

Derivatives Alert

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Frequently Asked Questions on Virtual Currency and CFTC Jurisdiction

On October 17, 2017, the Commodity Futures Trading Commission's (CFTC) newly formed financial technology (fintech) innovation group, LabCFTC, released its first fintech primer, "A CFTC Primer on Virtual Currencies" (VC Primer).¹ The VC Primer gives high-level background on the mechanics of how virtual currencies work, as well as some clues regarding how the CFTC and the Securities and Exchange Commission (SEC) may regulate virtual currencies and virtual tokens. The VC Primer also highlights a number of legal and regulatory questions that remain unanswered.

In order to spur and guide discussion on this important topic, we have developed a list of frequently asked questions, or FAQ, related to CFTC oversight of virtual currencies under the Commodity Exchange Act (CEA), 7 U.S.C. § 1 *et seq.* We understand that certain terms of art in the virtual currency space are not static and will evolve through innovations we cannot even contemplate now. But it is important to establish a common vocabulary for purposes of the FAQ. We provide that vocabulary in the first part of this alert and then identify and discuss the FAQ.

Vocabulary for FAQ:

- **Virtual Currency.** In a March 2014 notice, the Internal Revenue Service (IRS) defined virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value."² One example of virtual currency is bitcoin. Bitcoin runs on a "blockchain," which we explain below.³ Another term we use for virtual currency is "cryptocurrency."
- **Blockchain.** Blockchain technology allows multiple parties to engage in verified, immutable and transparent transactions without the need for a trusted third party acting as an intermediary. While a detailed discussion of blockchain technology is beyond the

¹ See LabCFTC Release (PR 7631-17), "A CFTC Primer on Virtual Currencies" (Oct. 17, 2017). The VC Primer includes a disclaimer that it "is not intended to describe the official policy or position of the CFTC, or to limit the CFTC's current or future positions or actions."

² IRS Notice 2014-21, 2014-16 I.R.B. 938. The VC Primer applies this IRS definition of "virtual currency."

³ See LabCFTC Release (PR 7631-17), *supra* note 1, at 5. See also "Bitcoins and the Blockchain: The CFTC Takes Notice of Virtual Currencies," Skadden client alert, Jan. 2016.

scope of this guide, the distinguishing feature of a blockchain is an automated and decentralized peer-to-peer network of computers, all of which have a copy of the ledger that reflects every transaction that has taken place on the chain. For example, the bitcoin blockchain has a distributed ledger of all bitcoin transactions on the chain. Advanced cryptography only allows a new block of transactions to be added to the chain when more than half the computers on the network affirm its validity.

- **Initial Coin Offerings and “Tokens.”** In recent months, entrepreneurs have successfully raised over \$3 billion through so-called initial coin offerings (ICOs.)⁴ Most of the projects make some use of blockchain technology. Although ICOs have taken a few different forms, in most cases the entrepreneur publishes a white paper outlining its business proposal and then sells virtual “tokens” to the public to raise capital. These tokens are typically based on a uniform protocol that operates on the Ethereum blockchain. In other words, the tokens are processed on the Ethereum blockchain and conform to certain standards with respect to how they can be issued and exchanged. Token issuers often use the proceeds from the token sale to fund their venture, while token holders have the right to resell their tokens in the future. Significantly, token holders usually do not have any equity or dividend rights in the venture. These tokens will typically be used to gain access to, or use the services of, the platform or application being built, and in some cases are used to raise capital for a fund that will invest in blockchain ventures.⁵
- **Comparing Cryptocurrency to ICO Tokens.** Tokens that are issued pursuant to an ICO share certain attributes with a virtual currency. For example, ICO tokens can also be used as a medium of exchange on certain platforms since token holders can exchange their tokens for cryptocurrency and, in some cases, other tokens. However, while cryptocurrency such as bitcoin can, in theory, be used to purchase multiple goods and services, tokens can typically be used only in connection with a specific project or platform. For example, a token issued for a social network blockchain might be required to gain access to that platform but would not have any other “use.” To many, the singular use of a token is what distinguishes it from a cryptocurrency.

⁴ See [Cryptocurrency ICO Stats 2017](#) (last visited Nov. 13, 2017).

⁵ See SEC, Release No. 81207, “[Report of Investigation Pursuant to Section 21\(a\) of the Securities Exchange Act of 1934: The DAO](#),” at 10 (July 25, 2017).

FAQ:

Is Virtual Currency a Commodity?

Yes. On September 17, 2015, the CFTC entered into a settlement order against a trading platform that listed bitcoin options.⁶ The CFTC noted the breadth of the CEA’s definition of “commodity”⁷ — which literally covers all goods, rights, articles, interests and services, in which futures contracts are or may be traded — and determined that “bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.” The breadth of the statutory commodity definition is confirmed by the fact that Congress has excluded only two things from that definition — onions and movie box office receipts.

What Are the Regulatory Implications of Virtual Currency Being a Commodity?

Virtual currency’s status as a commodity means that the CFTC could exercise its anti-fraud and anti-manipulation authority over virtual currency transactions. The CFTC has asserted its anti-fraud authority with respect to the offering, purchase or sale of virtual currency under CEA Section 6(c)(1) and CFTC Rule 180.1, both of which apply to “a contract of sale of **any commodity** in interstate commerce.”⁸ The CFTC is also likely to assert its anti-manipulation authority in this space under CEA Section 9(a)(2), since that authority similarly extends over “**any commodity** in interstate commerce.”⁹ Other than these enforcement-type powers, the CFTC would exercise only limited regulatory authority over virtual currency that is a commodity.

What CFTC Regulation Would Apply to Futures or Swaps on Virtual Currency?

The CEA imposes, and the CFTC administers, a comprehensive regulatory structure for trading in futures contracts and swaps. This structure includes registration, reporting, business conduct

⁶ *In re Coinflip, Inc.*, CFTC No. 15-29, 2015 WL 5535736, Comm. Fut. L. Rep. (CCH) ¶ 33,538 (Sept. 17, 2015).

⁷ *Id.* at *3. The VC Primer also points out that the definition of “commodity” under the CEA is broad. See LabCFTC Release (PR 7631-17), *supra* note 1.

⁸ See Complaint for Injunctive and Other Equitable Relief and for Civil Monetary Penalties Under the Commodity Exchange Act and Commission Regulations at 2, *CFTC v. Gelfman Blueprint, Inc.*, No. 1:17-cv-07181 (S.D.N.Y. Sept. 21, 2017), ECF No. 1 (emphasis added) (alleging that a bitcoin investment scheme was a deceptive device with respect to a commodity in interstate commerce).

⁹ CEA Section 9(a)(2) (emphasis added).

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standards and financial integrity protections. If a virtual currency underlies a swap or a futures contract, the swap or futures contract generally would be subject to that comprehensive regulatory jurisdiction (not only the anti-fraud and anti-manipulation provisions).¹⁰ If a virtual currency underlies a contract offered on a margined basis to retail customers (referred to in the FAQ as “margined retail commodity transactions”), and is not otherwise exempt, the transaction would be prohibited unless traded on a CFTC-regulated futures exchange like all other futures contracts. Two principal exemptions under the CEA’s margined retail commodity transaction provision are for transactions that (1) are a security, or (2) result in actual delivery of the commodity within 28 days.¹¹

Would Virtual Currency Be Considered an ‘Excluded Commodity’ or an ‘Exempt Commodity,’ and Why Does That Distinction Matter?

Both excluded and exempt commodities are subject to CFTC jurisdiction and may underlie futures contracts, swaps or margined retail commodity transactions. The regulatory treatment of excluded and exempt commodities is not identical, however, so it may be important to understand whether virtual currency is an excluded or exempt commodity. Based on the CFTC’s actions to date, it appears that the CFTC will treat virtual currency as an exempt commodity. Until the CFTC definitively resolves this question, however, some uncertainty will remain.

It might seem that virtual currencies would fall under the definition of “excluded commodity” because that definition includes “an interest rate, exchange rate, **currency**, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure.”¹² However, in a 2015 settlement order, the CFTC stated that virtual currency was not “real currency” in the course of determining that the respondents were operating an unregistered commodity options exchange with bitcoin as the

underlying commodity.¹³ Although the CFTC did not directly tie this statement to the term “currency” in the definition of excluded commodity, the statement suggests that the CFTC would not categorize virtual currency as an excluded commodity. The CFTC instead implied that virtual currency was an exempt commodity by considering whether the bitcoin options at issue were offered pursuant to the Trade Option exemption under CFTC Rule 32.3.¹⁴ The Trade Option exemption applies to exempt commodities¹⁵ (as well as agricultural commodities) but not to excluded commodities.¹⁶

Could Virtual Currency Be Considered Foreign Currency?

Given that the CFTC characterized virtual currency as not being “real currency” in *Coinflip*, it is unlikely that virtual currency would be considered foreign currency. As further evidence of the CFTC’s view, it chose not to analyze leveraged bitcoin contracts in *In re BFXNA Inc.* as retail foreign exchange transactions under CEA Section 2(c)(2)(C).¹⁷ Rather, the CFTC relied on CEA Section 2(c)(2)(D), which covers margined retail commodity transactions (but not transactions in foreign currency).

What if a Foreign Country Recognized a Virtual Currency as Its Own Currency?

It is unclear how the CFTC would handle a foreign country recognizing a virtual currency as its legal tender. Russia and China are rumored to be considering such a step. If that situation arose, certain foreign exchange regulatory provisions under the CEA could apply.

¹⁰The Chicago Mercantile Exchange (CME) and the Chicago Board Options Exchange (CBOE) both plan to offer bitcoin-based futures contracts. See Evelyn Cheng, “Bitcoin Surges to Record Above \$6,400 After CME Announces Launch of Futures for Digital Currency,” CNBC (Oct. 31, 2017),; see also Evelyn Cheng, “CBOE Plans to Launch Bitcoin Futures, Announces Agreement With Winklevoss Brothers’ Digital Currency Exchange,” CNBC (Aug. 2, 2017). In addition, LedgerX has begun offering bitcoin options. See Camila Russo, “Bitcoin Options Will Be Available This Fall,” Bloomberg (July 24, 2017).

¹¹ See CEA Section 2(c)(2)(D).

¹² CEA Section 1a(19)(i) (emphasis added).

¹³ See *In re Coinflip, Inc.*, 2015 WL 5535736, at *4 (“Bitcoin and other virtual currencies are distinct from ‘real’ currencies, which are the coin and paper money of the United States or another country that are designated as legal tender, circulate, and are customarily used and accepted as a medium of exchange in the country of issuance.”).

¹⁴ *In re Coinflip, Inc.*, 2015 WL 5535736, at * 3.

¹⁵ An exempt commodity is “a commodity that is not an excluded commodity or an agricultural commodity.” CEA Section 1a(20).

¹⁶ 17 C.F.R. § 32.3(a)(3). If a commodity option meets the criteria of the Trade Option exemption, it will generally be exempt from the CFTC’s swap regulations. Assuming that virtual currency is an exempt commodity, the Trade Option exemption potentially could apply to commercial users of virtual currency, such as retailers that accept virtual currency as payment. See “[Bitcoins and the Blockchain: The CFTC Takes Notice of Virtual Currencies](#),” Skadden client alert, Jan. 2016. On the other hand, as an exempt commodity, virtual currency would not be eligible for the special, light regulatory treatment Congress provided for certain currency-based forwards and swaps. See “[Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act](#),” 77 Fed. Reg. 69,694, 69,705 (Nov. 20, 2012) (using power granted to it under the CEA, see 7 U.S.C. § 1a(47)(E), Treasury Department determines that foreign exchange forwards and swaps should be carved out of the definition of “swap” under the CEA for most regulatory purposes); see also “[CFTC Asserts Jurisdiction in Bitcoin Markets](#),” Skadden client alert, Sept. 2015.

¹⁷ See generally *In re BFXNA Inc.*, CFTC No. 16-19, 2016 WL 3137612, Comm. Fut. L. Rep. (CCH) ¶ 33,766 (June 2, 2016).

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What if a Virtual Currency Is Considered a Security?

To date, neither the CFTC nor the SEC has determined that a virtual currency is a security.¹⁸ If a virtual currency was determined to be a security, a *futures contract* on that security could be considered a securities futures product subject to a special regulatory regime administered by the CFTC and SEC. A *swap* on that security could be considered a security-based swap subject to regulation by the SEC.

Are Tokens a Commodity?

Tokens could be commodities given the broad statutory definition of the term “commodity.” With respect to what CEA regulations apply, the considerations for tokens that are commodities would be the same as the considerations we discuss above for virtual currency as a commodity. If a token that is a commodity were referenced in a swap or futures contract, then the futures contract would be subject to CFTC regulatory jurisdiction, as would the swap, provided that the token is not a security.¹⁹

What if a Token Is Considered a Security?

The SEC has recently weighed in on whether a token can be a security and has said that it would need to consider the facts and circumstances, including the economic substance of the transaction rather than the form. As noted above with respect to virtual currency, if a token was determined to be a security, then a *futures contract* on that security could be considered a securities futures product subject to a special regulatory regime administered by the CFTC and SEC. A *swap* on that security could be considered a security-based swap subject to regulation by the SEC.

¹⁸In analyzing whether a token was a security, the SEC did not analyze whether the virtual currency (ether) used to purchase the tokens was a security. See SEC, Release No. 81207, *supra* note 5. With respect to whether tokens are securities, in an interview following a recent speech at the Institute on Securities Regulation, SEC Chairman Jay Clayton stated, “[w]hen you depart from the bitcoin or the ethereum, and you get into the tokens, the hallmarks become pretty clear.” See Dave Michaels and Paul Vigna, “SEC Chief Fires Warning Shot Against Coin Offerings,” *The Wall Street Journal* (Nov. 9, 2017).

¹⁹See LabCFTC Release (PR 7631-17), *supra* note 1 (“There is no inconsistency between the SEC’s analysis and the CFTC’s determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.”).

Could an Instrument Be Both a Commodity and a Security?

Yes. It is well established that some instruments can be both commodities and securities. The CEA and federal securities laws have provisions that effectuate CFTC and SEC agreements on how jurisdiction is to be allocated when a security is the subject of a futures contract, option or swap. For example, Treasury notes and bonds are securities.²⁰ When they are the subjects of a futures contract (and a related option) or a swap, these securities also are considered to be commodities under the CEA. In contrast, when Treasury notes or bonds are the subjects of an option they generally are treated as securities and subject to SEC regulatory jurisdiction. Under these CFTC-SEC agreements, the CFTC has jurisdiction over options on currency, except options on currency that are traded on a national securities exchange as securities, which are subject to SEC jurisdiction.

Could Virtual Currency or ICOs Be Considered a ‘Commodity Pool’ Subject to CFTC Regulation?

Whether a virtual currency or an ICO could be a commodity pool remains an unanswered question. The “commodity pool” definition refers to “any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in ‘commodity interests’”²¹ (*i.e.*, derivative contracts on commodities, such as futures, security futures products, swaps and margined retail commodity transactions).²² The CFTC tends to interpret this definition broadly. Even under its broad interpretation, however, the term commodity pool would seem to be aimed at capturing vehicles that are used to invest in “commodity interests” involving virtual currency rather than capturing the virtual currency itself.

Whether an ICO could be a commodity pool appears to be the more interesting question. If an ICO is structured as a vehicle that invests in commodity interests, it could be viewed as a commodity pool, but the analysis would depend on all the

²⁰Treasury notes and bonds are exempted securities under the securities laws. Futures contracts on exempted securities are subject to regulation like most other commodities under the CEA. However, futures contracts on nonexempted securities (like stocks) are subject to special and heightened regulation under the CEA.

²¹CEA Section 1a(10)(A) (“The term ‘commodity pool’ means any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests. ...”).

²²CEA Section 1a(10)(A)(i)-(iii).

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relevant facts and circumstances. For example, it is likely that the CFTC would closely analyze under the commodity pool definition an ICO that offers tokens for purposes of investing in futures or swaps. Similarly, the CFTC is likely to analyze whether the entrepreneur promoting the ICO is a “commodity pool operator”²³ and potentially subject to registration with the CFTC.

* * *

The regulatory treatment of virtual currency and virtual tokens is evolving rapidly as administrative agencies attempt to keep pace with even more rapid financial market developments and technological innovation. The FAQ in this alert are designed to provide guidance on the current regulatory landscape with the recognition that frequent updates may well be necessary, and which we intend to provide.

²³CEA Section 1a(11).

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