

New NFA Digital Asset Rule Shows Regulators On Offense

By **Nathan Howell and Kate Lashley** (May 22, 2023)

On March 29, the National Futures Association — the industrywide, self-regulatory organization for the U.S. derivatives industry — issued Compliance Rule 2-51,[1] applicable to NFA member firms and associated persons engaging in activities involving bitcoin and ether.

The rule imposes anti-fraud, just and equitable principles of trade, and supervision requirements on members and associates, and codifies members' existing disclosure obligations under NFA Interpretative Notice 9073. The rule takes effect on May 31.

Rule 2-51 is designed to expand the scope of the NFA's jurisdiction to members and associates' activities in the bitcoin and ether spot markets. The NFA and Commodity Futures Trading Commission already have rules that apply to the digital asset derivatives markets.

The rule thereby fills a regulatory gap created by the fact that the CFTC has only anti-fraud and anti-manipulation jurisdiction over the digital asset spot markets and, with the exception of certain limited disclosure requirements, the NFA previously had no jurisdiction over digital asset spot market activities at all.

In a public statement released following the NFA's issuance of Rule 2-51, CFTC Commissioner Caroline Pham commended the NFA "for taking action now to regulate the spot digital asset commodity markets and protect the retail public." [2]

Scope

Rule 2-51 applies to "digital asset commodities," a term expressly defined for purposes of the rule to refer only to bitcoin and ether. The two cryptocurrencies are the only two digital assets that currently underlie futures contracts listed on exchanges regulated by the CFTC, and as explained by the NFA in its submission letter to the CFTC, these "are also the two digital assets that have been most widely treated as commodities."

Notably, courts have, to date, agreed with the CFTC's arguments that bitcoin and ether are commodities, and certain public statements made by U.S. Securities and Exchange Commission officials indicate that bitcoin and ether are not securities, which means the new NFA rule is unlikely to conflict with SEC rules.[3] The NFA notes that if other digital assets are identified as commodities in the future, it could amend the rule to cover them.[4]

By its terms, Rule 2-51 applies to all activities in bitcoin and ether, including spot or cash market activities. Critically, the rule thereby expands the scope of the NFA's jurisdiction to activities in digital asset spot markets.

In its submission letter to the CFTC, the association explained that "NFA does not have any rules that specifically address its Members' digital asset activities in the spot markets" and that "this jurisdictional limit places NFA in an untenable position."



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The approach here is similar to that taken by the NFA in the early 2000s when it adopted Compliance Rule 2-36 to address the activities of firms that were registering as futures commission merchants to conduct retail forex activities. At that time, the NFA lacked jurisdiction over these members' activities since the association's rules were generally limited to exchange-traded futures activities.

In the time since the NFA's forex rules were implemented, the CFTC adopted Rules 180.1 and 180.2,[5] pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, which prohibit fraud and manipulation in connection with both spot commodity and commodity derivative transactions.

Anti-Fraud Provisions

The text of Rule 2-51(a) tracks closely to the anti-fraud provisions of NFA rules applicable to forex and exchange-traded futures and swaps, with some notable differences.

For example, the prohibitions in Rule 2-51(a) apply to members or associates "engaging in activities involving any digital asset commodity." This "activities involving" language is potentially broader in scope than the language in Rule 2-36(b) concerning forex transactions, which prohibits conduct "in any forex transaction," and language in Rule 2-2 pertaining to exchange-traded futures and swaps, which generally prohibits conduct with respect to "customers" or "counterparties."

Rule 2-51(a) also includes a prohibition on high-pressure sales tactics and language involving suitability that is not present in the NFA rule applicable to forex transactions. Pham specifically highlighted the importance of customer suitability requirements in her remarks.

Just and Equitable Principles of Trade

The Rule 2-51 requirements for members and associates to observe high standards of commercial honor and just and equitable principles of trade is nearly identical to similar provisions in NFA rules applicable to forex dealers and members and associates' futures and swaps business activities on CFTC-registered exchanges.

While "just and equitable principles of trade" would seem to provide the NFA with wide discretion to bring enforcement actions, historically, it has rarely charged members and associates for violating just and equitable principles of trade as a stand-alone violation without also alleging a violation of other rules.

Supervision

Rule 2-51 requires members to diligently supervise their employees and agents in the conduct of digital asset commodity activities on behalf of the member. It also requires associates with supervisory duties to diligently exercise those duties in the conduct of that associate's digital asset commodity activities on behalf of the member.

These requirements closely track the NFA's supervision requirements for forex transactions and exchange-traded futures and swaps. Unlike the NFA rules for forex transactions and exchange-traded futures and swaps, Rule 2-51 does not include a provision that expressly provides the NFA authority to require certain members to adopt enhanced supervisory requirements specified by the NFA board of directors.

Disclosures

Rule 2-51 requires members engaged in activities involving digital asset commodities to comply with the applicable requirements for futures commission merchants, introducing brokers, commodity pool operators and commodity trading advisers set forth in NFA Interpretive Notice 9073, originally released in May 2018, titled "Disclosure Requirements for NFA Members Engaging in Virtual Currency Activities."

The NFA did not modify any of the standardized language^[6] or revise the categories of risk disclosures that commodity pool operators and commodity trading advisers must include in disclosure documents, offering documents and promotional materials.

Like Rule 2-51, NFA Interpretive Notice 9073 includes requirements applicable to transactions in both digital asset derivatives transactions and spot markets. Notably, however, NFA Interpretive Notice 9073 continues to apply more broadly to "virtual currencies" and is not limited to bitcoin and ether.

Notification Requirements

NFA Notice I-23-10 mentions that over 100 members have reported to the association that they engage in digital asset-related business activities, in both commodity interests and spot markets. As a reminder, member firms have an ongoing obligation to notify the NFA if they engage in certain activities involving digital assets by updating the NFA Annual Questionnaire throughout the year to reflect significant changes in business activity.^[7]

These existing notification requirements apply to all digital assets, not just digital asset commodities as defined in Rule 2-51 (i.e., bitcoin and ether).

- Commodity pool operators and commodity trading advisers must notify the NFA if they execute a transaction involving any digital asset or digital asset derivative on behalf of a pool or managed account.^[8]
- Introducing brokers must notify the NFA if they solicit or accept any orders in digital asset derivatives.^[9]
- Futures commission merchants for which the NFA is the designated self-regulatory organization must notify the NFA if the firm decides to offer its customers or noncustomers the ability to trade any digital asset futures product, and must report daily the number of customers or noncustomers who traded a digital asset futures contract and gross open positions.^[10]

Takeaways

Rule 2-51 serves as a reminder to members engaged in digital asset activities of both their preexisting disclosure and NFA notification requirements, as well as the NFA's continued focus on activities in digital asset markets. Members should review existing compliance policies and procedures to ensure that they adequately cover activities related to digital

assets and the unique issues raised by such activities.

More generally, the rule reflects the increasing scrutiny of activities involving digital assets by all U.S. financial regulatory agencies. Given the high-profile collapses of certain market participants, such as FTX, and the extreme volatility of digital asset prices in the last year, there appears to be a consensus among regulators additional action is required — whether it be guidance, rulemaking or enforcement activity.

The at-times overlapping jurisdiction over digital asset activities among the CFTC, SEC, bank regulators, state authorities and self-regulatory organizations, including the NFA, may create uncertainty for market participants. But one thing is clear in the current environment: Where a regulator has legal authority over digital asset activities, expect them to exercise it.

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[1] See also Notice to Members I-23-10 setting forth the effective date. <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5552>.

[2] Statement of Commissioner Caroline D. Pham Regarding NFA Rule on Spot Digital Asset Commodity Activities (March 31, 2013). <https://www.cftc.gov/PressRoom/SpeechesTestimony/phamstatement033123>.

[3] See, for example, William Hinman, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018) <https://www.sec.gov/news/speech/speech-hinman-061418>. ("And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value"). More recently, however, SEC Chair Gary Gensler has made comments that suggest he may view Ether as a security. See Coindesk, SEC Chairman Gensler Suggests Again That Proof-of-Stake Tokens Are Securities: Report (March 15, 2023). <https://www.coindesk.com/policy/2023/03/15/sec-chairman-gensler-suggests-again-that-proof-of-stake-tokens-are-securities-report/>. In addition, the New York Attorney General has recently alleged that Ether is both a commodity and a security under the New York Martin Act. See *People of the State of New York vs. MEK Global Limited and Phoenixfin PTE Ltd*, Dkt. No. 450703/2023 (N.Y. Sup Ct. Mar 09, 2023). In testimony before the House Financial Services Committee, Chair Gensler stated only that it "depends on the facts and law" when asked specifically if Ether is a commodity or a security. Hearing Entitled: Oversight of the Securities and Exchange Commission (April 18, 2023).

[4] In addition to Bitcoin and Ether, the CFTC has previously identified Litecoin (LTC) and Tether USD (USDT), among other digital assets, as commodities in enforcement actions. However, a digital asset's status as a commodity does not necessarily preclude it from being offered and sold as a security under the federal securities laws. See Office of the General

Counsel, CFTC, Letter to Judge Castel Re: SEC v. Telegram Group, Inc., et al., No. 1:19-cv-09439 (PKC), SEC v. Telegram Group, Inc., et al., No. 1:19-cv-09439 (PKC), Dkt. 203 (Feb. 18, 2020). The law surrounding whether a transaction involving digital assets implicates the federal securities or commodities laws, or both, continues to evolve.

[5] 17 C.F.R. 180.1, 180.2.

[6] According to common usage at the time, Interpretative Notice 9073 (and its mandated disclosures) uses the term "virtual currency" rather than digital assets. The CFTC has since noted that "the term 'digital assets' encompasses the term 'virtual currency'" and that "it did not intend to create a bright line definition" through its previous use of the term "virtual currency." See The CFTC's Role in Monitoring Virtual Currencies. <https://www.cftc.gov/media/4636/VirtualCurrencyMonitoringReportFY2020/download>.

[7] Notice I-21-42, Action required: NFA adds virtual currency and micro contract-related questions to Annual Questionnaire (Dec. 6, 2021). As with Interpretative Notice 9073, the NFA Notices to Members setting forth notice requirements use the term "virtual currency" rather than "digital assets." <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5427>.

[8] Notice I-17-28, Additional reporting requirements for CPOs and CTAs that trade virtual currency products (Dec. 14, 2017). <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4974>.

[9] Notice I-17-29, Additional reporting requirements for IBs that solicit or accept orders in virtual currency products (Dec. 14, 2017). <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4975>.

[10] Notice I-17-27, Additional reporting requirements regarding virtual currency futures products for FCMs for which NFA is the DSRO (Dec. 14, 2017). <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4973>.