



U.S. Commodity Futures Trading Commission

## Technical Assistance Program

# The U.S. Commodity Futures Trading Commission's Approach to Crypto-Assets

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# Disclaimer

The opinions, analyses, and conclusions expressed herein are those of the presenter and do not necessarily reflect the views of the CFTC Divisions and Offices, other Commission staff, or the Commission itself or the United States Government.



# “THE WORLD IS CHANGING.

Our parents' financial markets are gone. The 21<sup>st</sup> century digital transformation is well underway. The digital technology genie won't go back in the bottle. Nor should it.”



“...what makes this era of financial technology innovation so challenging for us is that the development of new digital technologies and business models is intertwined with the existence of much older regulatory frameworks.” *Chairman J. Christopher Giancarlo, June 3, 2019.*

# Commodity Exchange Act

- ▶ The U.S. Commodity Futures Trading Commission's (CFTC) governing legislation: Commodity Exchange Act (CEA)
- ▶ Section 1a(9) of the CEA defines “commodity” to include “all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in”
  - The definition of “commodity” in the CEA is broad



# CFTC's Jurisdiction Over Crypto-Assets

- ▶ The CFTC first found that crypto-assets like Bitcoin are commodities in 2015
- ▶ CFTC jurisdiction:
  - The CFTC has full regulatory oversight of derivatives contracts over commodities (e.g., Bitcoin futures contracts)
  - The CFTC only has fraud and manipulation authority over the underlying commodity itself (e.g., Bitcoin)

# CFTC's Jurisdiction Over Crypto-Assets (Cont.)

- ▶ Most crypto-assets have elements of many different asset classes
- ▶ CFTC jurisdiction depends in each case on relevant facts and circumstances
  - The name “coin,” “token,” or “currency” is not determinative for regulatory purposes

# CFTC's Approach to Crypto-Assets

- ▶ As a general matter, the CFTC promotes responsible innovation to foster open, transparent, and financially sound markets
- ▶ Principled, flexible, and thoughtful regulatory approaches are necessary
- ▶ Two handed approach – balance strong enforcement on the one hand and a “do no harm” approach to innovation on the other
- ▶ Great potential in distributed ledger technology (DLT)



# Crypto-Assets Regulatory Approach

- ▶ CFTC approach to responsible regulation of virtual assets
  - Consumer education
    - Increase public understanding
  - Asserting legal authority
    - Assert the CFTC's legal authority over virtual asset derivatives
  - Market intelligence
    - Monitor virtual asset markets and underlying settlement reference rates
  - Robust enforcement
    - Police fraud and manipulation in cash or spot markets in addition to general regulatory and enforcement over virtual asset derivatives markets
  - Government-wide coordination
    - Coordinate with other U.S. federal and state authorities

# Crypto-Assets Regulatory Approach (Cont.)

- ▶ CFTC regulates Bitcoin and other crypto-assets as a commodity
  - No specific rules but defined through enforcement actions (e.g., settlement orders in Coinflip, TeraExchange, Bitfinex)
- ▶ CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets
  - <https://www.cftc.gov/Bitcoin/index.htm>

# CFTC's Response to Crypto-Assets

## Exercise of Authority

- ▶ Asserting legal authority over crypto-assets
- ▶ Declared crypto-assets like Bitcoin to be commodities in 2015
- ▶ The CFTC has full regulatory oversight over derivative contracts such as Bitcoin futures contracts
- ▶ The CFTC only has fraud and manipulation authority over the underlying commodity (e.g., Bitcoin itself)

# CFTC's Response to Crypto-Assets (Continued)

## Strong Enforcement

- ▶ The CFTC is dedicated to enforcing its jurisdiction in this space
- ▶ The CFTC first began filing crypto-asset enforcement actions in 2015
- ▶ Recent important rulings in enforcement actions include the *McDonnell* and *My Big Coin Pay Inc.* matters, confirming jurisdiction

# Crypto-Assets Enforcement

## ▶ Enforcement

- Coinflip (2015) – failure to comply with CEA/CFTC regulations for operating a facility for trading or processing “commodity options”
  - First action against an unregistered Bitcoin options trading platform
  - Settlement order – first finding that “Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities”
  - Further, the CFTC noted in the order that Bitcoin is “distinct from ‘real currencies’” of the US and other countries
  - The view that Bitcoin is not a currency aligns with that of other US regulators (SEC – investment contracts; IRS – property for tax purposes; Financial Crimes Enforcement Network – not a real currency)
- TeraExchange (2015)
- Bitfinex (2016)

# CFTC's Response to Crypto-Assets (Cont.)

## Market Intelligence

- ▶ Gain the ability to monitor markets for crypto-assets through the gathering of trade data
- ▶ Helps garner insight into the product and pursue enforcement actions where appropriate



# CFTC Regulatory Response: Crypto Currency

## Staff Competency

- ▶ This is the idea of keeping up with and learning about new technologies
- ▶ This effort is led by LabCFTC
- ▶ Through LabCFTC we engage with innovators in this space to learn about new technologies that may impact our regulatory jurisdiction

# CFTC's Response to Crypto-Assets (Cont.)

## Global and Domestic Cooperation

- ▶ The CFTC coordinates its approach to crypto-assets with other federal regulators
  - Primarily the SEC, but also Treasury, Federal Bureau of Investigation (FBI), Justice Department, and others
- ▶ The CFTC also coordinates with state entities, including state Attorney Generals
  - This includes state banking regulators who oversee crypto-asset through state money transfer laws
- ▶ The CFTC coordinates with international regulators

# CFTC's Response to Crypto-Assets (Cont.)

## Education and Outreach

- ▶ Customer Advisories, which warn investors of the risks of crypto-assets
- ▶ “CFTC Talks” podcasts on crypto-assets at [CFTC.gov/Media/Podcasts](https://www.cftc.gov/Media/Podcasts)
- ▶ Fact Sheet on the CFTC's role in regulating crypto-assets
- ▶ “Bitcoin Basics,” a downloadable brochure that provides basic information about Bitcoin

# CFTC Regulatory Response: Crypto asset

## Self-Certification and Heightened Review

- ▶ The vast majority of new products are brought to market through the self-certification process; the process is not new; Congress promulgated many years ago
- ▶ When a Designated Contract Market (DCM) wants to list a new contract, it can either submit the new contract to the CFTC for approval or self-certify that the contract complies with the CEA and Commission regulations
- ▶ If it self-certifies the new contract, it must certify in writing that it has determined that the contract complies with the CEA and Commission regulations; this is the same standard the Commission uses when reviewing products for approval

# Self-Certification Process

- ▶ In December 2017, Chicago Mercantile Exchange Inc. (CME) and Cboe Futures Exchange, LLC (CFE) self-certified new contracts for Bitcoin futures products
- ▶ This self-certification process is one that the U.S. Congress promulgated; it is not new
- ▶ It is important to note that the product self-certification process does NOT provide for public input or value judgments about the underlying spot market

# Crypto-Asset Stats

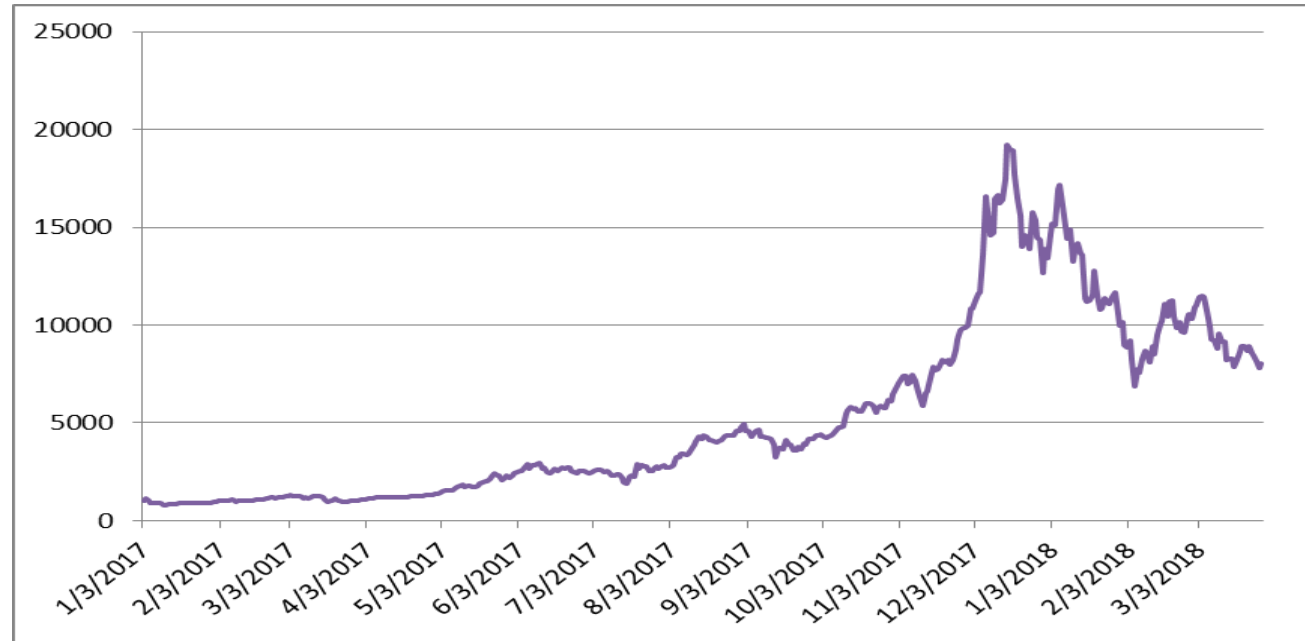
## ▶ Bitcoin futures

- December 2017 – CFE (CBOE) and CME self-certified the first Bitcoin futures products
  - CBOE contract (XBT) – represents 1 Bitcoin, settles against a daily price auction
  - CME contract (BTC) – represents 5 Bitcoins, uses its own Bitcoin reference rate which tracks several crypto-asset exchanges
- Margin:
  - CBOE: initial margin 44%; maintenance margin: 40%
  - CME: initial margin: 47%; maintenance margin: 43%
  - More than 10 times the margin required for CME corn futures products
  - Note – FCMs have the ability to and have required higher margin from their customers



# Crypto-Assets

## ► Bitcoin – historical price graph



- Jan. 3, 2017 – \$1,035.24
- Oct. 31, 2017 – CME announces plan to launch Bitcoin futures – \$6,434.21
- Dec. 11, 2017 – CBOE Bitcoin futures launched – \$16,470.00
- Dec. 17, 2017 – CME Bitcoin futures launched – \$18,953.00
- Mar. 28, 2018 – \$8,039.86

Data source: [bitcoincharts.com](https://bitcoincharts.com)

# Heightened Review

- ▶ CFTC staff engaged in a “heightened review” with CME and CFE, and worked collaboratively through several drafts of the terms and conditions of these Bitcoin futures products to address issues that arose
- ▶ At the heart of the CFTC’s heightened review is extensive visibility and monitoring of markets for crypto-asset derivatives and underlying settlement reference rates
- ▶ On May 21, 2018, CFTC staff released an advisory for crypto-asset products; the staff advisory laid out formal guidance on the “heightened review process”

# CFTC Regulatory Response: Crypto asset

## Heightened Review Elements:

- ▶ Derivatives Clearing Organizations (DCOs) set substantially higher initial and maintenance margins for cash-settled Bitcoin futures
- ▶ Designated Contract Markets (DCMs) set large trader reporting thresholds
- ▶ DCMs enter into direct or indirect information sharing agreements with spot market platforms to allow access to trade and trader data
- ▶ DCMs monitor data from cash markets

# CFTC Regulatory Response: Crypto asset

## Heightened Review Elements (cont.)

- ▶ DCMs agree to engage in inquiries, including at the trade settlement level
- ▶ DCMs agree to regular coordination with CFTC surveillance staff on trade activities, including providing trade settlement data upon request
- ▶ DCMs coordinate product launches so that the CFTC's market surveillance branch can carefully monitor minute-by-minute developments
- ▶ DCMS and Swap Execution Facilities (SEFs) disclose what affirmative steps they have taken to gather and accommodate appropriate input from concerned parties

# CFTC Regulatory Impact on Crypto-Assets

- ▶ CFTC faced criticism in some quarters for allowing Bitcoin futures to trade
- ▶ Many have recognized that the emergence of Bitcoin futures contracts sapped the Bitcoin price bubble at the end of 2017
  - Federal Reserve Bank of San Francisco article on May 7, 2018 <https://www.frbsf.org/economic-research/files/el2018-12.pdf>
- ▶ Some say Bitcoin achieved a more sustainable price level as a result of the Bitcoin futures

# Overview of CFTC Regulated Bitcoin Derivatives

## Bitcoin Swaps

- ▶ In 2014, TeraExchange, LLC, listed a bilateral (uncleared) cash-settled Bitcoin swap for trading; trading on a Swap Execution Facility (SEF) platform is limited to “eligible contract participants”

## Binary Options/Spread Contracts

- ▶ North American Derivatives Exchange Inc. (NADEX) listed cash-settled, fully margined, binary options based on the Tera Bitcoin Price Index from November 2014 to December 2016
- ▶ In December 2017, Cantor Futures Exchange, LP self-certified bundled binary options and NADEX, reentering the market, self-certified Bitcoin spread contracts



# Overview of CFTC Regulated Bitcoin Derivatives (Cont.)

## Physically Settled Bitcoin Options

- ▶ In September 2017, LedgerX, LLC, a SEF, listed cleared, physically settled Bitcoin options

## Bitcoin Futures Contracts

- ▶ On December 1, 2017, CME and the CFE, self-certified new contracts for Bitcoin futures products

# Regulatory Notices

FINRA Regulatory Notice 18-20 July 6, 2018

- ▶ “Encourage” each firm to promptly notify FINRA if it or its associated persons or affiliates currently engages, or intends to engage, in any activities related to digital assets
- ▶ Encourages each firm to keep its Regulatory Coordinator abreast of changes
- ▶ Risk Control Assessment Survey should disclose activity involving crypto’s
- ▶ Activities of interest include:
  - Purchases, sales or executions of transactions in digital assets
  - Purchases, sales or executions in pooled funds investing in digital assets
  - Creation, management or provision of advisory services
  - Purchases, sales or executions of transaction in derivatives
  - Participation in initial or secondary offerings
  - Creation or management of a platform for secondary trading
  - Mining of crypto’s
  - Recommend, solicit or accept orders in crypto’s
  - Display indications of interest in crypto’s
  - Provide or facilitate clearance and settlement of crypto’s
- ▶ Recording crypto’s using DLT

# Regulatory Notices

## FINRA Crypto Trading Platforms Advisory

- ▶ Warning these are not exchanges
- ▶ Not subject to regulatory oversight
- ▶ Risk of cyber attack
- ▶ Platforms aren't insured, not SIPC protected
- ▶ Charged fees
- ▶ Not best execution
- ▶ Not get immediate access to your funds
- ▶ Watch out for scams

# Regulatory Notices

## IOSCO Crypto Asset Trading Platform consultation report – May 2019

- ▶ Survey of regulatory framework around the world for crypto assets trading platforms
- ▶ Key findings
  - Custody and protection of assets on platform
  - Financial support of operating the platform
  - Conflict of interest
  - Availability of information on how the platform is operated
  - Market integrity and oversight
  - Price discovery
  - System resilience, reliability and integrity
  - Cyber security

# Regulatory Notices

SEC guidance on custody July 2019

- ▶ For digital securities only
- ▶ Comply with customer segregation rules
- ▶ Increased risks
  - Fraud
  - Lose of private key by custodian
  - Transfer to unintended address without recourse/reversal
  - Books and records and DLT
  - No SPIC protection if not a security
  - Not good control location