



## U.S. COMMODITY FUTURES TRADING COMMISSION

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### CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets

This backgrounder provides clarity regarding federal oversight of and jurisdiction over virtual currencies; the CFTC's approach to regulation of virtual currencies; the self-certification process generally, as well as specifically regarding the recent self-certification of new contracts for bitcoin futures products by designated contract markets (DCMs); background on the CFTC's "heightened review" for virtual currency contracts; and a discussion of the constituencies the CFTC believes could be impacted by virtual currency futures.

#### Federal and State Oversight of Virtual Currencies

US law does not provide for direct, comprehensive Federal oversight of underlying Bitcoin or virtual currency spot markets. As a result, US regulation of virtual currencies has evolved into a multifaceted, multi-regulatory approach:

- **State Banking** regulators oversee certain US and foreign virtual currency spot exchanges largely through state money transfer laws.
- The **Internal Revenue Service (IRS)** treats virtual currencies as property subject to capital gains tax.
- The **Treasury's Financial Crimes Enforcement Network (FinCEN)** monitors Bitcoin and other virtual currency transfers for anti-money laundering purposes.
- The **Securities and Exchange Commission (SEC)** takes increasingly strong action against unregistered initial coin offerings.

The **CFTC** also has an important role to play. In 2014, the CFTC declared virtual currencies to be a "commodity" subject to oversight under its authority under the Commodity Exchange Act (CEA).<sup>1</sup>

Since then, the CFTC has taken action against unregistered Bitcoin futures exchanges (BitFinex),<sup>2</sup> enforced the laws prohibiting wash trading and prearranged trades on a derivatives platform,<sup>3</sup> issued proposed guidance on what is a derivative market and what is a spot market in the virtual currency context,<sup>4</sup> issued warnings about valuations and volatility in spot virtual currency markets,<sup>5</sup> and addressed a virtual currency Ponzi scheme.<sup>6</sup>

#### CFTC Approach to Responsible Regulation of Virtual Currencies

The CFTC seeks to promote responsible innovation and development that is consistent with its statutory mission to foster open, transparent, competitive and financially sound derivative trading markets and to prohibit fraud, manipulation and abusive practices in connection with derivatives and other products subject to the CEA. The CFTC believes that the responsible regulatory response to virtual currencies involves the following:

- 1) **Consumer Education.** Amidst the wild assertions, bold headlines, and shocking hyperbole, there is a need for greater public understanding.

<sup>1</sup> Testimony of CFTC Chairman Timothy Massad before the U.S. Senate Committee on Agriculture, Nutrition and Forestry (Dec. 10, 2014), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6>.

<sup>2</sup> *In re BFXNA Inc. d/b/a Bitfinex*, Dkt. No. 16-19 (CFTC June 2, 2016),

<http://www.cftc.gov/idx/groups/public/@Irenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf>.

<sup>3</sup> *In re TeraExchange LLC*, Dkt. No. 15-33 (CFTC Sept. 24, 2015),

<http://www.cftc.gov/idx/groups/public/@Irenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf>.

<sup>4</sup> CFTC, Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60335 (Dec. 20, 2017), [www.gpo.gov/fdsys/pkg/FR-2017-12-20/pdf/2017-27421.pdf](http://www.gpo.gov/fdsys/pkg/FR-2017-12-20/pdf/2017-27421.pdf).

<sup>5</sup> CFTC, A CFTC Primer on Virtual Currencies (Oct. 17, 2017), [http://www.cftc.gov/idx/groups/public/documents/file/labctc\\_primercurrency100417.pdf](http://www.cftc.gov/idx/groups/public/documents/file/labctc_primercurrency100417.pdf).

<sup>6</sup> On September 21, 2017, the CFTC filed a complaint in federal court in the Southern District of New York against Nicholas Gelfman and Gelfman Blueprint, Inc., see <http://www.cftc.gov/idx/groups/public/@Irenforcementactions/documents/legalpleading/enfgelfmancomplaint09212017.pdf>.

- 2) **Asserting Legal Authority.** Asserting legal authority over virtual currency derivatives in support of the CFTC’s anti-fraud and manipulation efforts, including in underlying spot markets, is a key component in the CFTC’s ability to effectively regulate these markets.
- 3) **Market Intelligence.** Gaining the ability to monitor markets for virtual currency derivatives and underlying settlement reference rates through the gathering of trade and counterparty data will provide regulatory and enforcement insights into those markets.
- 4) **Robust Enforcement.** In addition to its general regulatory and enforcement jurisdiction over the virtual currency derivatives markets, the CFTC has jurisdiction to police fraud and manipulation in cash or spot markets. The CFTC intends to continue to exercise this jurisdiction to enforce the law and prosecute fraud, abuse, manipulation or false solicitation in markets for virtual currency derivatives and underlying spot trading.
- 5) **Government-wide Coordination.** The CFTC actively coordinates its approach to Bitcoin and other virtual currencies with other Federal regulators, including the Securities and Exchange Commission (SEC), Federal Bureau of Investigation (FBI), Justice Department and Financial Stability Oversight Council (FSOC). The CFTC also coordinates with state entities, including state Attorneys General, in addition to working with the White House, Congress and other policy-makers.

### **Virtual Currency Self-Certifications**

On Friday, December 1, 2017, the Chicago Mercantile Exchange Inc. (CME) and the CBOE Futures Exchange (CFE) self-certified new contracts for bitcoin futures products and the Cantor Exchange self-certified a new contract for bitcoin binary options.

- The product self-certification process was deliberately designed by Congress and prior Commissions to give the initiative to DCMs to certify new products. This is consistent with a DCM’s role as a self-regulatory organization (SRO) and the CFTC’s principles-based approach to regulation.
- This self-certification process is one that Congress promulgated and prior Commissions have implemented. Unless it is changed, the staff of the CFTC must work responsibly within the self-certification structure.
- It is notable that the product self-certification process does NOT provide for public input, the creation of separate guaranty funds for clearing, or value judgments about the underlying spot market.<sup>7</sup>
- There are limited grounds for the CFTC to “stay” self-certification such as filing a false statement in the certification.<sup>8</sup>
- In the case of the CME and CFE self-certifications, no such grounds were evident.
- Had it even been possible, blocking self-certification would not have stemmed interest in Bitcoin or other virtual currencies nor their spectacular and volatile valuations. Instead, it would have ensured that the virtual currency spot markets continue to operate without federal regulatory surveillance for fraud and manipulation.

The CFTC was well prepared to handle the recent self-certifications of Bitcoin futures products. CFTC staff knew that a virtual currencies market was evolving rapidly in 2017 and that the agency would likely see proposals for the launch of Bitcoin futures.

- The CFTC has past experience with virtual currency derivatives, such as TeraExchange swaps,<sup>9</sup> Nadex binary options,<sup>10</sup> and LedgerX options.<sup>11</sup>

<sup>7</sup> CEA section 5c(c)(1); 7 U.S.C. 7a-2(c); and 17 C.F.R. 40.2.

<sup>8</sup> See 17 C.F.R. 40.2(c). There are a few other limited avenues to provide additional time for consideration, such as the statutory requirement for special steps when a Systematically Important Derivatives Clearing Organization (SIDCO) proposes rule changes that could materially affect the nature or level of risk undertaken. But, there was no such finding of materiality of new Bitcoin futures, given market size. Also, this would not have applied to CFE contracts, which are not cleared by a SIDCO. Another avenue would have required the CFTC to adopt a rule through regular order and require DCM adoption. For a variety of reasons, that was not feasible.

<sup>9</sup> TeraExchange was registered as a swap execution facility (SEF) in October 2013 and its Bitcoin swaps were certified on September 11, 2014.

<sup>10</sup> Nadex’s Bitcoin options were certified on November 26, 2014.

<sup>11</sup> LedgerX was registered as a SEF in July 2017 and its Bitcoin options were certified on September 19, 2017.

- CME created the Bitcoin Reference Rate in December 2016. CFE approached the CFTC in July 2017.
- The CFTC built into its 2018 Congressional budget request<sup>12</sup> additional resources to strengthen its technological and econometric resources to support its ability to oversee virtual currency derivatives.

Although CFTC staff did not dictate the firm date for CME and CFE listing Bitcoin futures, the exact timing of these issues in 2017 did not affect the self-certification process.

### **Background on “Heightened Review” for Virtual Currency Self-Certifications**

Within the limits and parameters of the current self-certification process, CFTC staff has engaged in a “heightened review” with the DCMs and worked collaboratively through several drafts of the terms and conditions of these Bitcoin futures products to address issues. At the heart of the CFTC’s heightened review is extensive visibility and monitoring of markets for virtual currency derivatives and underlying settlement reference rates. Virtual currency self-certification under heightened review means that the CFTC not only has clear legal authority, but now also will have the means to police certain underlying spot markets for fraud and manipulation.

Heightened review includes:

- 1) derivatives clearing organizations (DCOs) setting substantially high initial<sup>13</sup> and maintenance margin for cash-settled Bitcoin futures;
- 2) DCMs setting large trader reporting thresholds at five bitcoins or less;
- 3) DCMs entering direct or indirect information sharing agreements with spot market platforms to allow access to trade and trader data;
- 4) DCM monitoring of data from cash markets with respect to price settlements and other Bitcoin prices more broadly, and identifying anomalies and disproportionate moves in the cash markets compare to the futures markets;
- 5) DCMs agreeing to engage in inquiries, including at the trade settlement level when necessary;
- 6) DCMs agreeing to regular coordination with CFTC surveillance staff on trade activities, including providing the CFTC surveillance team with trade settlement data upon request; and
- 7) DCMs coordinating product launches so that the CFTC’s market surveillance branch can carefully monitor minute-by-minute developments.

The CFTC expects that any registered entity seeking to list a virtual currency derivative product would follow the same process, terms and conditions.

### **Constituencies Impacted By Self-Certification of Virtual Currency Futures**

While engaged in this heightened review, the CFTC identified three constituencies impacted by virtual currency futures:

- **Market Participants and Consumers.** The CFTC seeks to look out for virtual currency market participants and consumers through the CFTC’s educational efforts, such as the CFTC Virtual Currency Primer,<sup>14</sup> CFTC Bitcoin consumer advisory,<sup>15</sup> the CFTC market advisory,<sup>16</sup> the CFTC Dedicated bitcoin webpage,<sup>17</sup> the CFTC analysis of Bitcoin spot market data,<sup>18</sup> and CFTC weekly publication of Bitcoin futures “Commitment of Traders” data.<sup>19</sup>

<sup>12</sup> The CFTC’s FY 2018 budget request was submitted on May 23, 2017.

<sup>13</sup> In the case of CME and CFE Bitcoin futures, the initial margin was ultimately set at 47 percent and 44 percent, respectively. By way of comparison that is more than ten times the margin required for CME corn futures product.

<sup>14</sup> See *supra* note 9.

<sup>15</sup> CFTC Customer Advisory: Understand the Risks of Virtual Currency Trading (Dec. 15, 2017),

[http://www.cftc.gov/idc/groups/public/@customerprotection/documents/file/customeradvisory\\_urvct121517.pdf](http://www.cftc.gov/idc/groups/public/@customerprotection/documents/file/customeradvisory_urvct121517.pdf).

<sup>16</sup> CFTC, Statement on Self-Certification of Bitcoin Products by CME, CFE and Cantor Exchange (Dec. 1, 2017),

<http://www.cftc.gov/PressRoom/PressReleases/pr7654-17>.

<sup>17</sup> CFTC, Bitcoin, <http://www.cftc.gov/Bitcoin/index.htm>.

<sup>18</sup> See *supra* note 8.

Market participants and consumers are also protected through DCOs greatly increasing initial margin levels and efforts by the National Futures Association (NFA), in conjunction with the CFTC, to direct NFA members to heighten customer protection.<sup>20</sup> Finally, the CFTC will work to protect consumers through its ongoing enforcement activities, including those against virtual currency Ponzi schemes<sup>21</sup> and unregistered futures exchanges.<sup>22</sup>

- **Public Interest.** The CFTC looks to protect the public interest in regard to virtual currencies through its formation of a virtual currency task team, including recruitment of greater virtual currency expertise, its establishment of “heightened review” of virtual currency futures, its assertive enforcement against fraud and manipulation in Bitcoin and other virtual currency and its providing legal certainty to CFTC anti-fraud and manipulation jurisdiction over spot markets. In fact, without the self-certification of Bitcoin futures products, the CFTC’s surveillance of virtual currency spot trading markets would be practically impossible and legally challengeable.
- **DCO Clearing Members.** The CFTC recognizes that major global banks and brokerages that are DCO clearing members are able to look after their own commercial interests by choosing not to trade virtual currency futures (as some have done), requiring substantially higher initial margins (as many have done), and through their active participation in DCO risk committees. One clearing member called for the CFTC to force DCOs to establish a separate clearing system for virtual currencies.<sup>23</sup> However, as noted above, the CFTC’s “hands were tied” by statute from requiring a separate clearing system or guaranty fund for Bitcoin futures. Where separate guaranty funds have been used by DCOs in the past, they have come about through independent negotiations between clearing members and DCOs, not by CFTC action.

It is important to note that there is no provision in statute or regulation for public input into new product self-certifications. Neither statute nor rule would have prevented CME and CFE from launching their new products before public hearings could have been called. Even if the CFTC could have held public hearings or requested public input, it is unlikely that the outcome would have changed, as the CFTC staff found no basis to determine their filings to be inconsistent with the CEA or CFTC regulations.

Independent from the self-certification process, the CFTC and its advisory committees have the ability to call hearings. Both the Market Risk Advisory Committee (MRAC) and the Technology Advisory Committee (TAC) will hold hearings this month, to allow clearing members, alongside the virtual currency futures trading platforms and appropriate representatives of the public interest, to discuss the process of self-certification of new products, such as virtual currencies, and, more broadly, the challenges and opportunities of virtual currencies for CFTC regulated derivatives and underlying spot markets.

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<sup>19</sup> CFTC, Commitments of Traders, <http://www.cftc.gov/MarketReports/CommitmentsofTraders/index.htm>.

<sup>20</sup> See NFA, Investor Advisory—Futures on Virtual Currencies Including Bitcoin (Dec. 1, 2017), <https://www.nfa.futures.org/investors/investor-advisory.html>; NFA, Additional Reporting Requirements Regarding Virtual Currency Futures Products for FCMs for Which NFA is the DSRO (Dec. 6, 2017), <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4973>; NFA, Additional Reporting Requirements For IBs That Solicit or Accept Orders in Virtual Currency Products (Dec. 14, 2017), <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4975>; NFA, Additional Reporting Requirements for CPOs and CTAs That Trade Virtual Currency Products (Dec. 14, 2017), <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4974>.

<sup>21</sup> See *supra* note 10.

<sup>22</sup> *In re Coinflip, Inc.*, Dkt. No. 15-29 (CFTC Sept. 17, 2015), <http://www.cftc.gov/idc/groups/public/@Irenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

<sup>23</sup> Chloe Aiello, Keep Bitcoin Away From the Real Economy, Says Billionaire 'Father of High Speed Trading,' *cnbc.com* (Nov. 15, 2017), <https://www.cnbc.com/2017/11/15/thomas-peterffy-keep-bitcoin-away-from-the-real-economy.html>.