



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and  
Intermediary Oversight

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**To: Registered Futures Commission Merchants**

**Subject: Accepting Virtual Currencies from Customers into Segregation**

**Date: October 21, 2020**

### I. Introduction.

Market participants have asked the Division of Swap Dealer and Intermediary Oversight (the “Division”) of the Commodity Futures Trading Commission (“Commission”) how the customer protection provisions of the Commodity Exchange Act (the “Act”) and its adopting regulations apply to virtual currencies deposited by futures customers or cleared swaps customers with futures commission merchants (“FCMs”) to margin futures, options on futures, or cleared swap transactions.<sup>1</sup> This advisory applies to deposited virtual currency underlying a physically-delivered futures contract or swap. In this Advisory, the Division is providing FCMs with its view regarding accepting and holding customer virtual currency assets and guidance on practices to consider in developing and maintaining their risk management programs when holding virtual currency as customer funds,<sup>2</sup> as well as other considerations discussed below.

This Advisory does not address virtual currency held by FCMs on behalf of customers trading futures or options on futures on foreign markets (i.e., Part 30 transactions). This Advisory also does not address virtual currency assets held by FCMs on their own behalf, including in a proprietary account.

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<sup>1</sup> The term “virtual currency” means “any digital representation of value that functions as a medium of exchange, and any other digital unit of account that is used as a form of a currency (i.e., transferred from one party to another as a medium of exchange); may be manifested through units, tokens, or coins, among other things; and may be distributed by way of digital ‘smart contracts,’ among other structures.” 85 Fed. Reg. 37734, 37736 n.53 (June 24, 2020).

<sup>2</sup> The term “customer funds” is defined in Commission regulation 1.3 and refers collectively to funds held by an FCM and belonging to futures customers and cleared swaps customers.

## II. Background.

The Division has considered the following provisions of the Act, the Bankruptcy Code, and Commission regulations for purposes of issuing this Advisory:

**Sections 4d(a)(2) and 4d(f) of the Act.** Section 4d(a)(2) requires an FCM to treat and deal with all money, securities, and property received from a futures customer to margin, guarantee, or secure contracts for the purchase or sale of a commodity for futures delivery, or an option on that contract, or any money, securities, or property accruing to the customer as the result of those trades or contracts, as belonging to the futures customer.<sup>3</sup> Section 4d(a)(2) of the Act further requires an FCM to account separately for the futures customer's funds. That provision also prohibits the FCM from commingling the futures customer's funds with the FCM's own funds, or from using the futures customer's funds to margin or guarantee the trades or contracts, or to secure or extend the credit, of any other person.<sup>4</sup> For convenience, however, Section 4d(a)(2) permits an FCM to commingle the funds of multiple futures customers and deposit those funds in one or more accounts with a bank, trust company, or the DCO that clears their the futures transactions. Section 4d(f) of the Act requires similar segregation requirements on FCM for customers engaging in swap transactions that are cleared by or through a registered DCO.

The purpose of these statutory provisions, and the Commission's regulations adopted thereunder, is to establish a system of segregation of customer property that is designed to result in an FCM holding sufficient funds in segregated accounts to meet their customer obligations in full.

**The Bankruptcy Code and Commission Part 190 Regulations.** An FCM is obligated to cover a customer's default.<sup>5</sup> In certain situations, a customer loss may be of such a magnitude that the FCM becomes insolvent because it cannot cover the loss from its own capital and financial resources. Under applicable laws and Commission regulations,<sup>6</sup> for an FCM that is considered insolvent and thus subject to liquidation, a customer loss would generally be apportioned pro-rata across the non-defaulting customers of the FCM, by what is referred to as account origin. For this purpose, all commodity futures customers are considered one origin (as are all foreign futures and, separately, all cleared swaps customers). As a result, loss that could not be restored by the FCM's capital in any of these three origins, would be distributed pro rata to all customers in that origin in a commodity broker liquidation under the Bankruptcy Code.

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<sup>3</sup> The term "futures customer" includes any person who uses an FCM as an agent in connection with trading in any contract for the purchase or sale of a commodity for future delivery or any option on the contract. The owner or holder of a "proprietary account" is excluded from that definition. *See* 17 C.F.R. § 1.3.

<sup>4</sup> The term "futures customer funds" includes all money, securities, and property received by an FCM or derivatives clearing organization ("DCO") from, for, or on behalf of, futures customers to margin, guarantee, or secure contracts for future delivery on or subject to the rules of a contract market or DCO. *See* 17 C.F.R. § 1.3.

<sup>5</sup> *See generally* 17 C.F.R. §§ 1.22 and 1.23.

<sup>6</sup> *See generally* 11 U.S.C. §§ 761-66 (commodity broker liquidation), 17 C.F.R. pt. 190.

**Commission Regulation 1.11.** The Commission requires an FCM to have a risk management program.<sup>7</sup> The program must include, with respect to segregation risk, policies and procedures for assessing the liquidity, marketability and mark-to-market valuation of all non-cash assets held as segregated funds, including permitted investments under Commission regulation 1.25. Those policies and procedures must ensure that all non-cash assets held in customer segregated accounts are readily marketable and highly liquid. The policies and procedures must: require daily measurement of liquidity needs with respect to customers; an assessment of procedures to liquidate all non-cash collateral in a timely manner and without significant effect on price; and the application of appropriate collateral haircuts that accurately reflect market and credit risk.<sup>8</sup>

### **III. Guidance on Customer Funds and Virtual Currency.**

In light of the foregoing provisions, the Division has considered the risks presented by an FCM's acceptance of virtual currency from customers. In particular, the Division has determined that receiving virtual currency from a customer and holding that currency as segregated funds creates additional risks for the other customers in the same origin. Specifically, virtual currencies present a degree of custodian risk that is beyond what is currently present with depositories, such as banks and trust companies.

Custodians of virtual currencies are typically not subject to a system of comprehensive federal or state regulation and oversight, which includes safeguarding of these novel assets, and this raises potential risks to the protection of customer funds held at such custodians. For instance, virtual currencies raise complicated issues with respect to the effective safeguarding and custodianship of such assets. There have been 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. There also have been reports of owner's or custodian's losing the ability to access virtual currencies held in electronic wallets due to the loss or misappropriation of digital keys that are necessary to perform transfers of, or otherwise access, these virtual currencies. These events have resulted in millions of dollars' worth of losses to the ultimate owners of the virtual currencies. Moreover, commercial insurance to cover such losses also appears to be limited at the current time, with payouts capped at low dollar thresholds, and high premiums charged by the few firms that are willing to provide coverage.

The Division has considered these risks in light of the existing requirements for customer funds held by FCMs. Accordingly, the Division is reminding FCMs that they must adhere to the following 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

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<sup>7</sup> See 17 C.F.R. § 1.11.

<sup>8</sup> See 17 C.F.R. § 1.11(e)(3)(i)(J).

- virtual currency futures, options on futures, or cleared swap contracts (each such entity, a “Depository”).<sup>9</sup>
- 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.<sup>10</sup>
  - 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 will be made without delay.<sup>11</sup>
  - 4) An FCM in preparing its daily and month-end segregation statements must report customer’s virtual currencies at fair market value on Line 1.B. (“Net ledger balance – Securities (at market)”) and on Line 12 (“Segregated funds on hand”). The FCM must report the total fair market value of customer virtual currency held at a bank or custodian, at a derivatives clearing organization, or at 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.<sup>12</sup>
  - 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.<sup>13</sup>
  - 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.<sup>14</sup>

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<sup>9</sup> Section 4d and 4d(f) of the Act provide that all money, securities, and property of customers may be held at a bank or trust company, or with a clearing house organization for the contract itself. The Division does not expect FCMs to hold customer’s virtual currency directly. However, any FCM that wishes to hold customer virtual currencies directly will have to demonstrate to the Division how the FCM satisfies the Commission’s segregation requirements, including retaining the appropriate possession and control of the virtual currencies and the safeguarding of the virtual currencies.

<sup>10</sup> See 17 C.F.R. §§ 1.20(a), 1.20(d), 22.2, 22.5, and 22.6

<sup>11</sup> See 17 C.F.R. § 1.20(h).

<sup>12</sup> See 17 C.F.R. §§ 1.10, 1.32, and 22.2(g).

<sup>13</sup> Virtual currencies held as customer funds in the context of this Advisory are not considered “readily marketable securities” as that term is used in Commission regulations 1.32(b) and 22.2(f)(5).

<sup>14</sup> See 17 C.F.R. §§ 1.23(a)(1), 22.2(e)(3)(i), and 22.17, which limit the types of proprietary funds an FCM may add to segregated futures customer accounts and segregated cleared swaps customer accounts to cash and the

- 7) An FCM may not invest any segregated futures customer or segregated cleared swap customer funds in virtual currency to be held on behalf of customers.<sup>15</sup>

In addition, the requirements of Commission regulation 1.11(e)(3)(i)(J) require FCMs that receive virtual currency from customers to consider the specific risks presented by holding such virtual currency as segregated or cleared swap customer funds. As a result, this Advisory is establishing the following guidance that an FCM should follow when designing and maintaining its risk management programs should the FCM accept virtual currency as customer funds:

- 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.
- 9) All virtual currency accepted by an FCM should not provide margin value to any contracts other than the contracts identified in Clause 8(a) 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).

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types of instruments set forth as permitted customer investments under 17 C.F.R. § 1.25. Requirements establishing targeted and residual interest amounts are set forth in 17 C.F.R. §§ 1.11(e)(3)(i)(D), 1.22, and 22.2.

<sup>15</sup> Virtual currency is not listed among the permissible investments for futures customers segregated funds under Commission regulation 1.25. *See also*, 17 C.F.R. § 22.2(e)(1) for permitted investments of cleared swaps customer funds.

- 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 time that is technologically and operationally possible, but should not exceed one day, unless the procedures of the Depository specify additional time as part of its controls related to transfers of virtual currency.<sup>16</sup>
- 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.<sup>17</sup> 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.<sup>18</sup>

Given the previously mentioned risks associated with virtual currency, the Division 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.

This guidance in no way limits the ability of the Division to refer an FCM to the Division of Enforcement for potential investigation relating to the FCM's practices involving virtual currencies, specific transactions involving virtual currencies or related contracts, or for any other reason. Staff will reevaluate and revisit this advisory, as necessary, to address any new or heightened concerns raised by FCMs holding customers' virtual currency assets.

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Issued in Washington, D.C. on October 21, 2020, by the Division of Swap Dealer and Intermediary Oversight.

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<sup>16</sup> In this regard, the Division notes that Commission regulation 1.20(h) provides that all customer funds deposited with a bank or trust company must be immediately available for withdrawal.

<sup>17</sup> Commission regulation 1.55(k) requires an FCM to provide specific disclosures concerning the significant types of business activities and product lines engaged in by the FCM, and the approximate percentage of the FCM's assets and capital that are used in each type of activity.

<sup>18</sup> Such disclosures should be considered additional information to be provided under Commission regulation 1.55(o)(1).