

TESTIMONY BY
VINCE Mc GONAGLE
DIRECTOR OF THE DIVISION OF MARKET OVERSIGHT
COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT
HOUSE AGRICULTURE COMMITTEE
WASHINGTON, DC
JUNE 23, 2022

Chairman Maloney, Ranking Member Fischbach, and Members of the Subcommittee, thank you for the opportunity to appear before you today to share my views on digital asset regulation as the Director of the Division of Market Oversight at the Commodity Futures Trading Commission (CFTC, Agency or Commission).

CFTC Mission

As you know, the CFTC is the primary regulator of the futures, options, and swaps markets. The Agency's mission is to promote the integrity, resilience, and vibrancy of the U.S. derivatives markets through sound regulation.

Our governing statute, the Commodity Exchange Act (CEA or Act), serves the public interest by mandating the establishment of a regulatory framework that allows the Agency to ensure market integrity, protect customer funds, avoid systemic risk, and police derivatives markets for manipulative activity, fraud and other abuses, while fostering innovation and fair competition.¹ As the transactions within our jurisdiction "are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities,"² the CEA outlines "a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission."³

Designated Contract Market Registration, Compliance Obligations, and Product Listing

Generally, in order for an entity to provide a trading facility for market participants (including retail customers) to trade futures, the market must apply to the Commission to be designated as a contract

¹ CEA § 3(b) (7 U.S.C. § 5(b)).

² CEA § 3(a) (7 U.S.C. § 5(a)).

³ CEA § 3(b) (7 U.S.C. § 5(b)). This system provides multi-tiered protections to market participants trading on our regulated exchanges, including the elimination of the risk of counterparty default or bankruptcy (because a regulated clearinghouse takes the opposite side of customers' transactions). Further, entities that broker futures trades (called futures commission merchants) are required to register with the CFTC, establish safeguards to prevent conflicts of interest, and segregate customer assets to protect the assets from the risk of the broker's bankruptcy. See CEA §§ 4d(a) and 4d(c) (7 U.S.C. §§ 6d(a) and 6d(c)).

market.⁴ To obtain and maintain designation, an entity must comply, on an initial and ongoing basis, with twenty-three Core Principles set forth in the CEA and CFTC regulations.⁵ By design, the designated contract market Core Principles ensure customer protections, establish guardrails that provide clarity regarding the risks and protections involved in trading derivatives products, and enhance transparency, without hindering the trading facilities' ability to innovate and compete fairly. This firm but flexible approach has allowed the CFTC, with authority from Congress, to evolve along with the derivatives markets.

The CFTC oversees designated contract markets through various tools, including rule enforcement reviews and system safeguards examinations to ensure compliance with the Core Principles. The CFTC also conducts direct surveillance of trading on designated contract markets. Designated contract markets are separately required to serve as self-regulatory organizations,⁶ and must establish and maintain effective oversight programs, including monitoring and enforcing compliance with their rules. As self-regulatory organizations and designated contract markets, they play a key role in safeguarding the integrity of the derivatives markets by, among other things, ensuring that their members understand and meet their regulatory responsibilities.

Among other things, the Core Principles require each designated contract market to establish and enforce rules to: ensure the protection of customer funds;⁷ protect market participants and markets from abusive practices; and promote fair and equitable trading on the contract market.⁸ The Core Principles also require each designated contract market to ensure that the contracts they list are not readily susceptible to manipulation, and require a designated contract market to have rules and resources in place to detect and prevent manipulation, price distortion, and disruptions of the cash-settlement or delivery process.⁹ The Core Principle addressing system safeguards requires each designated contract market to: establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk, through the development of appropriate controls and procedures and the development of automated systems that are reliable, secure and have adequate scalable capacity; establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery; and periodically conduct tests to verify that backup resources are sufficient to ensure

⁴ Such designation is required absent an applicable exemption or exclusion. Criteria, procedures, and requirements for designation as a designated contract market are set forth in Section 5 of the CEA (7 U.S.C. § 7) and Part 38 of the CFTC's regulations. Appendix A and B to Part 38 provide specific information on these requirements and guidance to applicants seeking to become designated contract markets. Similarly, absent any applicable exemption or exclusion, in order for an entity to operate a trading facility for the trading or processing of swaps by and between eligible contract participants, the entity must seek and obtain registration with the CFTC as a swap execution facility (SEF) through CEA Section 5h and Part 37 of the CFTC's regulations. For a definition of eligible contract participants, see CEA § 1a(18) (7 U.S.C. § 1a(18)).

⁵ See CEA § 5(d) (7 USC § 7(d)), with the implementing regulations under Part 38 of the CFTC's regulations.

⁶ See CFTC Regulation 1.3.

⁷ Core Principle (CP) 11 at CEA § 5(d)(11) (7 U.S.C. § 7(d)(11)).

⁸ CP 12 at CEA § 5(d)(12) (7 U.S.C. § 7(d)(12)).

⁹ CPs 3 and 4 at CEA § 5(d)(3)-(4) (7 U.S.C. § 7(d)(3)-(4)).

continued order processing and trade matching, price reporting, market surveillance, and maintenance of a comprehensive and accurate audit trail.¹⁰

Under the CEA and the Commission's contract review regulations, prior to listing any new product for trading, a designated contract market must submit to the Commission all new product terms and conditions, and subsequent associated amendments.¹¹ In all such submissions and amendments, a designated contract market is legally obligated to meet certain Core Principles—including Core Principle 3, which requires that a designated contract market only list contracts for trading that are not readily susceptible to manipulation.¹² Under the CEA, the designated contract market may file its new product submission under a process called "self-certification" by certifying that the product to be listed complies with the Act and CFTC regulations and providing a concise explanation and analysis of the product and its compliance.¹³

Similarly, under the CEA and the Commission's rule review regulations, prior to implementing a new or amended rule, a designated contract market must submit to the Commission the text of the rule and note any substantive opposing views to the rule that were not incorporated into the rule.¹⁴ In all such submissions, a designated contract market is legally obligated to meet Core Principles. The designated contract market may file its new or amended rule submission through self-certification by certifying that the rule complies with the Act and CFTC regulations and providing a concise explanation and analysis of the operation, purpose and effect of the new or amended rule and its compliance.¹⁵

¹⁰ CP 20 at CEA § 5(d)(20) (7 U.S.C. § 7(d)(20)).

¹¹ CEA § 5c(c) (7 U.S.C. § 7a-2(c)) and CFTC Regulations 40.2 and 40.3. These same processes also apply for products to be listed on SEFs, with compliance required with the corresponding SEF regulatory framework.

¹² The Commission has provided Guidance to designated contract markets and SEFs on meeting their Core Principle 3 obligations in Appendix C to Part 38 of the Commission's regulations. See 17 CFR pt. 38, Appendix C. At any time, Commission staff may ask a designated contract market or SEF for a detailed justification of its continuing compliance with core principles, including information demonstrating that any contract listed for trading on the designated contract market or SEF meets the requirements of the Act and designated contract market or SEF Core Principle 3, as applicable. See CFTC Regulations 38.5 and 37.5. Failure of a designated contract market or SEF to adopt and maintain practices that adhere to these requirements may lead to the Commission's initiation of proceedings to secure compliance.

¹³ CEA § 5c(c)(1)-(3) (7 U.S.C. § 7a-2(c)(1)-(3)) and CFTC Regulation 40.2. Alternatively, the designated contract market or SEF may voluntarily request that the CFTC review the exchange's analysis of the product and its compliance with the CEA and CFTC regulations and approve the new product for listing (through CEA 5c(c)(4)-(5) (7 U.S.C. § 7a-2(c)(4)-(5)) and CFTC Regulation 40.3).

¹⁴ CEA § 5c(c) (7 U.S.C. § 7a-2(c)) and CFTC Regulations 40.5 and 40.6. These same processes also apply for products to be listed on SEFs, with compliance required with the corresponding SEF regulatory framework.

¹⁵ CEA § 5c(c)(1)-(3) (7 U.S.C. § 7a-2(c)(1)-(3)) and CFTC Regulation 40.6. Alternatively, the designated contract market or SEF may voluntarily request that the CFTC review the exchange's analysis of the rule and its compliance with the CEA and CFTC regulations and approve the new rule (through CEA 5c(c)(4)-(5) (7 U.S.C. § 7a-2(c)(4)-(5)) and CFTC Regulation 40.5).

CFTC Regulatory Jurisdiction Involving Digital Assets

Digital assets have been broadly determined by the CFTC and federal courts to be commodities under the CEA.¹⁶ As discussed below, the CFTC has broad regulatory oversight over any futures, options, and swaps listed by designated contract markets.

The CFTC has regulated exchange listed futures contracts on digital assets since late 2017. By way of background, in 2017, three designated contract markets expressed interest to the CFTC in listing digital asset-based derivatives contracts for trading.¹⁷ These designated contract markets voluntarily provided the CFTC with advance draft contract terms and conditions for their proposed contracts.¹⁸ In December 2017, the three designated contract markets self-certified that they would list bitcoin derivatives contracts for trading.¹⁹ Though the Commission did not determine to stay the certifications or seek public comment at the time, the CFTC published two documents in connection with these self-certification submissions to provide the public with background information on the CFTC's oversight of, and approach to, virtual currency futures markets.²⁰

A few months later in 2018, staff issued an advisory to encourage innovation and growth of digital asset derivatives products to be traded on designated contract markets and cleared by derivatives clearing organizations within an appropriate oversight framework under the Core Principles.²¹ Specifically, staff clarified their priorities and expectations when reviewing new virtual currency derivatives to be listed on a designated contract market or to be cleared by a derivatives clearing organization.²²

¹⁶ The CFTC first found that Bitcoin and other virtual currencies are commodities in 2015. See *In re Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC No. 15-29 (Sept. 17, 2015), <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>. In 2017, the CFTC proposed guidance regarding its jurisdiction over certain types of retail transactions involving virtual currency. Following extensive industry engagement and public comment, the CFTC finalized this guidance in 2020. Retail Commodity Transactions Involving Certain Digital Assets, 85 Fed. Reg. 37,734 (June 24, 2020). In 2018, federal courts affirmed the CFTC's jurisdiction over digital assets in two cases, *CFTC v McDonnell*, 332 F.Supp.3d 641 (E.D.N.Y. 2018) and *CFTC v My Big Coin Pay Inc.*, 334 F.Supp.3d 492 (D. Mass. 2018). Certain digital assets may also be securities to which the securities laws apply. Whether or not a given digital asset is a security requires examination of the specific characteristics of that asset, as set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

¹⁷ CFTC Backgrounder on Self-Certified Contracts for Bitcoin Products, Dec. 1, 2017, available at https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet120117.pdf. Two designated contract markets intended to list futures contracts on bitcoin and a third designated contract market intended to list a new contract for bitcoin binary options.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ CEA § 5c(c)(3) (7 U.S.C. § 7a-2(c)(3)). See https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet120117.pdf and https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/backgrounder_virtualcurrency01.pdf.

²¹ See CFTC Staff Advisory No 18-14, <https://www.cftc.gov/LawRegulation/CFTCStaffLetters/index.htm>.

²² See *id.*

Since then, the trading of futures contracts in digital assets has grown notably. Today, of the sixteen designated contract markets that the CFTC oversees, five list for trading futures and options contracts on bitcoin, ether, or both. Market participants are actively trading over a dozen different futures and options contracts on digital assets across these five designated contract markets. When market participants trade digital asset-based futures contracts on a designated contract market, they are afforded the same customer protections and transparency as when they trade in futures contracts on any other asset class—including certainty over custody of their margin and clarity regarding bankruptcy protections.

CFTC Cash Market Enforcement Actions Involving Digital Assets

While the CFTC does not have direct statutory authority to regulate cash markets, the CFTC maintains anti-fraud, false reporting,²³ and anti-manipulation enforcement authority over commodity cash markets in interstate commerce (including digital asset cash markets). When the CFTC becomes aware of potential fraud or manipulation in an underlying market, we investigate and address misconduct through our enforcement authority. In the digital asset space, since 2014, the CFTC has aggressively exercised its enforcement authority bringing more than 50 enforcement actions.

Most recently, in FY 2021, the CFTC filed numerous cases charging retail fraud involving digital assets,²⁴ and cases charging platforms with illegally offering off-exchange trading in digital assets.²⁵ In all, the CFTC filed over 20 enforcement actions that included digital asset-related allegations of misconduct in FY 2021.

Thus far in FY 2022, the CFTC has filed several enforcement actions involving digital assets, including an action for making untrue or misleading statements and omissions of material fact in connection with the U.S. dollar tether token (USDT) stablecoin.²⁶ In addition, the Commission recently filed a complaint involving allegations 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.²⁷

The Derivatives Markets the CFTC Oversees Work Well

The CEA and the CFTC's regulatory framework have worked well for our futures markets for many decades. The CFTC's focus on customer protections, market integrity, price discovery and transparency has proven to be effective, even in times of volatility. The strength of our futures markets is why in 2010, Congress tasked the CFTC with creating an oversight system for the over-the-counter swaps markets after the 2008 financial crisis.

Following enactment of the Dodd-Frank Act, the CFTC thoughtfully and quickly enacted regulations to register trading facilities for swaps as swap execution facilities and to regulate the trading of swaps on

²³ *In re Coinbase Inc.*, CFTC No. 21-03 (Mar. 19, 2021).

²⁴ Press Releases 8366-21, 8374-21, 8381-21, 8441-21, 8434-21, 8434-21, and 8452-21.

²⁵ Press Releases 8374-21 and 8433-21.

²⁶ Press Release 8450-21.

²⁷ Press Release 8540-22.

swaps execution facilities as well as customer protections for swaps traded bilaterally. Today, the swaps markets that the CFTC oversees exceed \$300 trillion in gross notional outstanding. Of the swaps in the credit and interest rates markets (two of the largest swap asset classes in terms of volume and notional outstanding), a notable portion of the swaps positions are cleared at a derivatives clearing organization. By bringing the previously opaque over-the-counter swaps market under the CFTC's oversight, our extensive swaps markets now benefit from transparency, enhanced customer protections, and promoted competition.

Conclusion

Through the CFTC's extensive experience overseeing the trading of digital asset-based derivatives on CFTC-regulated exchanges as well as the CFTC's vigilant exercise of jurisdiction of its enforcement authority over commodity cash markets in interstate commerce, the CFTC has developed a keen understanding of digital assets, and will continue to deliver on its commitment to protect customers to the fullest extent of its statutory authority.

Thank you for the opportunity to appear before the Subcommittee. I look forward to answering any questions you may have.