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Preparing For The New NFA Cryptocurrency Requirements

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The Oct. 31 effective date is fast approaching for the National Futures Association disclosure requirements regarding virtual currency. Since the virtual currency market remains largely unregulated and opaque, the NFA has responded by adopting an interpretive notice that establishes disclosure requirements for futures commission merchants (FCM), introducing brokers (IB), commodity pool operators (CPO) and commodity trading advisers (CTA) that engage in virtual currency activities. While the NFA elected not to define virtual currency, the NFA stated in in a webinar hosted on Oct. 11 that the intent is for the term to broadly cover all kinds of digital assets and cryptocurrencies.

The NFA states that its recent adoption of the interpretative notice was due to "concerns that customers may not fully understand the nature of virtual currencies and virtual currency derivatives, the substantial risk of loss that may arise from trading these products and the limitations of NFA's regulatory authority over spot market virtual currencies."[1]

Overall, the new virtual currency disclosure requirements are an attempt to make it clear that virtual currencies remain an investor-beware market. While the NFA does require each CPO and CTA to immediately notify the NFA if it executes a transaction involving any virtual currency or virtual currency derivative on behalf of a pool or managed account and requires such firms to provide some level of reporting on those activities, the NFA lacks significant regulatory oversight authority over the virtual currency space. Although the virtual currency bitcoin has become a household name, and the anticipated U.S. Securities and Exchange Commission approval of a bitcoin exchange-traded fund would allow virtual currency investing to become even more mainstream, the NFA is sending a warning that substantial risks remain. By promulgating new disclosure requirements that emphasize the NFA's lack of regulatory oversight, the NFA may be signaling to past and future scorned investors that they best target their complaints elsewhere.

Since the interpretive notice goes into effect at the end of the month, it is important for NFA members to understand which disclosures are explicitly prescribed, and not merely suggested, in order to adequately prepare.

Prescribed Disclosures for FCMs and IBs

Starting Oct. 31, FCM and IB members must, at or before the time their customers trade a virtual currency derivative, provide two advisories: (1) the NFA Investor Advisory — Futures on Virtual Currencies Including Bitcoin, and (2) the CFTC Customer Advisory: Understand the Risks of Virtual Currency Trading. By Nov. 30, 2018, FCMs and IBs must also provide these two advisories to any existing customers that have traded a virtual currency derivative prior to the effective date.

In addition, FCMs and IBs engaging in any type of spot market virtual currency activity must provide standardized disclosure language to customers and counterparties, and also prominently display the disclosure language in any of their virtual currency-related promotional materials. The standardized disclosure explicitly states that the NFA does not have regulatory oversight authority over underlying or spot virtual currency products or transactions or virtual currency exchanges, custodians or markets.

For eligible contract participants, FCM and IB members may provide the advisories and disclosure language simply through their websites. Merely providing links to these advisories and disclosure language in a risk disclosure booklet or on the member's website is insufficient, however, for retail investors. Rather, members must provide the advisories and disclosure language in a prominently displayed manner. But what manner is sufficient? When asked to expand, the NFA explained that sending customers the disclosure language and links to the advisories via email, and clearly explaining what the links are, would suffice, provided that the communication is reasonably designed to achieve customer awareness.

By requiring conspicuous disclosures, even on social media platforms, the NFA wants investors to be put on notice that there is little to no recourse available in the event of virtual currency manipulation, cyberattacks and fraud. In the NFA-hosted webinar, the NFA explained that even when promoting virtual currency activities on Twitter, NFA members must tweet the standardized disclosure language, regardless of whether it takes multiple tweets due to Twitter's 280-character limit.

Prescribed Disclosures for CPOs and CTAs

CPOs and CTAs that engage in spot virtual currency transactions with customers or counterparties other than through a pool, exempt pool (under U.S. Commodity Futures Trading Commission Regulation 4.7) or managed account program must provide the same standardized disclosure required of FCMs and IBs. Like FCMs and IBs, these CPOs and CTAs must provide the prescribed disclosure to customers and counterparties, and prominently display it in promotional materials for any spot market virtual currency activities (other than as an investment in a pool or managed account program).

For those CPOs and CTAs that do engage in an underlying or spot virtual currency transaction in a pool (exempt or nonexempt) or managed account program, there is a separate prescribed disclosure, which is longer and more robust. The standardized disclosure advises that, although the CPO or CTA is a member of the NFA and therefore subject to the NFA's regulatory oversight, the NFA does not have "regulatory oversight authority over underlying spot virtual currency products or transactions or virtual currency exchanges, custodians or markets."[2] This disclosure must be prominently displayed in disclosure documents, offering documents and promotional materials related to the CPOs' and CTAs' virtual currency activities.

For all CPOs and CTAs, Oct. 31, 2018, is the effective date for promotional material disclosure requirements, while Nov. 21, 2018, is the effective date for updating disclosure documents and offering documents. Notably, CPOs and CTAs that are not exempt under CFTC Regulation 4.7 must also submit updated disclosure documents to the NFA by Nov. 21, 2018, and these documents cannot be used before the NFA reviews and accepts them.

Suggested Disclosures for Pool and Managed Account Programs

Spot Market Transactions

In addition to the mandatory disclosure language above, for CPOs and CTAs that advise on or trade in virtual currencies in the spot market for a pool (exempt or nonexempt) or managed account program, the NFA requires disclosure of the virtual currency risk factors applicable to their specific activities. The NFA does not, however, prescribe standardized risk factor language that must be included in their disclosure documents, offering documents and promotional material. Instead, the NFA provides general guidelines, and notes that these guidelines are not an exhaustive list of disclosure items. Depending on what activities CPOs and CTAs undertake on behalf of a pool or managed account, the NFA expects them to customize their disclosures to address applicable risks, including:

- *Unique Features of Virtual Currencies.* Virtual currencies are not legal tender in the U.S. and many continue to question whether they have any intrinsic value.

- *Price Volatility.* The price of a virtual currency is based on the perceived value of the virtual currency and subject to changes in sentiment, making these products extremely volatile. Certain virtual currencies have experienced daily price volatility of more than 20 percent.

- *Valuation and Liquidity.* The lack of a centralized pricing source poses a variety of valuation challenges. In addition, the dispersed liquidity may pose challenges for market participants trying to exit a position, particularly during periods of stress.

- *Cybersecurity.* Virtual currencies and related “wallets” or spot exchanges are subject to cybersecurity risks, including hacking, and the risk that publicly distributed ledgers may not be immutable.

- *Opaque Spot Market.* Unlike bank and brokerage accounts, virtual currency exchanges and custodians that hold virtual currencies do not always identify the owner. The opaque underlying or spot market presents asset verification challenges for market participants, regulators and auditors, and introduces an increased risk of manipulation and fraud, including the potential for Ponzi schemes, bucket shops, and pump-and-dump schemes.

- *Virtual Currency Exchanges, Intermediaries and Custodians.* The lack of regulatory oversight creates a risk that a virtual currency exchange may not hold sufficient virtual currencies and funds to satisfy its obligations and that such deficiency may not be easily identified or discovered. Moreover, many virtual currency exchanges have experienced significant outages, downtime and transaction processing delays and may have a higher level of operational risk than regulated futures or securities exchanges.

- *Regulatory Landscape.* Virtual currencies currently face an uncertain regulatory landscape. Although virtual currencies are not subject to federal regulatory oversight, the CFTC regulates many virtual currency derivatives, and the SEC has taken the position that it has authority over initial coin offerings, which may be subject to securities laws.

- *Technology.* The nascent and rapidly evolving technology underlying virtual currencies introduces substantial risks. Since a unique private key is required to access, use or transfer a virtual currency on a blockchain or distributed ledger. the loss, theft or destruction of a private key can result in an irreversible loss.

- *Transaction Fees.* A fee is generally necessary to ensure that a transaction is promptly recorded on a blockchain or distributed ledger, and the amounts of these fees are subject to market forces. Fees could increase substantially during a period of stress, and virtual currency exchanges, wallet providers and other custodians may charge high fees relative to custodians in many other financial markets.

Virtual Currency Derivative Transactions

Similarly, the NFA does not prescribe standardized disclosure language for CPOs and CTAs engaging in virtual currency derivative transactions in a pool (exempt or nonexempt) or managed account program. Instead, the NFA states that the risks associated with the unique features of engaging in virtual currency derivatives should be disclosed and that the potential impact these risks may have on the pool or managed account program should be explained. One example that the NFA provides is that virtual currency derivatives may experience significant price volatility, and since the initial margin for virtual currency derivatives may be set as a percentage of the value of a particular contract, margin requirements for long positions can increase if the price of the contract rises. Moreover, the rules of certain designated contract markets impose trading halts that may restrict a market participant’s ability to exit a position during a period of high volatility.

Looking Ahead

Unlike FCMs and IBs, for whom the NFA prescribes entirely standardized disclosure language, CPOs and CTAs have more flexibility, and therefore responsibility, to customize their disclosures. CTAs and CPOs, in particular, will want to take extra care in considering the risks applicable to their activities so that they may draft and implement appropriate disclosures. In addition to revising disclosure documents, offering documents and promotional materials to comply with the interpretive notice, companies that offer interests in virtual currency pools will want to work with their counsel to ensure the completeness and adequacy of their disclosures in order to protect themselves from potential liability under the federal securities laws.

The SEC has indicated that it holds largely the same views as the NFA regarding the risks of virtual currencies and need for enhanced disclosures. For example, in testimony before the Senate Banking Committee, SEC Chairman Jay Clayton stated, “My efforts — and the tireless efforts of the SEC staff — have been driven by various factors, but most significantly by the concern that too many Main Street investors do not understand all the material facts and risks involved. Unfortunately, it is clear that some have taken advantage of this lack of understanding and have sought to prey on investors' excitement about the quick rise in cryptocurrency and ICO prices.”[3] Accordingly, there has been a marked increase in SEC enforcement action and litigation within the virtual currency space. Notably, the SEC recently brought an action against an adviser to a fund organized to invest in virtual currencies that was not structured to rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.

Given the evolving nature of the virtual currency space, U.S. regulators will likely publish new guidance on virtual currencies before the end of the year, as major issues remain outstanding. For example, the

SEC is still considering whether and how to apply the traditional rules for custody, personal trading, and requirements for valuation to virtual currencies. Furthermore, the NFA has explicitly warned that “this Interpretive Notice may be supplemented in the future.”[4] Going forward, companies and their counsel will therefore want to be on alert for potential updates and additional virtual currency requirements to come.

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[1] https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5036

[2] https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9073

[3] https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission

[4] https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9073