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# The CFTC's Approach to Fintech

Presented by

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# What do we mean by Fintech?

**Financial technology is an umbrella term used to describe a wide range of technologies and applications of those technologies**

- A few well-known examples and categories of Fintech:
  - **Regtech.** This is used to mean both technology used by regulators to enhance their ability to surveil and regulate markets and technology used by regulated firms to comply with applicable law. For example, big data and AI systems used by the regulators to conduct market surveillance, compliance reviews, and enforcement
  - **Trade execution, settlement, and reporting systems** – some using blockchain technology – to streamline transaction processes and (crossing over to regtech) regulatory reporting
  - **Paytech.** Digital payment systems, from mobile apps to large-scale infrastructure for financial institutions
  - And, of course, the broad range of **digital assets**, from cryptocurrencies to ICO tokens to utility tokens to asset tokens
- While many of areas of Fintech raise pressing legal and policy considerations, we will focus on two areas that have been of particular interest to the CFTC and other U.S. regulators

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# Agenda

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1. Virtual Currencies and Blockchain

2. Regtech

# Brief Primer on Virtual Currencies and Blockchain

## Blockchain (or distributed ledger) technology

- The key technological innovation underpinning bitcoin and similar digital assets
- Combines three key technological features:
  - Distributed ledger – the immutable public ledger recording all transactions (i.e., the blockchain)
  - Cryptographic settlement – a mathematically secure way to settle transactions on the network and to verify the “truth” of the ledger without the need for a central trusted third party
  - Consensus rules and incentives – a highly structured set of rules that govern how transactions are agreed upon and create incentives for users to participate, including in some cases the creation of new coin (i.e., the mining process)

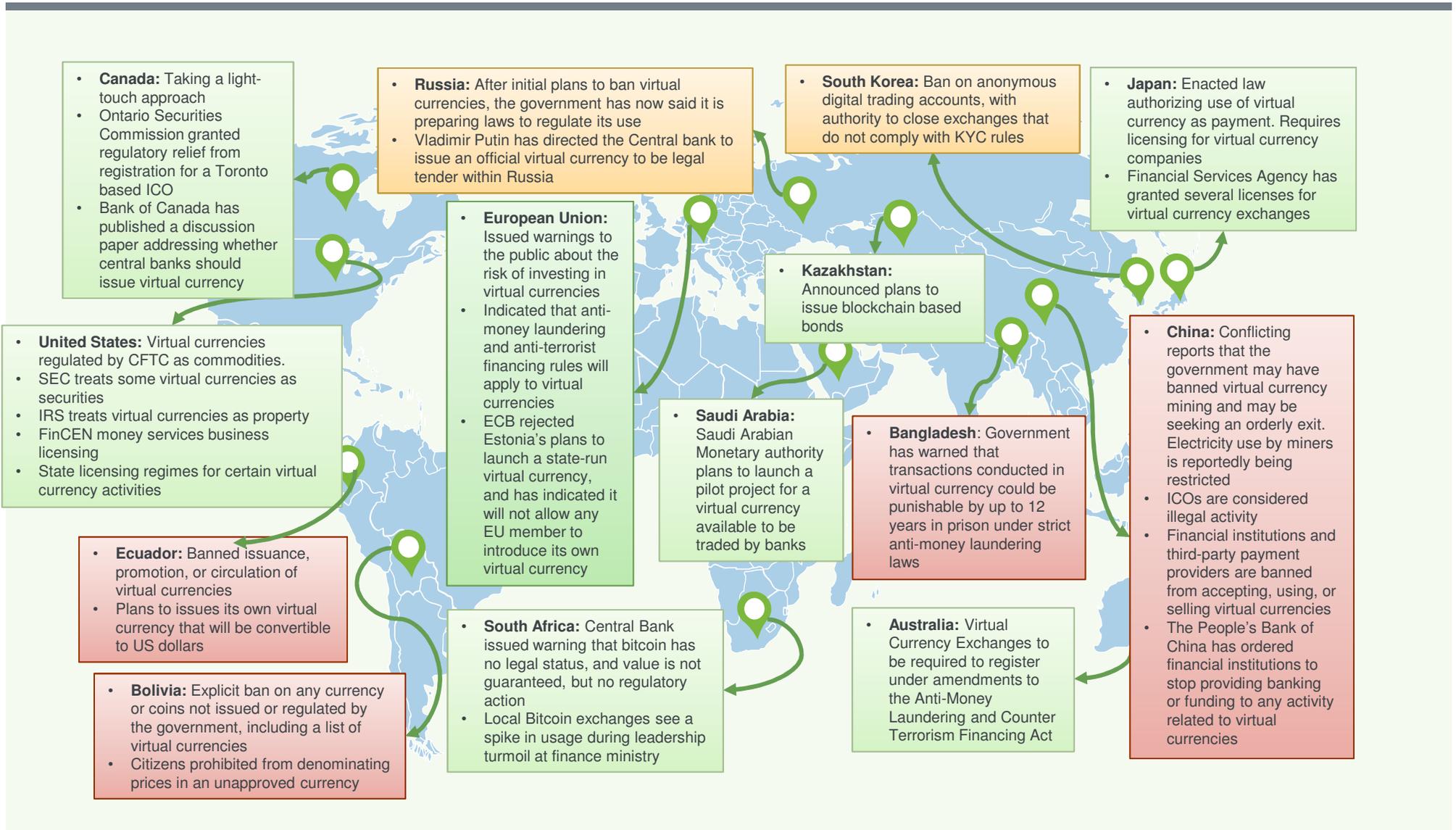
## Specific examples of blockchain technology in action

-  **Bitcoin.** The first use case. Proved the concept of blockchain technology as a medium of exchange for users to move value between one another, digitally and without a trusted third party
-  **Everledger.** An emerging use case. Designed to be a tamperproof record of title for valuable assets (e.g., diamonds) throughout the life of such assets

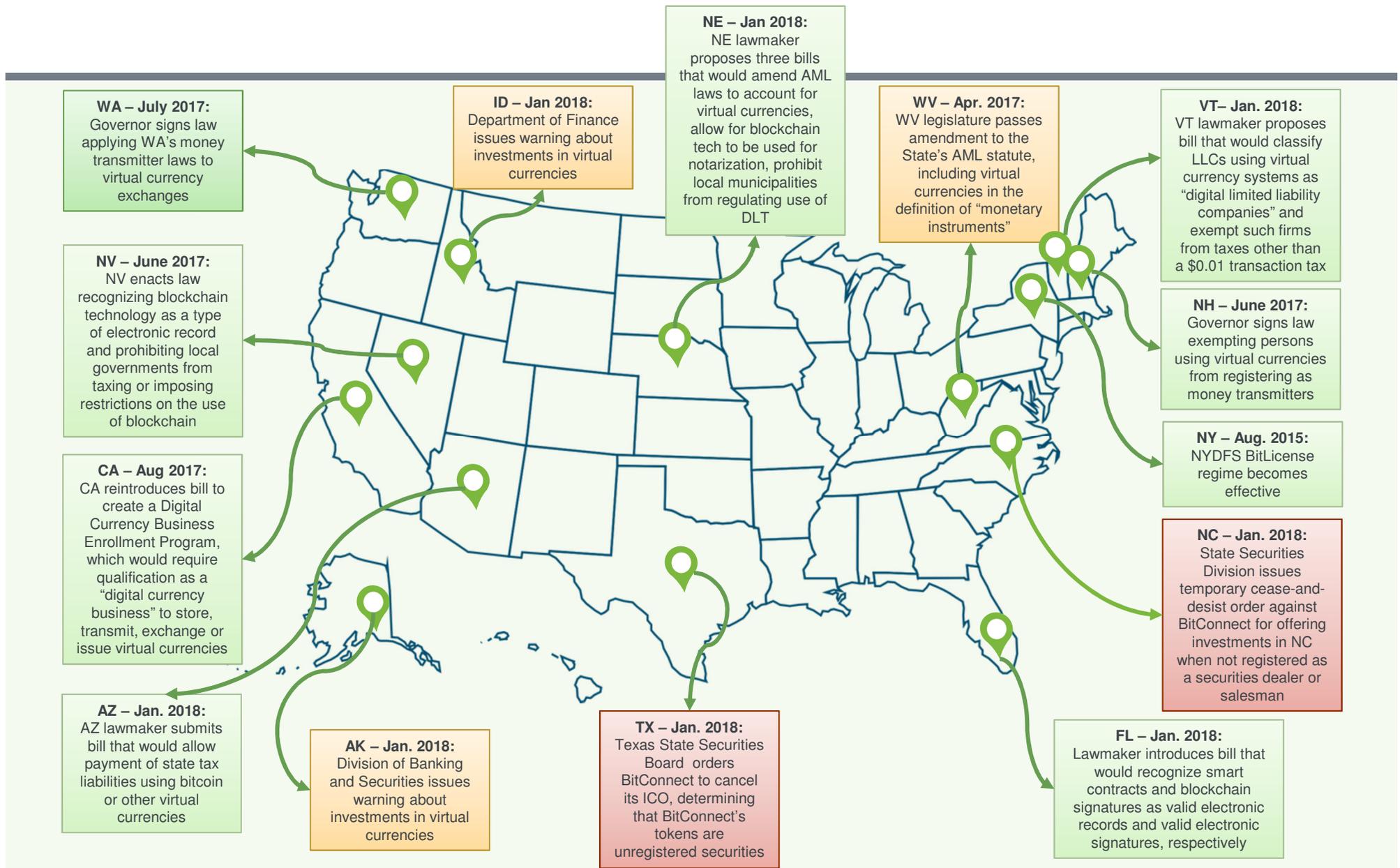
# But what *are* virtual currencies?

- Bitcoin was developed by Satoshi Nakamoto in 2008
  - “Satoshi Nakamoto” is a pseudonym for the creator (or perhaps the group of creators)
  - It is based on concepts that had been described in “cypherpunk” literature in the 1980s and 1990s
    - An emphasis on privacy and censorship resistance in digital communications is a core tenant of this ethos
    - These authors, for some time, had been seeking a way to replicate cash in the digital world
  - Bitcoin followed in that spirit, as a reaction, at least in part, to the financial crisis and a desire to develop a government-free, financial intermediary-free anarchist currency
- In the past few years, the number, type and flavor of virtual currencies and digital tokens have exploded (1,400+ listed on CoinMarketCap.com, an industry website)
  - Some virtual currencies, like bitcoin, are simply ledger entries that communities of users—now including investors and traders—have agreed have some value
  - Others are designed to power computer networks or to facilitate smart contracts transactions (e.g. ether on the Ethereum Network)
  - Others are designed to facilitate blockchain recordation and transactions in real assets—including, for example, real estate transactions
  - In many cases, these currencies or tokens are sold prior to the development of a working platform, in order to provide seed funding for the project

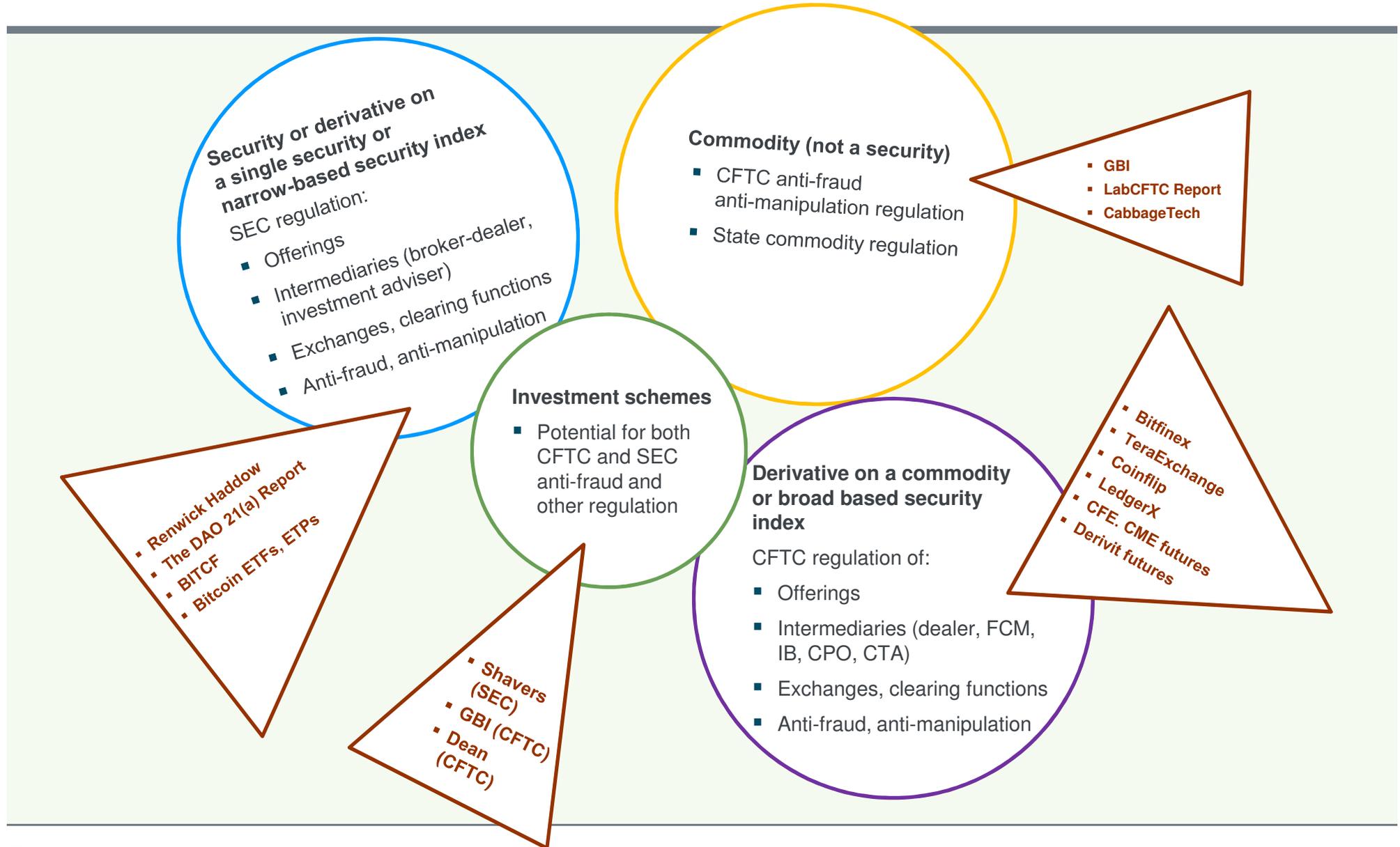
# International Response to Virtual Currencies



# U.S. State Response to Virtual Currencies



# The SEC-CFTC Jurisdictional Divide



# The CFTC's Approach to Virtual Currencies

- The CFTC has been very active in the regulation of virtual currencies
- The fundamental premise asserted by the CFTC: bitcoin and other similar virtual currencies are commodities under the Commodity Exchange Act
  - However, other types of virtual currencies, for example, many issued by companies in ICOs, may be securities
  - Virtual currencies invoke the SEC-CFTC jurisdictional divide between securities and commodities
- Key CFTC-related developments to date:
  - Bitcoin futures
  - Retail commodity transactions
  - Enforcement against fraud in virtual currency markets
  - LabCFTC

# Bitcoin Futures / Swaps

- In December 2017, the CME and Cboe Futures Exchange self-certified futures contracts on bitcoin. Cantor Exchange self-certified binary options on bitcoin
- In self-certifying these contracts, the exchanges were required under the CEA to find that the contract to be listed is not readily susceptible to manipulation. This finding is based, in part, upon accurate price information being available for the underlying bitcoin
  - Chairman Giancarlo recently described the “heightened review” process undertaken by the CFTC staff and the CME and CFE to design these contracts, including to set high margin requirements, and to apply enhanced surveillance measures to the contracts. The staff will also require, going forward, exchanges and clearinghouses to “disclose to the CFTC what steps they have taken . . . to gather and accommodate appropriate input from concerned parties” on contracts to be self-certified
  - In contrast, the SEC staff has declined to approve registration of bitcoin ETFs, based upon concerns that no regulated market exists for bitcoin
- The CFTC recently released a “backgrounder” on bitcoin futures, explaining the self-certification process and the benefits of bitcoin futures on the CFTC’s ability to regulate spot virtual currency markets
- LedgerX, a SEF and DCO, offers cleared bitcoin swaps. TeraExchange, a SEF, offers trading in bitcoin NDFs

# Retail Commodity Transactions

- The Commodity Exchange Act's retail commodity provisions—added to the CEA by the Dodd-Frank Act—broadly prohibit any leveraged, margined, or financed commodity transaction with a non-ECP, unless the transaction is conducted on a futures exchange as if they were futures transactions
- Some activities of virtual currency exchanges have run head-on into these retail commodity provisions
  - Virtual currency markets evolved as retail markets, with many exchanges not screening participant status as non-ECPs
  - Some virtual currency exchanges offer customers margin trading in virtual currency
- Transaction mechanics employed by some virtual currency exchanges—for example, the use of an off-blockchain omnibus ledger to record transactions—raise unique questions about what constitutes actual delivery of a virtual currency and the dividing lines between spot, retail commodity, and swap transactions under the CEA

# Retail Commodity Transactions

- Bitfinex enforcement: in June, 2016 the CFTC brought an enforcement action against Bitfinex, a virtual currency change finding that:
  - Bitfinex permitted users to borrow funds from other users on the platform in order to trade bitcoins on a leveraged, margined, or financed basis in violation of Section 2(c)(2)(D) of the CEA
  - Bitfinex did not actually deliver bitcoin to the traders who purchased them but instead held the bitcoins in deposit wallets that it owned and controlled; Bitfinex failed to register as an FCM in connection with holding customer funds
- In July 2016, Poloniex, another virtual currency exchange, filed a petition for rulemaking with the CFTC on actual delivery under the retail commodity transaction provisions
  - Poloniex argued that actual delivery should be satisfied where an exchange holds virtual currency in an omnibus account for which the exchange has the private key and designates customer funds through internal ledger entries
- In December 2017, the CFTC proposed interpretive guidance on actual delivery of virtual currencies under the retail commodity provisions
- The proposal reflects the same position the CFTC took in the Bitfinex order—actual delivery would not be satisfied for a virtual currency transaction unless:
  - the transaction is both reflected on the blockchain for that virtual currency (not only on a separate ledger maintained by a virtual currency exchange), and
  - the full amount of the currency is delivered to a virtual currency wallet under the full control of the intended recipient and with no control asserted by the offeror or seller

# Enforcement—Focus on Fraud

- To date, the CFTC has brought several enforcement actions against Ponzi scheme operators and others based upon garden-variety fraudulent conduct, though involving bitcoin and, in one case, litecoin
- Other regulators have also been increasingly active in bringing fraud related charges in the virtual currency area
  - SEC – Muchnee
  - Texas and North Carolina State regulators against Bitconnect, a virtual currency exchange (which recently announced that it is closing)

# LabCFTC

- In May 2017, the CFTC announced the creation of LabCFTC, an initiative designed to promote Fintech and Regtech development under the CFTC's regulatory purview
- LabCFTC is not a regulatory sandbox, but is meant to “provide greater regulatory certainty” to foster Fintech developments
- It also is meant to help the CFTC identify and utilize emerging technologies that the CFTC can use to carry out its functions
- LabCFTC has issued a primer on virtual currencies, which summarizes the treatment of virtual currencies under the CEA and the CFTC's approach to regulation of virtual currency activities

- As part of LabCFTC and more generally, the CFTC has begun to focus on the potential for technology to enhance the market surveillance and other capabilities of the CFTC
- Regtech areas commonly mentioned, both by regulators and the press, include:
  - Enhanced market surveillance through big data and AI tools developed by the private sector
  - Use of distributed ledger technology to lower costs, standardize, and streamline regulatory reporting (for example, swap data reporting)
  - Use of smart contracts to address regulatory requirement directly through contract code

# Questions?

