U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5003
Facsimile: (202) 418-5530

Office of
Public Affairs

CFTC Backgrounder on Self-Certified Contracts for Bitcoin Products

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 following fact sheet outlines the self-certification process of the Commodity Futures Trading Commission (CFTC), as well as the CFTC's role in oversight of virtual currencies.

Self-Certification Background

Prior to listing new contracts, the Commodity Exchange Act (CEA) provides designated contract markets (DCMs) with the option to either:

- submit a written self-certification to the CFTC that the contract complies with the CEA and CFTC regulations, or
- voluntarily submit the contract for Commission approval.

When a DCM self-certifies a new contract it must determine that the offering complies with the CEA and Commission regulations, including that the new contract is not readily susceptible to manipulation. This is the same standard the Commission uses when reviewing products for approval. A complete list of the DCM core principles is included at the end of this document. DCMs must provide an explanation and analysis to this effect. Unless the Commission finds that a new product would violate the CEA or Commission regulations, the DCM may list the new product no sooner than one full business day following the self-certification.

- As a matter of practice, exchanges bring the vast majority of new products to market through this self-certification process. Even though this process provides for a one-business-day listing period, CME, CFE and Cantor provided Commission staff with advanced draft contract terms and conditions for their bitcoin contracts. Commission staff reviewed this information, engaged in many discussions with the DCMs and the derivatives clearing organizations (DCOs) that will be clearing the contracts for CME and CFE, and evaluated whether any aspects of the contracts raise questions regarding compliance with the CEA and Commission regulations.

- Staff has assessed potential risk of defaults in these futures contracts on the DCOs. Based on analysis of different stress scenarios, staff estimates that any potential impact will not be significant to a DCO. CFTC staff will continue to monitor potential risk factors closely and work with the DCOs to ensure that the health of the clearing system is maintained.

- Given the current statutory and regulatory framework, the Commission has limited ability to require the DCMs to make changes to their contracts or to require the DCOs to change their approaches to clearing the contracts. For example, the Commission does not have the authority to require the DCOs to establish separate clearing systems or guaranty funds to clear these contracts. Those decisions are left to individual DCOs acting through established risk governance mechanisms and in compliance with the CEA and Commission regulations. But based on feedback received from a number of market participants, Commission staff did not find widespread support for these contracts to be cleared in a separate guaranty fund.

- CME, in its capacity as a DCO, plans to clear its own contracts, while CFE plans to clear its contracts at another DCO, the Options Clearing Corporation (OCC). Both DCOs provided Commission staff with information about how they intend to manage risks associated with bitcoin futures. Commission staff reviewed this information, including examining how the DCOs will satisfy their obligation to establish initial margin requirements that are commensurate with the risks of the contracts. Cantor plans to clear its contracts at Cantor Clearinghouse. Unlike the CME and CBOE, Cantor's contracts will be fully margined and thus do not raise the same type of risk issues.

CFTC Background

- The CFTC was established as an independent agency in 1974 by the CEA, assuming responsibilities that had previously belonged to the Department of Agriculture since the 1920s, namely, protecting against fraud, manipulation, and abusive practices related to the commodity futures markets. These markets have existed since the 1860s, beginning with agricultural commodities such as wheat, corn, and cotton.
- Ensuring that CFTC-regulated markets are resilient and reliable allows for market risk to be appropriately managed by American businesses, resulting in stable pricing for everything from groceries to energy services and home mortgage rates.
- The mission of the CFTC is to foster open, transparent, competitive, and financially sound markets. By working to avoid systemic risk, the Commission aims to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the CEA.
- To foster the public interest and fulfill its mission, the CFTC will act:
    - To deter and prevent price manipulation or any other disruptions to market integrity;
    - To ensure the financial integrity of all transactions subject to the CEA and the avoidance of systemic risk;
    - To protect all market participants from fraudulent or other abusive sales practices and misuse of customer assets; and
    - To promote responsible innovation and fair competition among boards of trade, other markets, and market participants.
- The CFTC believes responsible innovation is market-enhancing.

Virtual Currency Background

Although precise definitions on virtual currency offered by others are varied, an IRS definition provides us with a general idea:

- "Virtual currency is a digital representation of value that functions as a **medium of exchange, a unit of account, and/or a store of value**.
- In some environments, it operates like 'real' currency . . . but it **does not have legal tender status** [in the U.S.].
- Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as 'convertible' virtual currency. **Bitcoin is one example of a convertible virtual currency.**
- Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies."

The definition of "commodity" in the CEA is broad.

- It can mean a physical commodity, such as an agricultural product (e.g., wheat, cotton) or natural resource (e.g., gold, oil).
- It can mean a currency or interest rate.
- The CEA definition of "commodity" also includes "all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in."

The CFTC first found that Bitcoin and other virtual currencies are properly defined as commodities in 2015.

- The CFTC has oversight over futures, options, and swaps.
- The CFTC's jurisdiction is implicated when a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.

Beyond instances of fraud or manipulation, the CFTC generally does not oversee "spot" or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing.

> **For more information on virtual currencies, please see the CFTC Primer on Virtual Currencies issued by LabCFTC, the Commission's FinTech initiative, in October 2017.*

Futures Background

A commodity futures contract is an agreement to buy or sell a particular commodity at a future date. The price and the amount of the commodity are fixed at the time of the agreement. Some contracts contemplate that the agreement will be fulfilled by actual delivery of the commodity at a future date, while other contracts allow cash settlement in lieu of delivery. Most contracts are liquidated before the delivery date. A commodity futures option gives the purchaser the right to buy or sell a particular futures contract at a future date for a particular price. With limited exceptions, commodity futures and options must be traded through an exchange by persons and firms who are registered with the CFTC.

Many participants in the futures markets are commercial or institutional commodities producers or consumers. These participants trade futures to maximize the value of their assets, and to reduce the risk of financial losses from price changes. Other participants in the futures markets are speculators or liquidity providers who provide necessary liquidity to the futures markets so commercial participants can hedge their risks.

Companies and individuals who handle customer funds or give trading advice must register with the National Futures Association (NFA), a self-regulatory organization approved by the CFTC.

The CFTC seeks to protect customers by requiring:

- market risks and past performance to be disclosed to prospective customers;
- customer funds to be kept in accounts separate from the firm's own funds; and
- customer accounts to be adjusted to reflect each trading day's current market value at close

The CFTC also monitors registrant supervision systems, internal controls and sales practice compliance programs. The NFA provides detailed information for traders.

Key CFTC Terms

Designated Contract Market (DCM) – an exchange that may list for trading futures or option contracts based on all types of commodities and that may allow access to their facilities by all types of traders, including retail customers. Some DCMs have been operating for many years as traditional futures exchanges, while others are new markets that were only recently designated as contract markets by the CFTC. CFTC staff perform regular reviews of each DCM's ongoing compliance with the required core principles called Rule Enforcement Reviews.

Derivatives Clearing Organization (DCO) - an entity that enables each party to an agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the DCO for the credit of the parties; arranges or provides, on a multilateral basis, for the settlement or netting of obligations; or otherwise provides clearing services or arrangements that mutualize or transfer credit risk among participants. A DCO that seeks to provide clearing services with respect to futures contracts, options on futures contracts, or swaps must register with the CFTC before it can begin providing such services.

Futures Commission Merchant (FCM) - an intermediary that solicits or accepts orders for futures or options contracts traded on or subject to the rules of an exchange; and in or in connection with such solicitation or acceptance of orders, accepts money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result.

Introducing Broker (IB) - an intermediary that solicits or accepts orders for futures or options contracts traded on or subject to the rules of an exchange; and does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result.

DCM Core Principles

When a DCM self-certifies a new contract it must determine that the offering complies with the CEA and Commission regulations outlined in the core principles of the CEA. These principles are as follows:

§38.100 Core Principle 1.

(a) *In general.* To be designated, and maintain a designation, as a contract market, a board of trade shall comply with:

(1) Any core principle described in section 5(d) of the Act, and

(2) Any requirement that the Commission may impose by rule or regulation pursuant to section 8a(5) of the Act.

(b) *Reasonable discretion of the contract market.* Unless otherwise determined by the Commission by rule or regulation, a board of trade described in paragraph (a) of this section shall have reasonable discretion in establishing the manner in which the board of trade complies with the core principles described in this subsection.

§38.150 Core Principle 2.

(a) *In general.* The board of trade shall establish, monitor, and enforce compliance with the rules of the contract market, including:

(1) Access requirements;

(2) The terms and conditions of any contracts to be traded on the contract market; and

(3) Rules prohibiting abusive trade practices on the contract market.

(b) *Capacity of contract market.* The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market.

(c) *Requirement of rules.* The rules of the contract market shall provide the board of trade with the ability and authority to obtain any necessary information to perform any function described in this section, including the capacity to carry out such international information-sharing agreements, as the Commission may require.

§38.200 Core Principle 3.

The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.

§38.250 Core Principle 4.

The board of trade shall have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures, including:

(a) Methods for conducting real-time monitoring of trading; and

(b) Comprehensive and accurate trade reconstructions.

§38.300 Core Principle 5.

To reduce the potential threat of market manipulation or congestion (especially during trading in the delivery month), the board of trade shall adopt for each contract of the board of trade, as is necessary and appropriate, position limitations or position accountability for speculators. For any contract that is subject to a position limitation established by the Commission, pursuant to section 4a(a), the board of trade shall set the position limitation of the board of trade at a level not higher than the position limitation established by the Commission.

§38.350 Core Principle 6.

The board of trade, in consultation or cooperation with the Commission, shall adopt rules to provide for the exercise of emergency authority, as is necessary and appropriate, including the authority:

(a) To liquidate or transfer open positions in any contract;

(b) To suspend or curtail trading in any contract; and

(c) To require market participants in any contract to meet special margin requirements.

§38.400 Core Principle 7.

The board of trade shall make available to market authorities, market participants, and the public accurate information concerning:

(a) The terms and conditions of the contracts of the contract market; and (b)(1) The rules, regulations and mechanisms for executing transactions on or through the facilities of the contract market, and

(2) The rules and specifications describing the operation of the contract market's:

(i) Electronic matching platform, or

(ii) Trade execution facility.

§38.450 Core Principle 8.

The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

§38.500 Core Principle 9.

The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade. The rules of the board of trade may authorize, for bona fide business purposes:

(a) Transfer trades or office trades;

(b) An exchange of:

(1) Futures in connection with a cash commodity transaction;

(2) Futures for cash commodities; or

(3) Futures for swaps; or

(c) A futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.

§38.550 Core Principle 10.

The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information:

(a) To assist in the prevention of customer and market abuses; and

(b) To provide evidence of any violations of the rules of the contract market.

§38.600 Core Principle 11.

The board of trade shall establish and enforce:

(a) Rules and procedures for ensuring the financial integrity of transactions entered into on or through the facilities of the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization); and

(b) Rules to ensure:

(1) The financial integrity of any:

(i) Futures commission merchant, and

(ii) Introducing broker; and

(2) The protection of customer funds.

§38.650 Core Principle 12.

The board of trade shall establish and enforce rules:

(a) To protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and

(b) To promote fair and equitable trading on the contract market.

§38.700 Core Principle 13.

The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.

§38.750 Core Principle 14.

The board of trade shall establish and enforce rules regarding, and provide facilities for alternative dispute resolution as appropriate for, market participants and any market intermediaries.

§38.800 Core Principle 15.

The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other person with direct access to the facility (including any party affiliated with any person described in this paragraph).

§38.850 Core Principle 16.

The board of trade shall establish and enforce rules:

(a) To minimize conflicts of interest in the decision-making process of the contract market; and

(b) To establish a process for resolving conflicts of interest described in paragraph (a) of this section.

§38.900 Core Principle 17.

The governance arrangements of the board of trade shall be designed to permit consideration of the views of market participants.

§38.950 Core Principle 18.

The board of trade shall maintain records of all activities relating to the business of the contract market:

(a) In a form and manner that is acceptable to the Commission; and

(b) For a period of at least 5 years.

§38.1000 Core Principle 19.

Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall not:

(a) Adopt any rule or taking any action that results in any unreasonable restraint of trade; or

(b) Impose any material anticompetitive burden on trading on the contract market.

§38.1050 Core Principle 20.

Each designated contract market shall:

(a) Establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk, through the development of appropriate controls and procedures, and the development of automated systems, that are reliable, secure, and have adequate scalable capacity;

(b) Establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allow for the timely recovery and resumption of operations and the fulfillment of the responsibilities and obligations of the board of trade; and

(c) Periodically conduct tests to verify that backup resources are sufficient to ensure continued order processing and trade matching, transmission of matched orders to a designated clearing organization for clearing, price reporting, market surveillance, and maintenance of a comprehensive and accurate audit trail.

§38.1100 Core Principle 21.

(a) *In General.* The board of trade shall have adequate financial, operational, and managerial resources to discharge each responsibility of the board of trade.

(b) *Determination of adequacy.* The financial resources of the board of trade shall be considered to be adequate if the value of the financial resources exceeds the total amount that would enable the contract market to cover the operating costs of the contract market for a 1-year period, as calculated on a rolling basis.

§38.1150 Core Principle 22.

The board of trade, if a publicly traded company, shall endeavor to recruit individuals to serve on the board of directors and the other decision-making bodies (as determined by the Commission) of the board of trade from among, and to have the composition of the bodies reflect, a broad and culturally diverse pool of qualified candidates.

§38.1200 Core Principle 23.

The board of trade shall keep any such records relating to swaps defined in section 1a(47)(A)(v) of the Act open to inspection and examination by the Securities and Exchange Commission.