

CLIENT ALERT

# CFTC Guidance on Handling of Virtual Currency by Futures Commission Merchants Supports Further Maturation of Digital Asset Class

October 22, 2020

## AUTHORS

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On October 21, 2020, an operating division of the U.S. Commodity Futures Trading Commission issued guidance to futures commission merchants regarding how to hold virtual currency on deposit from customers that are trading certain futures and swaps. The Division of Swap Dealer and Intermediary Oversight issued Letter No. 20-34 in response to requests from the industry for guidance as to how the CFTC's existing regulations apply to a customer depositing virtual currencies with its FCM for purposes of margining trades in physical-delivery futures and cleared swaps.<sup>1</sup>

The guidance showcases the CFTC's continuing effort to lead on regulatory issues involving virtual currency, including understanding how the current financial regulatory framework applies to the novel issues presented by virtual currency. The guidance provides additional support for the maturation of virtual currency as an increasingly mainstream, tradable asset class.

### **The Existing Regulatory Framework and the Need for Guidance**

The Commodity Exchange Act and related CFTC regulations impose obligations on FCMs to segregate customer funds used to margin futures and swaps trading. In the event of a customer default, the FCM must cover the customer's default with the FCM's own capital. However, if an FCM becomes insolvent because it cannot cover a customer loss, the loss

<sup>1</sup> A copy of the CFTC press release, which includes a link to CFTC Letter No. 20-34 (Oct. 21, 2020) is available [here](#).

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## **CFTC Guidance on Handling of Virtual Currency by Futures Commission Merchants Supports Further Maturation of Digital Asset Class**

would be apportioned pro rata across the non-defaulting customers of the FCM based upon what is referred to as account “origin.”<sup>2</sup> In light of the shared risk between an FCM and its customers, the CFTC’s regulations require that an FCM have a risk management program that addresses, among other topics, the liquidity, marketability and mark-to-market valuation of all non-cash assets held as segregated funds.

According to the Division, guidance on how FCMs hold virtual currency on deposit from customers was necessary because virtual currency “present[s] a degree of custodian risk that is beyond what is currently present with depositories, such as banks and trust companies.”<sup>3</sup> In particular, the Division cited “numerous reports of incidents involving the loss or misappropriation of virtual currencies as a result of a custodian’s failure to effectively safeguard assets or digital keys, including incidents of the hacking of systems designed to hold virtual currencies and other forms of theft.”<sup>4</sup> With these concerns in mind, the guidance addresses the FCM segregation requirements under Sections 4d(a)(2) and 4d(f) of the Commodity Exchange Act, the Bankruptcy Code and related CFTC bankruptcy regulations in Part 190, and an FCM’s risk management program in CFTC Rule 1.11. Market participants and FCMs should be cognizant of the fact that the guidance does not address customer trading in foreign futures markets, or virtual currency assets an FCM may hold on its own behalf such as an FCM’s proprietary account.

### **Guidance to FCMs When Holding Virtual Currency as Customer Funds**

The Division provided the following guidance that FCMs must adhere to when holding virtual currency as customer funds.

1. Virtual currency held as customer funds by an FCM must be deposited only with a bank, trust company, or another FCM, or with a clearing organization that clears virtual currency futures (including options on futures) or cleared swap contracts (each such entity, a “Depository”).
2. An FCM must deposit virtual currency held as customer funds with a Depository under an account name that clearly identifies the funds as customer funds and shows that the funds are segregated as required by the Act and Commission regulations. An FCM also is required to obtain the appropriate written acknowledgment letter from each Depository holding customer funds.
3. Virtual currency must be available for withdrawal from a Depository upon the demand of an FCM, so that delivery pursuant to the terms of the contracts to which the virtual currency relates to will be made without delay.
4. In preparing its daily and month-end segregation statements, an FCM must report the customer’s virtual currencies at fair market value on Line 1.B. (“Net ledger balance – Securities (at market)”) and on Line 12

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<sup>2</sup> There are separate account origins for futures, foreign futures and cleared swap customers.

<sup>3</sup> CFTC Letter No. 20-34 at 3.

<sup>4</sup> *Id.*

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## CFTC Guidance on Handling of Virtual Currency by Futures Commission Merchants Supports Further Maturation of Digital Asset Class

(“Segregated funds on hand”) on Form 1-FR-FCM. The FCM must report the total fair market value of customer virtual currency held at a bank or custodian, derivatives clearing organization, or another FCM as supplemental information. The fair market value of the virtual currencies must be reported in U.S. dollars and must reflect the FCM’s reasoned judgment based on spot market or other appropriate market transactions.

5. An FCM, in computing its daily and month-end segregation requirement, may not offset a debit or deficit in a futures customer’s or cleared swaps customer’s account by the value of any virtual currency held in the respective customer’s account. Therefore, an FCM may be required to deposit its own funds into segregation to cover any debit or deficit.
6. An FCM may not deposit its own virtual currencies in futures customer or cleared swaps customer segregated accounts for any reason, including in order to meet targeted or residual interest requirements.
7. An FCM may not invest any segregated futures customer or segregated cleared swaps customer funds in virtual currency to be held on behalf of customers.

### **Guidance for FCM Risk Management Programs**

The Division issued the guidance below related to an FCM’s risk management program. FCMs that accept and hold customer virtual currency for trading related to futures and swaps should review this guidance carefully because the Division noted that it *“may determine to examine any FCM that accepts and holds customer virtual currency assets to determine how it is choosing to meet its obligations under Commission regulation 1.11. The Division may also instruct any FCM, at any time, to cease receipt of virtual currency from its customers until such time as any non-compliance with the Act and Commission regulations is addressed by the FCM.”*

8. An FCM should limit the acceptance of virtual currency into segregated and cleared swaps segregated accounts as follows:
  - a. The particular type of virtual currency (e.g., bitcoin or ether) relates solely to customer trading of futures (or options on such futures) or cleared swaps contracts that provide for the physical delivery of that virtual currency – provided that the virtual currency is intended to margin, guarantee, or secure such customer trading and has been formally determined to be an acceptable form of collateral for those contracts by the relevant designated clearing organization; and
  - b. The amount of virtual currency accepted reasonably relates to the customer’s level of trading in those contracts during each calendar quarter, with the reasonable relationship to be determined by the FCM and the determination to be documented in the books and records of the FCM pursuant to its risk management program policies and procedures.

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9. All virtual currency accepted by an FCM should not provide margin value to any contracts other than the contracts identified in item 8a above; provided, however, that an FCM would be entitled to use any virtual currency held in a customer's trading account to cover the customer's default resulting from losses on virtual currency or non-virtual currency futures or cleared swap transactions, as applicable.
10. An FCM that holds virtual currency for a customer should contact the customer and initiate a return of that virtual currency if the customer has ceased trading the contracts to which the virtual currency relates and thus there is no related open futures position, with the notice and return to be completed within a reasonable time frame that should not exceed 30 days after the customer has ceased trading for a period of 90 days (*i.e.*, the return to be effected within a total of 120 days from the cessation of trading).
11. Each withdrawal of virtual currency from a Depository upon demand by the FCM in order to liquidate customer accounts or return customer funds should be completed within a timeframe that is technologically and operationally possible, but should not exceed one day, unless the Depository's procedures specify additional time as part of its controls related to transfers of virtual currency.
12. Before accepting any virtual currency into segregation, an FCM should provide 45 days' prior written notice to all futures and cleared swaps customers that the FCM will begin accepting virtual currency as of a specified date. The prior written notice should be delivered to customers in the same manner as those customers have elected to receive other communications regarding their accounts with the FCM. An FCM should thereafter include the total amount of customer activity in virtual currency being supported by the deposit of actual virtual currency, by customer origin, as part of its disclosures required under Commission regulation 1.55.

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If you have any questions regarding this client alert, please contact one of the authors, any member of our CFTC team listed below, or the Willkie attorney with whom you regularly work.

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Willkie has a dedicated team of attorneys with extensive knowledge and experience in all aspects of the Commodity Exchange Act and the CFTC regulatory regime. We would be pleased to assist on your matters.

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