Bitcoins and the Blockchain: The CFTC Takes Notice of Virtual Currencies

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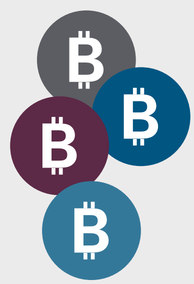
As interest in bitcoin derivatives has increased, the Commodity Futures Trading Commission (CFTC) has turned more of its attention toward virtual currencies. For a little more than a year, at least two trading facilities registered with the CFTC have offered bitcoin derivatives for trading in the United States. Another company plans to offer bitcoin derivatives on its platform and applied in 2014 to register a derivatives clearinghouse for bitcoin derivatives. More recently, the CFTC brought two enforcement actions related to bitcoin derivatives. In *In re Coinflip, Inc.*, it asserted jurisdiction over bitcoin-based derivatives contracts and shut down an unregistered facility offering bitcoin options; in *In re TeraExchange, LLC*, the CFTC issued a cease-and-desist order to a registered swap market called a SEF, for "swap execution facility," after finding that the SEF publicly claimed certain bitcoin trades represented actual market liquidity when the trades were in fact prearranged wash trades.

What Are Bitcoins?



Bitcoins are digital assets that can be used as a medium of exchange to purchase goods and services and can be electronically transferred, stored or traded.

Unlike traditional coins or bills, notes or coupons, or even tokens, bitcoins do not exist outside the blockchain. The blockchain exclusively records how many bitcoins exist and who owns them.

Bitcoins are not legal tender, they are not pegged to any fiat currency and no government backs them.

Bitcoin transactions differ from transactions involving traditional money, which rely on trusted third parties like banks to stand between the involved parties. In a traditional transaction, a bank, which maintains its own internal ledger of deposits, transfers, payments and withdrawals, provides certainty to the seller that the buyer has sufficient money for the transaction. The bank then records the transfer of that money from the buyer to the seller and ensures that the buyer cannot use that same money in a subsequent transaction. Bitcoin transactions do not involve a trusted third party but instead rely on mathematical cryptography to create a secure and accurate public ledger. Every bitcoin transaction is recorded on the blockchain, a decentralized computer-based ledger that is distributed across multiple network nodes that are owned by no one person or institution. The owners of each of these nodes contribute computing power to run cryptographic math functions that verify and record transactions on the blockchain — a process referred to as "mining." The process of mining causes new bitcoins to come into existence on the blockchain, and the miners are incentivized to continue mining with these new bitcoins. The blockchain maintains a secure transaction history and record of ownership as bitcoins are transferred from one party to the next.

The CFTC also has taken notice of an innovative ledger system known as the "blockchain," which verifies and records all bitcoin transactions. In speeches in late 2015, CFTC Chairman Timothy G. Massad and Commissioner J. Christopher Giancarlo each commented on the potential impact of blockchain technology on financial ecosystems. The blockchain's impact on derivatives markets was a topic at a CFTC advisory committee meeting, which included a discussion of "smart futures contracts." As Commissioner Giancarlo observed, there are numerous potential innovations that may be possible with "smart derivatives" using blockchain technology, including contracts that "value themselves in real time, automatically calculate and perform margin payments and even terminate themselves in the event of a counterparty default."

Many industry observers predict that bitcoin or the blockchain will significantly disrupt existing financial market infrastructures and reshape traditional payment systems, transaction clearing and settlement services, derivatives markets, and other financial market processes that rely on third-party intermediaries. Tellingly, a number of exchanges and investment banks are investing heavily in research related to bitcoin and blockchain applications, according to press reports.

Susceptible to Manipulation?

Market participants should expect the CFTC's interest in and scrutiny of bitcoin spot markets to grow as more CFTC-registered trading facilities self-certify bitcoin derivatives contracts for trading. In particular, one should expect the CFTC to focus on whether particular bitcoin derivatives that are listed for trading are not readily susceptible to manipulation — a statutory requirement under the Commodity Exchange Act (CEA) applicable to all CFTC-registered trading facilities.

TeraExchange's self-certification of its bitcoin derivatives illustrates the CFTC's interest. TeraExchange's bitcoin contract is a nondeliverable U.S. dollar/bitcoin forward that is cash-settled in dollars to the bitcoin spot price. CFTC staff questioned TeraExchange's initial proposal for a settlement index because it included too few price inputs. In response, TeraExchange developed its own proprietary index based on a volume-weighted average of bitcoin spot market transactions from multiple bitcoin exchanges. The CFTC staff ultimately did not object to TeraExchange self-certifying the bitcoin contract that settled to the new index.

In similar contexts, the CFTC has aggressively investigated and brought enforcement actions related to manipulation of indices comprising spot market transactions. In this regard, the CFTC's recent settlements with multiple investment banks related to the World Market/Reuters foreign currency exchange (FX) benchmark serves as a warning to bitcoin market participants. These settlements demonstrate that the CFTC will investigate alleged attempts to manipulate an index used to settle derivatives contracts, even if the conduct is limited to trading in the underlying commodity itself, which is outside the CFTC's jurisdiction for nearly all other purposes. Therefore, as the bitcoin derivatives market grows, we may see CFTC investigations focused on activity in the bitcoin spot market and any impact on bitcoin price indices, even though the CFTC's jurisdiction is largely limited to derivatives on bitcoin.

An 'Exempt' Rather Than 'Excluded' Commodity

In its recent order shutting down Coinflip's unregistered bitcoin options trading platform, the CFTC shed light for the first time on how it classifies virtual currencies under the CEA. Whether bitcoin should be regulated as a currency or other form of property is a question that has vexed many U.S. regulators. (See September 30, 2015, Skadden client alert "CFTC Asserts Jurisdiction in Bitcoin Markets.") The CFTC concluded in Coinflip that bitcoin and other virtual currencies are "commodities," but, consistent with other federal regulators, the CFTC's order did not conclude bitcoin was a "currency" within the meaning of the CEA.

Many had wondered whether the CFTC would classify bitcoin as a currency, which is enumerated in the CEA definition of "excluded commodity" (and includes most financial commodities such as interest rates, exchange rates and currencies). Transactions in currency are eligible for exemptions from most CFTC regulations if offered in the form of FX swaps or FX forwards between nonretail counterparties. Furthermore, retail customers are prohibited from engaging in off-exchange derivatives transactions except for FX transactions with certain financial institutions such as retail foreign exchange dealers, futures commission merchants, broker-dealers and banks. Off-exchange FX transactions generally are considered to be subject to lighter regulation than transactions executed on a CFTC-registered designated contract market (*i.e.*, futures exchange).

Whether intentional or not, the CFTC's legal analysis in the *Coinflip* settlement order implies that bitcoin and other virtual currencies are "exempt commodities" (defined as "a commodity that is not an excluded commodity or agricultural commodity" that includes metals, energy and weather events). Categorizing bitcoin as an exempt commodity would preclude bitcoin operators from relying on regulatory exemptions for certain FX transactions under the CEA. In its analysis, the CFTC notes that Coinflip's bitcoin options were illegal in part because they could not rely on the "trade option exemption." Such exemption is only available to options on exempt or agricultural commodities (not excluded commodities such as currencies). Notably, the CFTC made no mention of the trade option exemption's inapplicability to excluded commodities when it concluded that Coinflip could not claim the exemption. Instead, the CFTC concluded that Coinflip could not rely on the trade option exemption because participants on Coinflip's platform did not satisfy the exemption's requirement that the option buyer be a commercial user of bitcoin.

The *Coinflip* order clearly suggests that a bitcoin option could satisfy the trade option exemption if the option buyer was a commercial bitcoin user, and therefore, bitcoin could only be an exempt commodity. This conclusion has other implications as well. Commercial users of bitcoin (*e.g.*, retailers that accept bitcoin as payment, participants on the blockchain network that mine bitcoins or bitcoin merchants) could claim the trade option exemption. Similarly, as an exempt commodity, forward contracts that result in delivery of bitcoin between commercial market participants could be excluded from the CEA and CFTC jurisdiction.

Conclusion

As long as interest in bitcoin derivatives persists, the CFTC is likely to continue to regulate them actively. Bitcoin market participants should be aware that the CFTC could assert itself on a number of fronts that have only an indirect relationship to bitcoin derivatives. Furthermore, the CFTC is likely to be presented with fresh challenges as new applications for blockchain technology are developed. Many already have speculated that the blockchain could be adapted to significantly enhance efficiencies in collecting margin and collateral on derivatives and for clearing and settling securities transactions. As with any type of innovative technology, bitcoin derivatives and blockchain applications have the potential to test both the industry and the CFTC in the coming years.