Bridging the Week by Gary DeWaal

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Between Bridges – July 27, 2018: National Futures Association Proposes Interpretive Notice Requiring FCM, IB, CTA and CPO Disclosures Regarding Virtual Currency Activity

Between Bridges Bitcoin Ecosystem

Published Date: July 26, 2018

National Futures Association Proposes Interpretive Notice Requiring FCM, IB, CTA and CPO Disclosures Regarding Virtual Currency Activity

The National Futures Association has proposed to adopt an Interpretive Notice that would require futures commission merchants, introducing brokers, commodity trading advisors and commodity pool operators to affirmatively make certain disclosures to customers, counterparties or investors that engage or may engage in activities related to spot virtual currencies or derivatives based on virtual currencies with or through them.

NFA proposes very different disclosure obligations for FCMs and IBs as compared to CTAs and CPOs, and, generally, NFA proposes different requirements in connection with activities related to spot virtual currencies as opposed to virtual currency derivatives.

FCMs and IBs

Under NFA's proposed requirements, FCMs and IB members must provide to all customers that engage in a virtual currency derivatives transaction with or through them a copy of or access to two CFTC and NFA guidances:

- the December 1, 2017 NFA Investor Advisory entitled "Futures on Virtual Currencies Including Bitcoin" (click here to access), and
- the Commodity Futures Trading Commission's Customer Advisory named "Understand the Risks of Virtual Currency Trading" (click here to access).

In the case of an introduced account, either the FCM or the IB must provide these publications, but not both.

For new customers, the publications must be provided at or before the time a customer first engages in a virtual currency derivatives transaction. For existing customers, the publications must be provided within 30 days of the date of NFA's Interpretive Notice.

Additionally, FCMs and IB members engaging in transactions involving spot virtual currencies with customers or counterparties must also provide to such persons a standardized disclosure using certain precise words provided by NFA. This language makes clear, among other items, that the self-regulator does not exercise authority over spot virtual currencies or virtual currency exchanges, custodians or markets. The mandatory wording must also be provided to any customer or counterparty at or before its first virtual currency transaction and be included in any relevant

promotional material.

For eligible contract participants, both the publications and the mandatory disclosure language may be provided through an FCM's or IB's website. However, for retail clients (presumably, non-ECPs), the publications and mandatory disclosure language must be provided in writing or electronically in a "prominent manner designed to ensure a customer is aware of them." NFA held out that FCMs and IBs could augment their existing customer risk disclosure booklet or use email, as ways that such communication could occur.

CTAs and CPOs

NFA will require separate disclosures for CPOs and CTAs dealing with spot virtual currencies and derivatives based on spot virtual currencies. Generally, NFA cautioned CTAs and CPOs to carefully evaluate the risks associated with such activities and tailor their disclosure documents, offering documents and promotional material to address these risks.

Similarly, as with FCMs and IBs, there is certain mandatory language that must be prominently displayed in all disclosure documents, offering documents and promotional material where the pool, exempt pool or managed program engages in spot transactions involving virtual currencies. Among other provisions, the mandatory language requires disclosure that an investor should be aware that, "given certain material characteristics of [virtual currencies], including lack of a centralized pricing source and the opaque nature of the virtual currency market, there currently is no sound or acceptable practice for NFA to adequately verify the ownership and control of a virtual currency or the valuation attributed to a virtual currency" by the CTA or CPO.

Additionally, NFA will require CTAs and CPOs engaging in spot virtual currency transactions in a pool or managed account program to address each of the following topics in their disclosure documents, offering documents and promotional material related to virtual currencies "if applicable to their activities", but will not mandate the precise language of the disclosure:

- unique features of virtual currencies (e.g., virtual currencies are not legal tender and may have no intrinsic value);
- price volatility (e.g., virtual currencies may experience extreme price volatility);
- valuation and liquidity (e.g., the lack of a centralized pricing source poses valuation challenges);
- cybersecurity (e.g., the "hacking vulnerabilities" of virtual currencies and related wallets or spot exchanges pose risks);
- opaque spot market (e.g., transactions on decentralized markets are pseudonymous);
- virtual currency exchanges, intermediaries and custodians (e.g., such entities are largely unregulated in the US and foreign markets);
- regulatory landscape (e.g., the regulatory landscape is rapidly evolving and changes in laws may have an impact on virtual currency networks and users);
- technology (e.g., the new technology associated with virtual currencies and the possibility of forks may impact market participants); and
- transaction fees (e.g., blockchains may require fees to record transactions).

NFA does not propose to mandate any specific language for CTAs and CPOs engaging in derivatives transactions involving virtual currencies in a pool, exempt pool or managed account program.

However, NFA requires that "unique features" of such transactions must be addressed in their disclosure documents, offering documents and promotional material related to their virtual currency derivatives activity. These include that virtual currency transactions may sustain significant price volatility and that margin requirements may be set as a percentage of the value of a particular contract (e.g., that initial margin requirements will increase for long positions as market prices rise).

If a CTA or CPO engages in spot virtual currency transactions or derivatives involving virtual currencies with a customer other than as expressly provided for in the Interpretive Notice, it must also provide certain precise disclosure language. The mandatory language provides, among other things, that NFA has no regulatory oversight authority over such activity. This language must be provided at or before the time a CPO or CTA commences any underlying spot or virtual currency activity with the customer or counterparty and must also be prominently set forth in any promotional literature related to virtual currencies.

Miscellaneous

Designated by the CFTC as a registered futures association, NFA is the principal industry-wide self-regulatory organization for the United States derivatives industry.

The proposed Interpretive Notice was provided to the CFTC by NFA under the Commission's self-certification regime for registered futures associations. (Click here to access Section 17(j) of the Commodity Exchange Act, 7 U.S.C. §21(j).) Unless the CFTC objects, NFA expects to make its Interpretive Notice effective 10 days after its CFTC submission, potentially as soon as by July 30.

Click here to access a copy of the Interpretive Notice.

> **Compliance Weeds**: NFA's proposed disclosure requirements for CTAs and CPOs, in particular, are quite extensive and must be carefully reviewed and implemented by persons engaging in either spot or derivatives on virtual currencies activities. Because precise disclosure language is generally not mandated, CTAs and CPOs must carefully consider the risks of such activities and make appropriate disclosures.
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> Generally, FCMs and IBs considering to engage in spot virtual currency transactions should consider whether state money transmitter and other requirements might apply to such activities. For example, although the Financial Enforcement Crimes Enforcement Network of the US Department of Treasury has an exception from money service business licensing for persons regulated or examined by the Securities and Exchange Commission or the CFTC, the exception is limited to circumstances where the CFTC or SEC "functionally" regulates such entities (Click here to access 31 C.F.R 1010.100 (ff)(8); click here to also access FinCEN Guidance 2008-G008.) Although some states have similar exemptions from their money transmitter requirements for registered FCMs "to the extent of its operation as such a merchant," it appears possible that a regulator could take a view that, if NFA states that virtual currency activity is not part of an FCM's regulated activity, then such activity is not part of an FCM's operation as an FCM. (Click here, e.g., to access Alabama Code 1975 §8-7A-3(5).)
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> Additionally, to the extent that an FCM, IB, CTA or CPO engages in transactions with digital tokens that the Securities and Exchange Commission may regard as securities, other regulatory obligations may exist. (Click here for background on the SEC's views regarding digital tokens

that may be securities.)

A few weeks ago, the Financial Industry Regulatory Authority asked all member firms to voluntarily notify it in writing if they, any of their associated persons, or any of their affiliates currently engage or intend to engage in any activities related to digital assets, including cryptocurrencies and other virtual coins or tokens, even if such assets are not securities. FINRA encouraged all member firms to provide such information "promptly" and to update their Regulatory Coordinator through July 31, 2019, if they, their APs or their affiliates begin or intend to begin engaging in any new activity related to digital assets that was not previously disclosed. (Click here for background in the article, "FINRA Asks Members to Volunteer Information Regarding Crypto-Asset Activity" in the July 15, 2018 edition of *Bridging the Week*.)

The next regular edition of *Bridging the Week* will be August 6, 2018.

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