

## **Alert** | Futures & Derivatives



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### **NFA Expands its Authority over Cryptocurrencies**

National Futures Association (NFA) is the self-regulatory organization for the U.S. futures and derivatives industry and derives its authority as a registered futures association by designation from the Commodity Futures Trading Commission (CFTC). On March 29, 2023, NFA adopted Compliance Rule 2-51 (Rule 2-51), which took effect May 31, 2023. Rule 2-51 expands the scope of NFA's authority over NFA members (Members) and associate members (Associates) engaging in spot or cash transactions in “digital asset commodities.” Rule 2-51 imposes anti-fraud, just and equitable principles of trade, and supervisory requirements on Members and Associates transacting in such markets. Rule 2-51 also reconfirms NFA members’ disclosure obligations in such markets as originally set forth in NFA’s May 2018 Interpretive Notice 9073 (IN 9073). As adopted, Rule 2-51 only applies to Members or Associates’ spot or cash market activities in two digital assets that have derivatives listed on exchanges regulated by CFTC: Bitcoin (BTC) and Ether (ETH). In its rule submission to CFTC, NFA noted that if other digital assets are identified or designated as commodities in the future, NFA could amend Rule 2-51 to cover such assets.

Under IN 9073, NFA exercised only limited jurisdiction over Members’ activities in digital asset spot markets – including cryptocurrencies not yet clearly recognized by courts as commodities. IN 9073 implemented various customer risk disclosure and notification requirements for futures commission merchants (FCMs), introducing brokers, commodity pool operators, and commodity trading advisors that engage in activities related to virtual currencies or virtual currency derivatives. Standardized disclosures required NFA members to inform customers that NFA does not have regulatory oversight over cash or spot virtual currency transactions. Although Rule 2-51 does not change the content of these disclosures, it represents a substantial expansion of NFA’s assertion of authority beyond these disclosures.

NFA operates under delegated authority from CFTC, and thus its jurisdiction may not exceed that of CFTC. CFTC's jurisdiction under the Commodity Exchange Act, as amended (CEA), includes regulating derivatives on "commodities" (as broadly defined in the CEA) and conduct constituting fraud or price manipulation in commodities in interstate commerce.

While many subsections of Rule 2-51 fall within CFTC's authority over fraud and manipulation in spot markets and essentially reiterate NFA's virtual currency disclosure and notification requirements as set forth in IN 9073, two key sections go beyond the scope of IN 9073 and may extend outside CFTC's jurisdiction. Subsection (a)(ii) of Rule 2-51 states that Members may not make a communication that employs or is part of a "high-pressure approach." However, not every "high pressure approach" rises to the level of market manipulation. Federal courts have held that there can be "no manipulation without an intent to cause artificial prices." A "high pressure approach" may not be an attempt to influence market prices.

Further, "high pressure approach[es]" are not necessarily fraudulent. Under the CEA, fraud involves the "making of a misrepresentation, misleading statement, or deceptive omission." Sales pressure could be exerted on a customer without making misleading statements or misrepresentations or constituting fraud.

Subsection (a)(v) of Rule 2-51, which states that Members may not "engage in manipulative acts and practices" and clearly falls within CFTC's jurisdiction, would appear to make subsections (a)(iii) and (a)(iv) of Rule 2-51 redundant. Subsection (a)(iii) prohibits members from "willfully mak[ing]" false records in connection with any transaction involving a digital asset commodity. Subsection (a)(iv) prohibits the dissemination of "false or misleading information" that affects (or tends to affect) the price of any digital asset commodity.

Although it is unclear what conduct NFA sought to regulate by adding subsections (iii) and (iv), presumably something more than manipulative conduct was the intended target. One possible explanation could be an effort to expand NFA jurisdiction beyond fraudulent or market manipulative conduct over Members operating in the digital asset spot market. An attempted expansion of this nature could potentially be open to challenge as falling outside the scope of CFTC, and thus NFA, authority.

Moreover, Rule 2-51(b) requires Members to "observe high standards of commercial honor and just and equitable principles of trade" when conducting their business involving any digital asset commodity. The term "just and equitable principles of trade" is broad and not necessarily limited only to fraudulent or manipulative activities. NFA modeled subsection (b) on NFA Compliance Rule 2-4 (Rule 2-4), which requires Members to follow just and equitable principles in their commodity futures and swaps business.

NFA has interpreted Rule 2-4 to require FCMs to disclose costs associated with futures and swaps to their customers. If, for example, fees and charges related to a future transaction are not calculated on a per trade or round-turn trade basis, the FCM must disclose to its customers in writing how it calculates such fees or charges. If such an interpretation were applied to Rule 2-51(b), Members participating in the digital asset commodity spot markets would be required to disclose more than just the risks of digital asset commodities. Members would also have new required fee- and charge-related disclosure obligations. Such obligations may further expand NFA's authority beyond CFTC's jurisdiction.

CFTC Commissioner Caroline Pham stated in connection with adoption of Rule 2-51 that a parallel exists between Compliance Rule 2-51's expansion into the digital asset spot market and NFA Compliance Rule 2-36 (Rule 2-36)'s application to the spot retail foreign exchange (retail forex) market in the early 2000s.

Both rules prohibit fraud and market manipulation by Members and impose “just and equitable principles of trade” in digital asset and forex markets, respectively.

This comparison of Rule 2-51 and Rule 2-36 has potentially significant implications. Although Rule 2-36’s prohibition regarding retail forex transactions eventually was codified by the Dodd-Frank Act to expand the CFTC’s jurisdiction, CFTC (and therefore NFA) did not always have statutory authority to regulate retail forex transactions. For years there existed a so-called Zelener loophole, named after the Seventh Circuit Court of Appeals decision in *CFTC v. Zelener*, which held that CFTC did not have jurisdiction to pursue enforcement actions involving rolling spot forex transactions. NFA’s expansion of authority to the digital asset spot market may face similar legal challenges.

CFTC guidance and court opinions issued in the future discussing Rule 2-51 may address these issues and establish some guidance regarding the scope of NFA’s authority to regulate non-derivative transactions in digital assets considered to be commodities. However, the boundaries of CFTC’s jurisdiction in this area are not well-established. CFTC has taken the position in more than one enforcement action that Litecoin, Tether USD, and “other digital assets” are also commodities. If grafted into Rule 2-51, such a position could further expand NFA’s authority over digital assets beyond BTC and ETH. If and whether such expansion occurs will likely be analyzed and potentially challenged as markets in cryptocurrencies continue to evolve and mature.

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