatives platforms. In addition, these markets have a very short history of trading, marked by substantial periods of volatility and price swings. This raises questions about whether clearinghouses can adequately assess the inherent risk of virtual currency contracts in setting margin levels for these contracts.

II. Guidance

In light of the risks discussed above, staff highlights certain key areas that require particular attention in the context of listing a new virtual currency derivatives contract pursuant to Commission Regulation 40.2 or 40.3. The topics are: (A) enhanced market surveillance; (B) coordination with CFTC staff; (C) large trader reporting; (D) outreach to stakeholders; and (E) DCO risk management.

A. Enhanced Market Surveillance

DCMs and SEFs, as self-regulatory organizations (SROs), must establish and maintain an effective oversight program designed, among other things, to ensure that listed contracts are not readily susceptible to manipulation⁶ and to detect and prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.⁷ Without adequate visibility into the underlying spot markets, an exchange has diminished ability to effectively identify and address risks in the trading of listed virtual currency derivatives. Accordingly, as part of Commission staff's review of an exchange's surveillance program, staff will assess the exchange's visibility into the underlying spot markets.

Under existing CFTC regulations, DCMs and SEFs must be able to obtain from its traders information on the traders' activities in the reference spot market.⁸ However, Commission staff believes that a well-designed market surveillance program of an exchange (*i.e.*, a DCM or SEF) for virtual currency derivatives includes an information sharing arrangement with the underlying spot market(s) that make up the cash-settlement price to facilitate the exchange's access to a broader range of trade data. Such arrangements would provide the exchange with the right and ability to access trade data on the relevant spot market(s). Such data may include, but not be limited to, information relating to the identity of the trader, prices, volumes, times, and quotes from the relevant market makers or traders.

Additionally, under CFTC regulations, DCMs and SEFs must conduct real-time monitoring of all trading activity on its electronic trading platforms to identify disorderly trading and any market or system anomalies.⁹ For virtual currency derivatives traded on an exchange, Commission staff

⁶ See 7 U.S.C. §§ 7(d)(3), 7b-3(f)(3).

⁷ See 7 U.S.C. §§ 7(d)(4), 7b-3(f)(4).

⁸ See 17 CFR §38.253(b) and 17 CFR §37.404.

⁹ See 17 CFR §38.157 and 17 CFR §37.203(e).

believes that continuously monitoring relevant data feeds (price, volume, etc.) from the appropriate spot market(s), especially during and around the settlement period, serves to identify anomalies and disproportionate moves in the spot market(s), which can impact trading on the exchange. If the exchange identifies any such patterns, Commission staff would expect the exchange to engage in appropriate inquiries, which may include obtaining spot market trader-level data. Given the nature of the underlying spot market, staff believes that a heightened level of monitoring, with respect to trading activities on the spot market, is warranted.¹⁰

The value of accessing and monitoring data from relevant spot markets depends on the level of visibility into those markets. Federal know your customer (“KYC”) and other anti-money laundering (“AML”) regulations provide critical transparency into financial transactions.¹¹ As the virtual currency markets develop, staff expects that the exchanges’ virtual currency contracts will be based on virtual currency spot markets that follow these or similar regulations.¹²

B. Close Coordination with CFTC Surveillance Group

Close coordination between the Commission and the listing exchange in monitoring for potential manipulation or fraud serves a critical role in effective oversight of the virtual currency derivatives contracts. Staff expects exchanges to regularly discuss with Commission staff a wide range of issues related to the surveillance of virtual currency derivatives contracts, and provide surveillance information as requested by Commission staff.¹³ Upon request, the exchange must also provide to Commission staff data related to the settlement process referenced by the contract to enable staff to conduct its own independent surveillance. Coordination of the timing of derivative contract launches with Commission staff also allows staff to better monitor trading in the newly-listed contracts.

C. Large Trader Reporting

Under the Commission’s Large Trader Reporting System, clearing members, futures commission merchants (“FCMs”), and foreign brokers (collectively called “reporting firms”) file daily reports with the Commission under Part 17 of the CFTC’s regulations.¹⁴ The reports show futures and

¹⁰ Currently, for cash-settled contracts, a DCM must monitor the pricing of the index to which the contract will be settled and the continued appropriateness of the methodology for deriving the index, but does not have a direct obligation to monitor the availability and pricing of the commodity making up the index. *See* 17 CFR §38.253(a).

¹¹ *See* 31 CFR §1010.

¹² Staff understands that virtual currency spot platforms operate outside the territory of the United States. To the extent an exchange includes a virtual currency spot market platform located outside the United States as part of the basis for a contract, staff expects the exchange will have verified that the platform meets its home jurisdiction’s KYC/AML regulations, which must be in accord with the “International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation-The FATF Recommendations,” developed by the Financial Action Task Force on Money Laundering. *See* <http://www.fatf-gafi.org/publications/fatfrecommendations/documents/fatf-recommendations.html>.

¹³ For example, 7 U.S.C. § 5h(f)(5) requires swap execution facilities to have rules that allow them to obtain information necessary to perform the functions required under the CEA and to share that information with the Commission upon request.

¹⁴ *See* 17 CFR §17.

option positions of traders with positions at or above specific reporting levels as set by the Commission. Current reporting levels are in CFTC Regulation 15.03(b).¹⁵

The Commission may, through rulemaking, raise or lower the reporting levels in specific markets to strike a balance between collecting sufficient information to oversee the markets and minimizing the reporting burden on traders that are reportable. An exchange can set the reporting level of contracts in a particular commodity at a level that is lower than the level specified in the Commission's regulations.

As noted above, the virtual currency markets and the trading of financial instruments based on virtual currency are new and rapidly growing. Compared to other financial markets, it is relatively difficult to obtain information about trading in the virtual currency spot markets. Yet information about trading in the spot markets is important because manipulation in those markets is likely to have an adverse effect on the derivatives markets.

Staff believes that the existing large trader reporting regime may be instrumental in identifying traders who may be engaging in manipulative activity in the virtual currency market.¹⁶ To that end, staff recommends that the exchange set the large trader reporting threshold for any virtual currency derivative contract at five bitcoin (or the equivalent for other virtual currencies).¹⁷ Staff believes that this level could help facilitate surveillance of the futures and options markets by increasing the exchange's ability to focus on relevant information in the spot market.

D. Outreach to Members and Market Participants

As a general matter, Commission staff believes that broad-based participation in the exchanges' deliberative processes promotes fairness and confidence in the markets and helps exchanges better fulfill their responsibilities as SROs. Given the particular characteristics of virtual currency contracts, and the concerns about price volatility and lack of transparency regarding the underlying commodity, Commission staff expects exchanges to take extra care to engage meaningfully with relevant stakeholders. For example, an exchange's broad outreach to market participants helps to better inform the exchange as it develops the contract's terms and conditions and related rules and procedures.

Prior to listing a new contract on virtual currency, staff expects an exchange to solicit comments and views on issues relating to the listing, beyond those that relate to the contract's terms and conditions and its susceptibility to manipulation. Consultations that cover a broad scope of topics may generate information relevant to the impact of listing and clearing the new contract on members and market users.¹⁸ Thus, for example, the exchange should consider consulting

¹⁵ See 17 CFR §15.03(b).

¹⁶ Under CFTC regulations at 17 CFR §18.05, traders subject to large trader reporting are subject to possible reporting of spot market activity.

¹⁷ Staff believes that at this level reporting will cover 70-90 percent of the total open interest in these contracts; however, staff will make any adjustments as the market and contract develops.

¹⁸ See 17 CFR §38, app. C, (a)(1) ("Demonstration of Compliance that a Contract is Not Readily Susceptible to Manipulation"). In this regard, the CFTC's current guidance encourages a DCM, when listing a new product, to

with, and soliciting input from, members and other relevant stakeholders, beyond those market participants interested in trading the new contract. For example, clearing members and FCMs, including those who do not plan to offer clearing services for the new contract, can provide valuable insight into DCO risk management.

As part of its submission to the Commission for the listing of a virtual currency derivative contract (on either a self-certification or prior approval basis), an exchange should consider including (in addition to the explanation and analysis of the product and how it complies with the Act and regulations) an explanation of any substantive opposing views learned from this outreach and how the exchange addressed such views or objections. As Commission staff reviews virtual currency derivatives contracts, it would benefit the exchanges to include as much information as possible as part of the submission process in order to avoid any confusion or potential problems in the rollout of the new contract.

E. DCO's Risk Management¹⁹

Once the DCO that will clear the proposed cleared contract has been identified, staff will request from the DCO the information discussed below. Staff may also request other information relevant to the clearing of the proposed contract.²⁰ Staff will review the DCO's proposed initial margin requirements to assess whether they are commensurate with the risks of the contracts, including risks that result from any unusual product characteristics.²¹ Staff will review, among other things, the ability of proposed margin requirements to adequately cover potential future exposures to clearing members based on an appropriate historic time period. If staff believes that the initial margin level is not adequate, staff will require the DCO to make appropriate adjustments and submit the DCO's revised initial margin requirement, along with any supporting data.

In addition, staff intends to seek information related to the governance process for approving the proposed contract(s). Staff expects that the DCO will explain its consideration of the views of clearing members in approving the proposed contract, including the DCO's response to any dissenting views regarding how the virtual currency derivatives contract will be cleared. Staff also will review the DCO's adherence to its internal governance procedures for new contract approval.²²

reach out to "market users" to obtain their views on the contract's terms and conditions and whether they reflect the underlying cash market and will perform the intended risk management and/or price discovery functions.

¹⁹ To the extent a proposed contract is not cleared, this guidance would not apply. As noted above, staff would reevaluate and revisit this guidance, as necessary, to address any new or heightened concerns raised by virtual currency derivatives contracts that are not cleared.

²⁰ The requests would be made pursuant to Commission regulations that require the DCO, upon Commission request, to "file with the Commission such information related to its business as a clearing organization . . . in the format and manner specified, and within the time provided, by the Commission in the request." 17 CFR §39.13(c)(5)(i).

²¹ As a general matter, staff expects margin requirements for virtual currency contracts to exceed those of less volatile commodities.

²² Staff's governance review will include an assessment of the DCO's compliance with its product eligibility requirements pursuant to 17 CFR §39.12(b)(1) and the DCO's consideration of the individual product eligibility

F. Staff Notice

To date, the existing self-certification process for new contracts has worked well. Typically, exchanges reach out to Commission staff in advance of launching a new contract. In the case of the CME and CFE bitcoin futures contracts, Commission staff and exchange staff had extensive discussions over a course of months leading up to the product launch to ensure that staff understood the bases for the self-certifications that the contracts and the settlement processes were not readily susceptible to manipulation. This type of lengthy engagement is not unusual for products that may implicate complex issues.

To bring greater transparency to the process, if Commission staff is unable to confirm that the contract being self-certified complies with the CEA and regulations, but the exchange lists (or intends to list) the contract, staff may notify the exchange of its concerns in writing. Additionally, Commission staff may make such notice public and transmit a copy of such letter to other regulators, as appropriate.

All questions regarding this advisory, with the exception of DCO risk management, should be directed to the Division of Market Oversight (Jeanette Curtis (202) 418-5669 or Phil Colling (202) 418-5287). Questions regarding DCO risk management should be directed to the Division of Clearing and Risk (Scott Sloan (312) 596-0708).

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factors listed therein, including but not limited to the availability of reliable prices for the contract, the ability of the DCO to measure risk for purposes of setting margin requirements, and the operational capacity of the DCO and its clearing members to address any unusual product risk characteristics.