

May 29, 2018

Recent Virtual Currency Actions by the CFTC and State Regulators

CFTC Staff Issues Advisory for Exchanges and Clearinghouses Listing Virtual Currency Derivatives and Announces Agreement for Information Sharing with State Securities Regulators amid “Operation Cryptosweep”

SUMMARY

On May 21, 2018, the staff of two divisions of the Commodity Futures Trading Commission (the “CFTC”) published a staff advisory (the “Advisory”) that provides guidance for CFTC-registered exchanges and clearinghouses when listing virtual currency derivative products.¹ The following key areas are highlighted in the Advisory as requiring particular attention by entities that list, trade and clear a virtual currency derivatives contract:

- enhanced market surveillance;
- close coordination with CFTC staff;
- large trader reporting;
- outreach to a broad range of stakeholders prior to listing;
- Derivatives Clearing Organization (“DCO”) risk management and governance; and
- the possibility of a staff notice to exchanges identifying concerns regarding new products, including potential public release of the notice and sharing with other regulators.

On the same date, the CFTC, in a joint press release with the North American Securities Administrators Association (the “NASAA”), announced that it had signed a Memorandum of Understanding Regarding the Treatment of Non-Public Information Shared Between State Securities Administrators and the CFTC (the “Agreement”) to establish a closer working relationship between the CFTC and individual state

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securities agencies (the “Joint Release”).² The Agreement sets out a framework for the sharing of confidential information to assist participants in enforcing the Commodity Exchange Act (the “CEA”).

The signing of the Agreement coincides with the NASAA’s announcement of a coordinated international crackdown on fraudulent Initial Coin Offerings (“ICOs”) and virtual currency-related investment products, dubbed “Operation Cryptosweep.” To date, Operation Cryptosweep has generated nearly 70 investigations and 35 pending or completed enforcement actions in both the United States and Canada.

CFTC ADVISORY ON VIRTUAL CURRENCY DERIVATIVE LISTINGS

In 2015, the CFTC determined that bitcoin and other virtual currencies were “commodities” for purposes of the CEA, giving the CFTC regulatory authority over virtual currency futures contracts as well as the authority to investigate and bring enforcement actions in connection with fraud and manipulation that occur in the spot markets in violation of the CEA.³ This view has been accepted by at least one district court.⁴ The CFTC has interpreted 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.⁵

The Advisory, issued jointly by the CFTC’s Division of Market Oversight and Division of Clearing and Risk, notes that, unlike traditional commodities, there exists neither a widely adopted commercial use for virtual currencies nor robustly regulated financial markets through which to trade these products. Therefore, the observable prices for virtual currencies are less clearly connected to any intrinsic value or supply and demand than for other commodities. These factors present heightened concerns about potential market manipulation and other problematic activity in connection with the trading of virtual currency products. For example, according to a Bloomberg report, the Justice Department, working with the CFTC, has opened a criminal probe into whether traders are manipulating the price of bitcoin and other virtual currencies using illegal practices, including “spoofing” trades.⁶

In response to these risks, the CFTC has been monitoring developments in these products and discussing the risks they present with market participants. This effort includes a recent collaboration with the Chicago Mercantile Exchange (“CME”) and Cboe Futures Exchange (“CFE”) to review bitcoin futures contracts listed pursuant to Commission Regulation 40.2.⁷ The Advisory is a continuation of this interaction with market participants, providing guidelines for designated contract markets (“DCMs”), swap execution facilities (“SEFs”) and derivatives clearing organizations (“DCOs”) in discharging their self-regulatory responsibilities while keeping pace with unique challenges posed by virtual currency derivatives. The Advisory is comprised of six brief sections, each of which is summarized below.

Enhanced Market Surveillance

The Advisory highlights the importance of heightened access to information by an exchange – *i.e.*, a DCM or SEF – regarding the underlying spot market(s) to produce a well-designed market surveillance

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program in the context of virtual currency derivatives. Under existing regulations, each DCM and SEF must establish and maintain an effective oversight program to prevent manipulation, price distortions and disruptions of the delivery or cash-settlement process. The CFTC staff believes that a heightened level of monitoring of the trading activities of the underlying spot market(s) for virtual currency derivatives is warranted. Access to spot market data such as trader identities, prices, volumes, times and quotes from the relevant market makers or traders would facilitate effective surveillance. Additionally, continuously monitoring these data feeds from the spot market(s), especially around the settlement period, would help identify anomalies in the spot market(s), which can in turn impact trading on the exchange. The Advisory also highlights the importance of Federal know your customer and anti-money laundering regulations, or the equivalent laws in the home jurisdiction of the relevant spot market(s), in providing transparency into the data obtained from the relevant spot market(s). The guidance states that “[a]s 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.”

Close Coordination with CFTC Surveillance Staff

Consistent with the CFTC’s emphasis on continuously discussing new developments with market participants, the CFTC staff expect to have regular discussions with exchanges concerning a wide range of issues related to the surveillance of virtual currency derivatives. The CFTC staff also expect that exchanges will provide surveillance information and data related to the settlement process upon request.

Large Trader Reporting

The CFTC’s Large Trader Reporting System requires reporting firms, which includes clearing members, futures commission merchants and foreign brokers, to file daily reports showing futures and option positions of traders at or above specific reporting levels outlined in CFTC Regulation 15.03(b).⁸ However, exchanges can set the reporting level in a particular commodity at a level lower than what is specified by regulation. Given the nature of virtual currency markets, and the significance of the large trader reporting regime in detecting market manipulation, the Advisory recommends that exchanges set the large trader reporting threshold for any virtual currency derivative contract at five bitcoin (or the equivalent for other virtual currencies). The current reportable position level for both the CME and CFE is set at five bitcoin, which, as the contract unit for the CME contract is five bitcoin, translates into a reportable limit of only one contract. Given the large price volatility of bitcoin and other virtual currencies, it may prove difficult to determine the five-bitcoin equivalent for other currencies.

Outreach to Stakeholders

The Advisory notes the importance for a CFTC-registered derivatives exchange that proposes to list a new virtual currency-based contract of taking “extra care” to engage meaningfully with relevant stakeholders. Prior to any new listing of a virtual currency contract, the CFTC expects that an exchange will solicit comments on issues relating to the listing that go beyond the contract’s terms and its susceptibility to manipulation. The guidance emphasizes the importance of soliciting input from

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stakeholders other than those interested in trading or clearing the new contract, such as clearing members that can provide insight into DCO risk management. Finally, the Advisory encourages exchanges to include an explanation of any opposing views learned from this stakeholder engagement process, and how the exchange addressed them, with any submission to the CFTC for the listing of a new virtual currency derivative. Exchanges are also encouraged to include as much information as possible in submissions for new listings.

DCO Risk Management

Upon learning of a DCO that will be clearing a proposed contract, the CFTC will request relevant information relating to the DCO's proposed initial margin requirements and the governance process for approving the proposed contract, including its consideration of the views of the clearing members in approving the proposed contract and the DCO's response to any opposing views regarding the manner in which the contract will be cleared. The DCO's proposed initial margin requirements must be commensurate with the risks of the proposed contract including risks that result from any unusual product characteristics and the ability of proposed margin requirements to adequately cover potential future exposures to clearing members based on an appropriate historic time period. The CFTC staff may require the DCO to adjust the proposed margin requirement and submit supporting data. Currently, the required initial margin for the CME contract is set at 43% of notional (47% for speculators) while the required initial margin for the CFE contract is set at 40% of the daily settlement price (43% for speculators).

Staff Notice

While acknowledging that "the existing self-certification process for new contracts has worked well" so far, the Advisory notes that a "lengthy engagement" between CFTC staff and the relevant exchange is "not unusual for products that may implicate complex issues." The Advisory notes that if the CFTC staff is not able to confirm that a self-certified product actually does comply with the CEA and applicable regulations, and an exchange nonetheless intends to proceed with the listing, the CFTC staff may notify the exchange of its concerns in writing, and may also make that notice public and available to other regulators.

The CFTC staff made clear that the Advisory is not a compliance checklist; rather, it is guidance on the CFTC's priorities and expectations when reviewing newly listed virtual currency derivatives at this time. CFTC Commissioner Rostin Benham described the Advisory as "another step in providing the public with greater transparency into this process" while noting that the Advisory only "clarifies expectations, it does not equate a change to the regulatory process." The Advisory follows the release earlier this year by the CFTC of a "backgrounder" memorandum describing the self-certification process for virtual currency futures in the wake of the listing of the CME and CFE bitcoin futures contracts – a process that had been criticized by some market participants, including clearing member firms that were not privy to the nature of the informal review and discussion process.⁹

INFORMATION SHARING AGREEMENT AND OPERATION CRYPTOSWEEP

While the CEA is generally enforced by the CFTC, it specifically grants authority to state securities regulators to enjoin certain violations of the CEA.¹⁰ To further this provision, on May 21, 2018, the CFTC and the NASAA entered into an Agreement that will set out an understanding between the CFTC and participating state securities regulators with respect to the treatment of non-public information shared between the CFTC and these state securities regulators when cooperating in the enforcement of the CEA. The information shared under the Agreement could also lead to enforcement actions under state securities laws, commodity codes or other laws. The NASAA negotiated on behalf of the state security administrators that are its members, each of which will have to sign on individually to be a party to the Agreement, and the NASAA will serve as a liaison to facilitate communication between the state security administrators and the CFTC. CFTC Chairman Giancarlo applauded the cooperation as ensuring that the “rapidly evolving financial technology space has the appropriate oversight to pursue bad actors, protect market participants, and allow for market-enhancing innovation.”¹¹ Joseph P. Borg, NASAA President, called the Agreement “particularly relevant given the recent epidemic of schemes involving cryptocurrencies and other modern types of commodities.”¹²

The Agreement was signed contemporaneously with the announcement of the initial results of “Operation Cryptosweep,” a task force that was formed in April 2018 and that is being led by the NASAA with more than 40 participating state and provincial regulators in the United States and Canada. In connection with the announcement of Operation Cryptosweep, which has identified 30,000 virtual currency-related domain name registrants to date, NASAA President Borg stated that “[t]he actions announced today are just the tip of the iceberg.”¹³ Borg described the “expanding exploitation of the crypto ecosystem by fraudsters” as a “significant threat to Main Street Investors” adding that “[d]espite a series of public warnings from security regulators at all levels of government, cryptocriminals need to know that state and provincial securities regulators are taking swift and effective action to protect investors from their schemes and scams.”¹⁴ Operation Cryptosweep comes amid the steadily increasing focus of the Securities and Exchange Commission (the “SEC”) and CFTC on targeting fraudulent activity in the virtual currency markets and raising public awareness of the risks associated with ICOs and virtual currency-related investment products, a critical component of Operation Cryptosweep. A week prior to the announcement the SEC launched “HoweyCoins.com”, a phony website designed to mimic a typical too-good-to-be-true ICO and demonstrate how easily fraudulent offerings of this type can be constructed.¹⁵ The announcement of Operation Cryptosweep also follows a recent analysis published by *The Wall Street Journal*, which discovered red flags such as plagiarized investor documents, promises of guaranteed returns and missing or fake executive teams in 271 out of the 1,450 ICOs in the sample.¹⁶

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ENDNOTES

- ¹ CFTC, *Advisory with Respect to Virtual Currency Derivative Product Listings*, CFTC Staff Advisory No. 18-14 (May 21, 2018), available at https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/2018-05/18-14_0.pdf.
- ² CFTC, *NASAA Sign Agreement for Greater Information Sharing Between Federal Commodities Regulator and State Securities Regulators*, CFTC and NASAA joint press release, CFTC release No. 7730-18, available at <https://www.cftc.gov/PressRoom/PressReleases/7730-18>.
- ³ See *In the Matter of: Coinflip, Inc.*, CFTC Docket No. 15-29, 2015 WL 5535736 (Sept. 17, 2015) (“Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities”).
- ⁴ *CFTC v. McDonnell, et al.*, No. 1:18-cv-00361 (E.D.N.Y. Mar. 6, 2018) (“[Virtual Currencies] fall well within the common definition of “commodity” as well as the CEA’s definition of “commodities” . . .”).
- ⁵ *Retail Commodity Transactions Involving Virtual Currency*, 82 Fed. Reg. 60335 (Dec. 20, 2017), available at <http://www.cftc.gov/idc/groups/public/@Irfederalregister/documents/file/2017-27421a.pdf>.
- ⁶ Robinson, Matt, *U.S. Launches Criminal Probe into Bitcoin Price Manipulation*, Bloomberg (May 24, 2018) available at https://www.bloomberg.com/news/articles/2018-05-24/bitcoin-manipulation-is-said-to-be-focus-of-u-s-criminal-probe?utm_content=crypto&utm_campaign=socialflow-organic&utm_source=twitter&utm_medium=social.
- ⁷ See 17 CFR § 40.2 and *CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets* (Jan. 4, 2018), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.
- ⁸ See 17 CFR § 15.03(b).
- ⁹ *CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets* (Jan. 4, 2018), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf; see also our memo to clients *CFTC Issues New Guidance Relating to Virtual Currency Regulations*, January 31, 2018, available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_CFTC_Issues_New_Guidance_Relating_to_Virtual_Currency_Regulations.pdf.
- ¹⁰ 7 U.S.C. §13a-2.
- ¹¹ The Joint Release.
- ¹² *Id.*
- ¹³ NASAA, *State and Provincial Securities Regulators Conduct Coordinated International Crypto Crackdown* (May 21, 2018), available at <http://www.nasaa.org/45121/state-and-provincial-securities-regulators-conduct-coordinated-international-crypto-crackdown-2/>.
- ¹⁴ *Id.*
- ¹⁵ The phony website created by the SEC and corresponding “HoweyCoin” White Paper, available at <https://www.howeycoins.com/index.html>.
- ¹⁶ Coulter Jones and Shane Shifflett, *Buyer Beware: Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud*, The Wall Street Journal (May 17, 2018), available at <https://www.wsj.com/articles/buyer-beware-hundreds-of-bitcoin-wannabes-show-hallmarks-of-fraud-1526573115>.

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