CFTC Issues Advisory on Virtual Currency Derivative Product Listings

June 21, 2018

On May 21, 2018, the Commodity Futures Trading Commission (the "CFTC") issued Staff Advisory No. 18-14 (the "Advisory"), summarizing CFTC staff priorities and expectations in its review of new virtual currency derivative product listings. The Advisory addresses certain key areas that require particular attention in the context of listing a new virtual currency derivatives contract pursuant to CFTC Regulation 40.2 (self-certification) or 40.3 (voluntary submission for CFTC review and approval).

Background. The CFTC notes that it has determined that bitcoin and other virtual currency are properly defined as commodities. The CFTC interprets the term "virtual currency" broadly. The term encompasses 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. The CFTC notes that virtual currency differs from commodities like oil and gold, where commercial uses predominate. Virtual currency also differs 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, 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.

The CFTC indicates that the significant risks associated with virtual currency markets justify close scrutiny by both CFTC staff and registered entities, such as designated contract markets ("DCMs"), swap execution facilities ("SEFs") and derivatives clearing organizations ("DCOs").

Guidance. In light of these risks, the CFTC provides guidance on a series of topics relating to the listing of new virtual currency derivatives contracts:

- *Enhanced Market Surveillance:* DCMs and SEFs must establish and maintain an effective oversight program designed, among other things, to ensure that listed contracts are not readily susceptible to manipulation. The CFTC believes that a well-designed market surveillance program should include an information-sharing arrangement with the underlying spot market(s) that make up the cash-settlement price to facilitate access to a broader range of trade data. DCMs and SEFs must also conduct real-time monitoring of all trading activity on their electronic trading platforms to identify disorderly trading and any market or system anomalies.

Consistent with the concerns expressed in the Advisory, and as reported by The *Wall Street Journal* on June 8, 2018, the CFTC has demanded that several bitcoin exchanges, including Bitstamp, Coinbase, itBit and Kraken, hand over comprehensive trading data to assist a probe into whether manipulation is distorting prices in markets linked to bitcoin.

- *Coordination with CFTC Staff:* The CFTC staff expects exchanges regularly to discuss with them a wide range of issues related to the surveillance of virtual currency derivatives contracts, and to provide surveillance information as requested by the CFTC. Upon request, the exchange must also provide to the CFTC data related to the settlement process referenced by the contract.

- *Large Trader Reporting:* Under the CFTC's Large Trader Reporting System, clearing members, futures commission merchants ("FCMs") and foreign brokers file daily reports with the CFTC showing futures and options positions of traders with positions at or above specified levels. The CFTC recommends that an exchange set the large trader reporting threshold for any virtual currency derivatives contract at five bitcoin (or the equivalent for other virtual currency).

- *Outreach:* Given the particular characteristics of virtual currency derivatives contracts, and the concerns about price volatility and lack of transparency, the CFTC staff expects exchanges to take extra care to engage meaningfully with market participants and other stakeholders. Prior to listing a new contract on virtual currency, the CFTC staff expects an exchange to solicit comments and views on issues relating to the listing. For example, the exchange should consider consulting with members and other relevant stakeholders beyond those market participants that are interested in trading the new contract. The CFTC also indicates that, as part of a submission to the CFTC for the listing of a virtual currency derivatives contract, an exchange should consider including an explanation of any substantive opposing views learned from such outreach and how the exchange addressed such views and objections.

- *DCO Risk Management:* The CFTC indicates that once a DCO that will clear a proposed contract has been identified, the CFTC staff will request certain information from the DCO. For example, the CFTC will review the DCO's proposed initial margin requirements to assess whether they are commensurate with the risks of the contracts. In addition, the CFTC expects the DCO to provide information related to the governance process for approving the proposed contracts and an explanation of 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. The CFTC will also review the DCO's adherence to its internal governance procedures for new contract approval.

Staff Notice of Regulatory Concerns. The CFTC notes that if the CFTC staff is unable to confirm that a contract being self-certified complies with the Commodity Exchange Act and CFTC regulations, but the exchange lists (or indicates its intention to list) the contract in any case, the CFTC staff may notify the exchange of its concerns in writing. The CFTC may also make such notice public and transmit a copy to other regulators, as appropriate.

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Please do not hesitate to contact us with any questions.

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