Self-Certification:
Past, Present, and Future

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The Issue

- 2015, the CFTC classified Bitcoin as a commodity in an order against Coinflip Incorporated (d.b.a Derivabit).

- The CFTC has jurisdiction over futures and other derivatives involving commodities but the cash (spot) markets for these commodities do not fall under the jurisdiction of the CFTC.

- The CFTC does have fraud and manipulation enforcement jurisdiction over these markets and market participants

- Bottom line: Crypto exchanges are not regulated at the federal level

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Gap in Spot Market Regulation Creates Problems

- No registration or disclosure requirements
- No listing standards
- No best execution requirement
- No custody standards
- No business continuity standards or insolvency regime
- No prohibitions on churning, wash trading, spoofing
- No post-trade reporting or transparency
- No recordkeeping

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Proposals to Plug Gap in Spot Market Regulation

- Which agency should be responsible for oversight over crypto spot markets?
  - Crypto industry wants CFTC
  - Others (me) say SEC
  - Self-Regulatory Organization
  - New agency
- CFTC is the front runner

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The Digital Commodities Consumer Protection Act

- Defines “digital commodity”

- Introduces new categories of registration including “digital commodity broker,” “digital commodity custodian,” “digital commodity dealer,” “digital commodity trading facility” (collectively, “digital commodity platforms”)

- Requires the Commission to adopt customer protection rules, including requiring a digital commodity platform to disclose to customers material conflicts of interest and material risks of trading digital commodities;

- Permits a digital commodity platform registered with the Commission to also be registered with the Securities and Exchange Commission

- Preempts registration requirements under state law relating to money transmission, virtual currency, and commodity brokers.

- Requires that a digital commodity platform comply with all applicable core principles

- A digital commodity trading facility may self-certify a contract or rule

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Self-Certification Overview

- In keeping with the rationale behind self-regulation:
  - market actors, by virtue of having better information and knowledge of market events, are in a superior position to determine the appropriate level and scope of regulation.
- The 2000 Commodity Futures Modernization Act introduced the self-certification process
  - Liberalized the regulatory regime for futures and OTC derivatives
- Self-certification requires a designated contract market to verify that a new contract complies with CEA and CFTC regulations (Core Principles).
  - Provided the CFTC does not object to the findings of the self-certification, the exchange may list the new product one day after submitting the self-certification
  - DCMs could also voluntarily request the CFTC's pre-trading approval for their contracts
- On Friday, December 1, 2017, the Chicago Mercantile Exchange Inc. (CME) and the CBOE Futures Exchange (CFE) self-certified new contracts for cash-settled bitcoin futures products.

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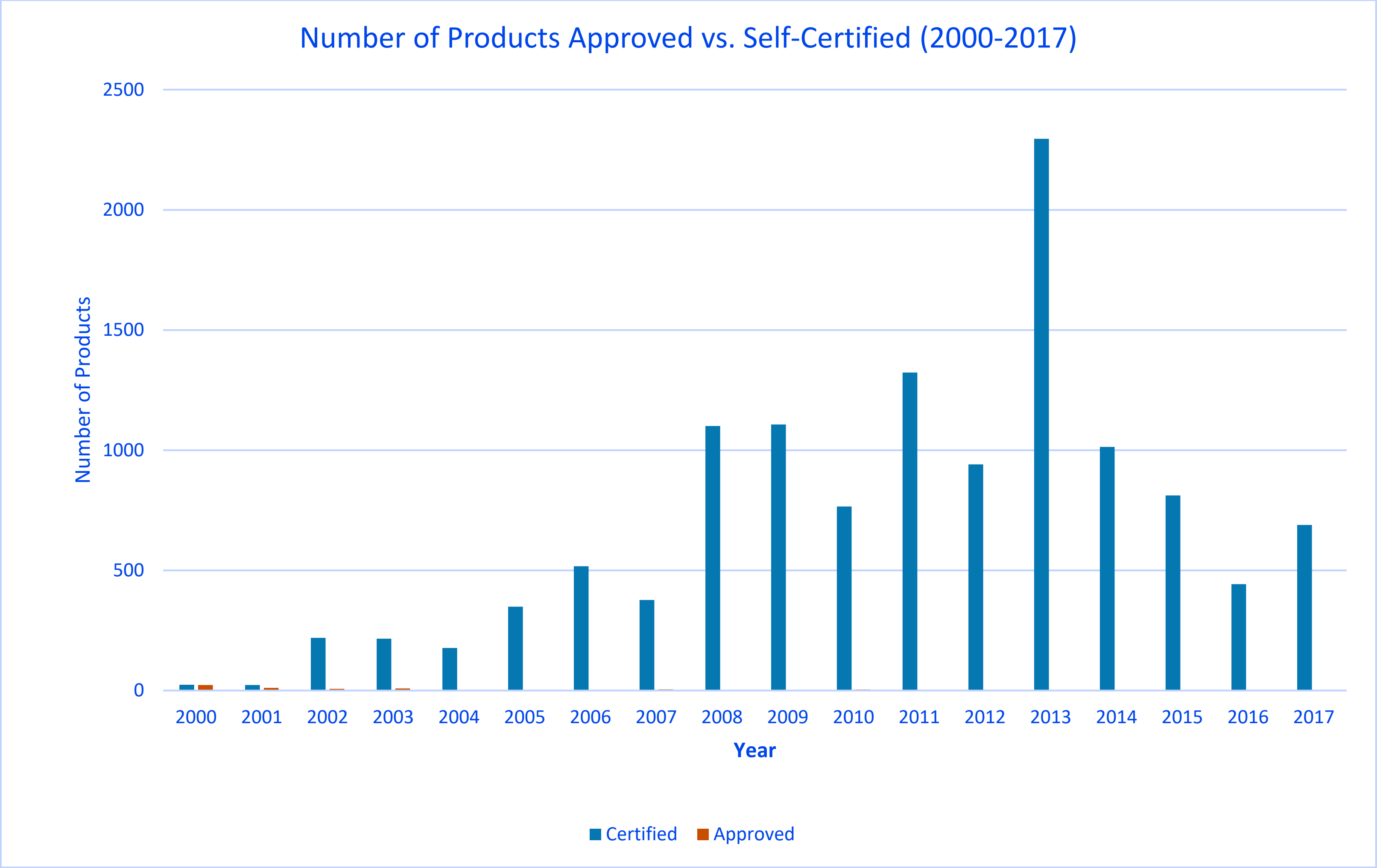
Self-Cert Quickly Became Exclusive Listing Mechanism



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2017 Self-Certification of BTC Futures

- Controversial at the time, less so today
- Dodd-Frank required all DCMs to comply with a total of 23 core principles as a condition of obtaining and maintaining designation as a contract market.
  - Each of the 23 core principles and the final implementing regulations, guidance and acceptable practices, apply to all "contracts'' listed on a DCM.
- Core Principle 3: CONTRACTS NOT READILY SUBJECT TO MANIPULATION – "The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation."
- Because of cash settlement, manipulation hinges on the contract's reference price
- But what is the price of Bitcoin?
  - Different prices on different exchanges
- CFE and CME chose different reference prices that utilize different methodologies
  - CFE chose Gemini Bitcoin Auction
  - CME created Bitcoin Reference Rate (BRR)

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Differences of Opinion

- Is it possible to construct a derivatives contract so it is not readily susceptible to manipulation when the underlying asset is easily, and frequently manipulated?

- Speaking at the January 2018 meeting of the CFTC's Market Risk Advisory Committee ("MRAC"), Amir Zaidi, director of the CFTC's Division of Market Oversight ("DMO"), stated:

> "it is not the responsibility of DCMs or the CFTC to oversee on a daily basis every cash commodity market or make suitability judgments about the underlying commodity market and whether a futures contract should be able to be listed on it. Rightly, we are not overseeing cash markets and participants on a daily basis for abusive practices and risks. Every cash market underlying futures contracts can be manipulated. Gold, silver, FX, bitcoin cash markets, they can all be manipulated. However, making detailed judgments about the level of manipulation, generally, in those cash markets, and if it is too little or too much to list a futures contract, is a different analysis from whether a futures contract is readily susceptible to manipulation."

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Bitcoin Futures: Myth vs. Reality

- CFTC and their supporters hold up BTC Futures as a resounding success
- Facts don’t support this
- Gemini complaint reveals self-certification’s flaws

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Gemini Complaint

- On June 2nd, CFTC filed a civil complaint against Gemini “for making false or misleading statements of material facts or omitting to state material facts to the CFTC in connection with the self-certification of a bitcoin futures product.”

- Gemini offered low interest, unsecured loans of “digital assets controlled by Gemini Principal-1 and Gemini Principal-2 from an entity they controlled” to certain market maker customers for the express purpose of increasing “trading on the Gemini Exchange and/or the Gemini Bitcoin Auction.”

- “For one auction in December 2016, approximately 70% of the total auction trading volume resulted from a single auction participant trading with itself.”

- Gemini entered into custom fee arrangement with select market participants “that were not available to all Gemini market participants and that were not disclosed to the public on Gemini’s website” for the express purpose of incentivizing participation in the Bitcoin auction.

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Self-Cert in the DCCPA

- ‘Digital Commodity Trading Facility’
  - “A trading facility that facilitates the execution or trading of digital commodity trades between persons”
  - They may “1) list for trading a contract for a digital commodity and 2) approve and implement a new rule or rule amendment”
- Prior to carrying out the above, DCTF shall “provide to the Commission a written certification that the contract, new rule, rule amendment…complies with this Act”
  - For a contract not previously listed on any DCTF, the listing will become effective 30 business days after CFTC receives certification
  - 10 days otherwise
  - Both periods can be shortened by rule or regulation
- CFTC can stay self-cert for no more than 90 days if:
  - It is a novel or complex issue
  - Inadequate explanation
  - Potential inconsistency with the Act
- CFTC can request public comment within the stay window

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Self-Cert in the DCCPA

- Core Principles still apply, including:
  - "A digital commodity trading facility shall permit trading only in transactions in digital commodities that are not readily susceptible to manipulation."

- When assessing a rule or listing, CFTC "may" consider:
  - "whether the operating structure and system of the digital commodity is secure from cybersecurity threats, including the possibility of material alterations by persons acting collectively;"
  - "whether the functionality of the digital commodity will protect holders from operational failures;"
  - Additional information around the issue and reserve for "a digital commodity that purports to have a fixed value"

- DCTF's can also request prior approval from the CFTC

- CFTC authorized to delist contracts

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Takeaways

- DCTF’s, like all asset exchanges, have economic incentives to list as many products/contracts as possible
- Expect they will may make full use of self-certification
- Self-cert may overwhelm CFTC resources; 90 days is not a lot of time
- CFTC does have discretion to halt new listings. Will they exercise it?
- Far more opportunities for manipulation in crypto than other asset classes
- Will the CFTC review, and understand, the code?
- Bottom line: I fear self-cert will be abused

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Alternatives

- Pre-approval only
- New York Department of Financial Services (DFS) issued new coin listing guidance in 2020
- A VC Entity that wishes to self-certify the use of new coins without the prior approval of DFS must create a coin-listing policy in accordance with a general framework
  - Include robust procedures that comprehensively address all steps involved in the review and approval of coins.
  - The policy must be tailored to the VC Entity's specific business model, operations, customers and counterparties, geographies of operations, and service providers; and to the use, purpose, and specific features of coins being considered.
- DFS also maintains a "Greenlist" of cryptocurrencies that any entity licensed by DFS to conduct virtual currency business activity in New York is free to list.
  - DFS will maintain a record of all coins approved for VC Entities, whether directly by DFS or through the self-certification process, including their approved use.
  - If a coin has received such approval for a specific use by three different and unrelated VC Entities DFS will prepare to add that coin for that specific use to the Greenlist.
- These policies provide for more rigorous review of new cryptocurrencies and exchanges' procedures for listing new cryptocurrencies than the self-certification process within the CEA.

Questions or Comments?

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