CFTC AND NFA ANNOUNCE CHANGES IN REGULATION REGARDING POSITION LIMITS AND VIRTUAL CURRENCY

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INTRODUCTION

The Commodity Futures Trading Commission ("CFTC"), the U.S. federal regulatory agency for futures and other derivatives, and the National Futures Association ("NFA"), the industry-wide self-regulatory organization, both recently announced changes to their regulatory frameworks. The CFTC is proposing to permit increased trading in security futures products ("SFP"), which will likely impact a discrete number of market participants under the CFTC's supervision. Separately, NFA has adopted a new Interpretive Notice effective October 31, 2018, entitled "Disclosure Requirements for NFA Members Engaging in Virtual Currency Activities" (the "Interpretive Notice"), which imposes additional disclosure requirements in the burgeoning area of virtual currency.

CFTC'S REGULATIONS GOVERNING SFP POSITION LIMIT AND POSITION ACCOUNTABILITY STANDARDS

On July 31, 2018, the CFTC published for public comment a proposal to update speculative position limit parameters for designated contract markets ("DCM") that list for trading SFPs, which are essentially futures whose underlying instrument is either a "narrow-based" security index (generally, an index of nine or fewer component stocks) or a single equity or debt security. Click here for the proposal. A position limit is a level that, if exceeded, subjects a trader to exchange disciplinary action. A position accountability level is a level that, when reached, requires a trader to provide information to the DCM and consent to halt increasing its position if so ordered by the DCM.

As SFPs are considered both a futures contract and a securities contract, they are regulated by both the U.S. Securities and Exchange Commission (the "SEC") and the CFTC. SFPs and security options serve economically equivalent or similar functions. When first adopted, the CFTC's SFP position limits were set at levels generally comparable to those applicable to options on individual securities. However, over time, position limits for SFPs remained essentially unchanged, while security options limits have been allowed to increase, putting SFPs at a competitive disadvantage. [1]

There are several differences in the position limit rules applicable to SFPs and security options, including: (1) position limits are set on a net basis for SFPs and a gross basis for security options; (2) differing numerical limits; (3) position limits for SFPs are applicable only during the last five trading days, whereas limits on security options are applicable throughout the lifespan of the contract; and (4) the volume test adopted by the CFTC for position

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limits on SFPs has been based on average daily trading volume over a six-month period, while the volume test for security options is based on total trading volume over the same time period. This has resulted in security option limits more than ten times greater than those for SFPs.

The CFTC is seeking to provide a level regulatory playing field for SFPs and security options. To achieve this goal, the CFTC's proposed amendments contain six key changes to the current CFTC regulatory regime:

1. Increases the default level of speculative position limits in SFPs to 25,000 (100-share) contracts net or gross from 13,500 (100-share) contracts net and introduces the criterion by which DCMs may set higher levels of speculative position limits based upon 12.5% of the estimated deliverable supply of the relevant underlying security if certain conditions are met.
2. Amends position accountability provisions such that a DCM could substitute position accountability for position limits when six-month total trading volume in the underlying security is in excess of 2.5 billion shares and there are more than 40 million shares of estimated deliverable supply and increases the maximum level under the position accountability regime to 25,000 (from the current 22,500) contracts.
3. Provides that position limits will apply for a longer period than five days if the terms of an SFP provide for delivery prior to the last five trading days.
4. Provides that the limits for physically-delivered basket (index) equity SFPs will be based upon the underlying security with the lowest estimated deliverable supply, rather than the lowest average daily trading volume. Limits for cash-settled equity index SFPs will be required during the last five trading days, but otherwise DCMs will have greater leeway in setting limits under CFTC guidance based more upon shares outstanding than on trading volume.
5. Provides DCMs the authority to approve exemptions to limits provided that those exemptions are consistent with CFTC Regulation 150.5.
6. Reduces the frequency that estimated deliverable supply and six-month total trading volume is required to be calculated to at least semi-annually, rather than monthly. Also, DCMs would be required to lower the position limit levels if the estimated deliverable supply warrants lower levels and to enact position limits if the six-month total trading volume or estimated deliverable supply ceases to support using position accountability provisions.

If adopted, these amendments would mark the first change in the CFTC position limit regulations applicable to SFPs in over 15 years. If adopted substantially as proposed, these amendments would permit greater liquidity in SFP trading, thereby facilitating risk management for entities using SFPs.

Comments on the proposal are due on October 1, 2018.

NFA'S INTERPRETIVE NOTICE ON DISCLOSURE REQUIREMENTS FOR VIRTUAL CURRENCY ACTIVITIES

In another example of heightened regulatory concern about virtual currency activities, on July 20, 2018, NFA submitted to the CFTC a new Interpretive Notice effective October 31, 2018, which can be found here. NFA is concerned that virtual currencies and virtual currency derivatives may attract customers that do not understand the substance and mechanics of such transactions, the substantial risk of loss from trading in them, and the

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limitations of NFA's role in oversight of these products. [2] Accordingly, the Interpretive Notice sets forth new disclosure requirements for NFA members that are Commodity Pool Operators (“CPO”), Commodity Trading Advisors (“CTA”), Futures Commission Merchants (“FCM”), or Introducing Brokers (“IB”) engaging in transactions involving virtual currency products.

CPOS AND CTAS REQUIREMENTS – ACTION REQUIRED

Under the Interpretive Notice, CPO and CTA members must consider the risks arising from their activities in virtual currencies and virtual currency derivatives and customize their disclosure documents, offering memoranda, advisory agreements, and promotional materials (collectively, the “Materials”) to address the risks of their specific activities.

The Interpretive Notice sets forth a nonexhaustive list of topics that every CPO or CTA member that operates a pool or managed account program trading in virtual currency transactions must address in their Materials: (1) the unique features of virtual currencies (not legal tender like fiat currency); (2) price volatility (some have exceeded 20% daily); (3) valuation and liquidity (no centralized pricing source and dispersed liquidity may make exit transactions difficult); (4) cybersecurity (despite claims made about the security of a blockchain, “wallets” or exchanges are hackable); (5) opaque spot market (controller and owner not identified); (6) virtual currency exchanges, intermediaries, and custodians (relatively new and unregulated globally); (7) regulatory landscape (uncertain throughout the world); (8) technology (rapidly evolving, and loss of private key may be irreversible); and (9) transaction fees (may be charged by miners and other ancillary parties). NFA requires robust disclosure regarding these topics and perhaps others but does not mandate prescribed language.

In addition, the Interpretive Notice requires that every CPO or CTA member that operates a pool or managed account program trading underlying or spot virtual currencies include in their Materials prescribed disclosures (1) addressing the limits of NFA's oversight, and (2) informing investors that, given certain characteristics of these products (e.g., lack of centralized pricing source and opaqueness of market), there currently is no sound or acceptable practice that NFA can use to verify the ownership and control of underlying or spot virtual currencies.

The Interpretive Notice also requires that CPO and CTA members engaging in virtual currency derivative transactions in a pool or managed account program address in their Materials certain unique risks of virtual currency derivatives. These include (1) significant price volatility, (2) the initial margin may be set as a percentage of the value of a particular contract, which means that margin requirements for long positions can increase if the price of the contract rises, (3) some FCMs may impose restrictions on customer trading activity in virtual currency derivatives, such as requiring additional margin, imposing position limits, prohibiting naked shorting or prohibiting give-in transactions, and (4) DCMs may impose trading halts that may restrict a market participant's ability to exit a position during a period of high volatility. CPOs and CTAs should also consider whether some of the issues discussed above regarding the underlying or spot market would also affect derivatives. The Interpretive Notice does not mandate prescribed language but states that the impact these risks may have on a pool's or managed account program's performance should be explained.

Further, the Interpretive Notice recognizes that a CPO or CTA member may also engage in underlying or spot virtual currency transactions with customers or counterparties other than through a commodity pool or managed account program, such as when the CPO or CTA is trading for its own account. Therefore, the Interpretive Notice also requires CPO or CTA members to provide to customers and counterparties a prescribed disclosure that

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specifies that NFA does not have regulatory oversight authority over underlying or spot virtual currency products, or transactions or virtual currency exchanges, custodians or markets, and to display the prescribed disclosure in any promotional materials for any underlying or spot market virtual currency activities, other than as an investment in a pool or managed account program.

Failure to follow the disclosure guidelines in the Interpretive Notice may be deemed conduct inconsistent with a member's obligations under NFA Compliance Rule 2-4 to observe high standards of commercial honor and just and equitable principles of trade, as well as a violation of NFA Compliance Rule 2-29, which requires, among other things, that promotional material include all material information necessary to ensure that such material is not misleading.

NFA requires that its CPO and CTA members make the required disclosures in their Materials related to any pool or managed account that they operate and that engages in virtual currency or virtual currency derivatives transactions. This includes a pool that is being operated in accordance with CFTC Regulation 4.13(a)(3) and for which registration as a CPO would not be required, a managed account that is traded in accordance with CFTC Regulation 4.14(a)(8) and for which registration as a CTA would not be required, and pools and managed accounts open only to investors meeting the standards of a “Qualified Eligible Person” (“QEP”) in accordance with CFTC Regulation 4.7, which require the operator or manager to register as a CPO or CTA, respectively, but are eligible for certain regulatory relief, in addition to any pool or managed account that must be fully compliant with Part 4 of the CFTC's regulations.

CPO and CTA members engaged in or soliciting investors to engage in activities related to virtual currencies or virtual currency derivatives should review any disclosure documents or offering memoranda that are currently in use to determine whether such documents are materially complete in light of the requirements set forth in the Interpretive Notice. If not, the documents must be updated within 21 days of the effective date of the Interpretive Notice (i.e., by November 21, 2018). If a disclosure document that has been or is required to be filed with NFA is updated, the updated document must be filed with NFA by November 21, 2018, (and accepted by NFA before it is used). Disclosure documents with no material changes other than updates to incorporate the prescribed disclosure language required by the Interpretive Notice may be filed for expedited review or, where permitted, as a supplement. NFA will provide education on the requirements prior to the effective date in order to ensure that members understand their obligations. [3]

FCMS AND IBS REQUIREMENTS – ACTION REQUIRED

Under the Interpretive Notice, NFA member FCMs and IBs are required to provide the “NFA Investor Advisory – Futures on Virtual Currencies Including Bitcoin” and the “CFTC Customer Advisory: Understand the Risk of Virtual Currency Trading” to any customer that participates in a virtual currency derivatives transaction through or with the FCM or IB member. NFA does not deem displaying the new prescribed disclosure on an FCM or IB member's website sufficient notice to retail customers. Rather, it must be provided to the retail customer in writing or electronically (i.e., in a risk disclosure booklet or an email that includes links to advisories and disclosure language) in a prominent manner designed to ensure customer awareness. The Interpretive Notice requires that these disclosures be made to customers at the time of, or before, the customer first engages in a virtual currency derivative transaction. FCM and IB members are also required to provide these advisories to any customer that has traded a virtual currency derivative prior to the effective date by November 30, 2018.

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Additionally, for transactions in underlying or spot virtual currencies, the Interpretive Notice requires FCM and IB members to provide a customer (or counterparty) with a prescribed disclosure addressing the limits of NFA oversight, which must be prominently displayed in any promotional material related to such transactions.

CONCLUSION

Even for firms that do not engage in much or any SFP trading, the CFTC's proposed amendments that would loosen the limits DCMs must impose on such trading are a reminder of some lessons to keep in mind for anyone trading in any commodity interest markets: (1) even if there is no specific CFTC position limit on a particular instrument, the exchange where the product is listed for trading is likely to have a limit or at least a position accountability level that needs to be monitored and complied with; (2) the CFTC remains committed to the concept of position limits generally; and (3) despite regulators' aspirations to harmonize regulations, products that appear similar on the surface or in economic substance, such as SFPs and security options, may be subject to quite different regulatory frameworks by different regulators.

NFA member firms that act as intermediaries or principals for virtual currency or virtual currency derivatives transactions should take immediate action to ensure that their Materials meet the disclosure standards set out by NFA in the Interpretive Notice. For CPO and CTA members, this will require drafting disclosures regarding various issues pertaining to virtual currency or virtual currency derivatives transactions, in addition to certain prescribed disclosures. Please be aware that NFA will not limit its scrutiny to its traditional areas of coverage, derivatives transactions of pools, and managed accounts subject to the full panoply of CFTC regulations, but will also cover pools and managed accounts operated by NFA members in accordance with a claim of exemption from registration or regulatory requirements. Please contact your K&L Gates' attorney to determine the appropriate steps to ensure you are in compliance.

NOTES

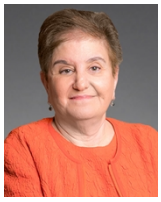
[1] CFTC regulations set parameters for DCM limits, and DCMs generally certify, in accordance with CFTC Regulation 40.6, that their rules establishing limits are in compliance with CFTC regulations and the Commodity Exchange Act; the SEC must approve rules of national securities exchanges setting limits on security options trading.

[2] For more on the risks of and regulatory requirements related to investing in virtual currencies and virtual currency derivatives transactions, click here and here.

[3] *See* NFA Notice to Members I-18-13, August 9, 2018, available here.

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