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Client Update
LabCFTC Primer: The CFTC's Views on Regulation of Virtual Currencies

LabCFTC, an initiative launched by the U.S. Commodity Futures Trading Commission (the "CFTC") in May 2017, recently issued its Primer on Virtual Currencies (the "Primer").[1]

The Primer summarizes a number of points that are generally consistent with the market's current understanding of the CFTC regulatory landscape. It provides a good overview of the development of the CFTC's claim to jurisdiction over certain transactions in virtual currencies. It also provides an opportunity to take stock of open issues that have not yet been resolved by the CFTC.

BACKGROUND ON VIRTUAL CURRENCIES

After providing a brief introduction to virtual currencies (including Bitcoin in particular)[2] and the features of blockchains,[3] the Primer points out that:

- Bitcoin and other virtual currencies have been determined by the CFTC to be commodities.

- The CFTC has jurisdiction over virtual currency transactions if they involve derivatives or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.

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[1] The primer is available at http://www.cftc.gov/PressRoom/PressReleases/pr7631-17. The stated goal of LabCFTC is to serve as the focal point of FinTech policy consideration and development by the CFTC. LabCFTC indicates that its primers are intended to be educational tools, and they are not intended to describe the official policy or position of the CFTC.

[2] The Primer reaffirms the CFTC's definition of a 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, but that does not have legal tender status.

[3] The Primer describes blockchains as distributed ledger systems that capture "blocks" of transactions, and it notes that such distributed ledger technology underpins many virtual currencies, but can also be used within private, permissioned ledger systems. This description of blockchains appears to be limited to blockchains of the type underpinning Bitcoin. Virtual currencies minted and circulated on blockchains using different types of validation mechanisms (such as a proof of stake) can equally be regulated by the CFTC.

- Outside of instances of fraud or manipulation, the CFTC does not generally oversee spot or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage or financing.

VIRTUAL CURRENCIES AS COMMODITIES

The Primer reiterates the CFTC's view that the definition of "commodity" in the Commodity Exchange Act (the "CEA") is broad and includes "all services, rights and interests…in which contracts for future delivery are presently or in the future dealt in." The CFTC first found that Bitcoin and other virtual currencies are commodities in 2015.

Coinflip

From March 2014 to August 2014, Coinflip, Inc. and its CEO, Francisco Riordan, operated an online trading facility called Derivabit that designated numerous put and call options on Bitcoin as eligible for trading on the Derivabit platform.[4] The CFTC found that such activity constituted the operation of a facility for the trading or processing of "swaps" (as defined in section 1a(47) of the CEA) without registration under the CEA and the CFTC regulations as a swap execution facility ("SEF") or designated contract market ("DCM"). The CFTC also found that, because Bitcoin and virtual currencies are commodities, Coinflip violated sections of the CEA and the CFTC regulations that prohibit a person from offering to enter into, entering into, confirming the execution of or otherwise conducting any activity related to any commodity option transaction without meeting certain additional requirements.[5]

TeraExchange

In the TeraExchange matter, the CFTC issued an order holding that TeraExchange LLC, a provisionally registered swap execution facility ("SEF"), had actively arranged two offsetting non-deliverable forwards based on Bitcoin and U.S. dollars, which constituted both wash trades and prearranged trades in violation of the CEA.[6] The CFTC found that, in doing so, Tera violated

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[4] *In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (Sep. 17, 2015), available at: http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/ enfcoinfliporder09172015.pdf. Our prior Client Update regarding the CFTC's holdings that Bitcoin and other virtual currencies are commodities is available at: https://www.debevoise.com/~/media/files/insights/ publications/2015 /10/20151004_in_two_recent_orders_cftc_holds_that_bitcoins_are_commodities.pdf.

[5] Such additional requirements are either (i) registration as a SEF or DCM or (ii) compliance with the CFTC's "trade option" exemption. The CFTC's order in Coinflip found that the Bitcoin option contracts did not comply with the trade option exemption. Additional information on the CFTC's trade option exemption is available in our Client Update, "CFTC Final Rules on Commodity Options" (Apr. 20, 2012), available at: http://www.debevoise.com/insights/publications/2012/04/cftc-final-rules-on-commodity-options.

[6] *In the Matter of TeraExchange LLC*, CFTC Docket No. 15-33 (Sep. 24, 2015), available at: http://www.cftc.gov/ idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf.

its obligation under the CEA and the CFTC regulations to enforce rules prohibiting wash trading and prearranged trading on its SEF platform.

Bitcoin is certainly a commodity subject to the CEA, particularly in light of the CME's planned listing of Bitcoin futures for trading.[7] The issue is whether all cryptocurrencies should be treated as commodities. Altcoin and Litecoin, which have no functionality other than as a store of value and a purported medium of exchange, are commodities, even if no futures on either of them are currently traded. Ethereum tokens (ETH) started out, and are actively used, as utility tokens used to power smart contracts on the Ethereum protocol, but they are actively traded and purchased and held in many instances by those who have no plan or intention of using them to put any smart contracts on the Ethereum protocol. In other words, ETHs are utility tokens as well as virtual currencies, and the CFTC certainly treats them as commodities. The same can be said about Ripple tokens (XRP).

A more difficult question is whether a utility token or security token that has functionality other than as a store of value or medium of exchange should be treated as a commodity if a large number of investors hold it as an investment. In addition, given the evolution of ETH from a pure utility token to a combination of utility token and virtual currency, a pure utility token may evolve into a virtual currency and may be regarded as a commodity. In that case, it is not clear at what point in time such a token will be considered as a commodity. It is possible that the CFTC may ultimately take the view that all blockchain tokens are commodities since the early buyers of tokens are almost invariably investors.

PERMITTED ACTIVITIES

While clearly not exhaustive, the Primer provides several examples of activities involving virtual currencies that are permitted under the CEA and CFTC regulations. Permitted activities include:

- The listing of a Bitcoin swap for trading by "eligible contract participants" on a SEF.

  The CFTC uses *TeraExchange* as an example of such a permitted activity. Although TeraExchange consented to an order by the CFTC in 2015 instituting sanctions for its failure to enforce wash trading and prearranged trading rules (as discussed above), it is used by LabCFTC here as an example of a permitted listing of Bitcoin swaps for trading on a registered (or provisionally registered) SEF platform by eligible contract participants.

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[7] See *CME Group Announces Launch of Bitcoin Futures*, CME Group News Release (Oct. 31, 2017), available at: http://www.cmegroup.com/media-room/press-releases/2017/10/31/cme_group_announceslaunchofbitcoin futures.html.

- The establishment of a derivatives exchange as a DCM listing binary options based on a Bitcoin price index for trading by customers, including retail customers.

  With respect to the establishment of a derivatives exchange as a DCM, the Primer points to *NADEX* (the North American Derivatives Exchange Inc.). NADEX listed binary options based on the Tera Bitcoin Price Index for trading on its DCM from November 2014 to December 2016.

- The listing of digital currency options by a registered SEF for trading and the clearing and settlement of transactions in such options through a derivatives clearing organization ("DCO").

  In this last category, the Primer provides the example of *LedgerX*. In July 2017, LedgerX, LLC became registered as a SEF and as a DCO, and it intends to list digital currency options for trading by eligible contract participants. The CFTC's order of registration as a DCO indicates that LedgerX is permitted to clear fully collateralized digital currency swaps and that a contract cleared by LedgerX will be considered fully collateralized if LedgerX holds, at all times, funds sufficient to cover the maximum possible loss a counterparty could incur upon liquidation or expiration of the contract, in the form of the required payment.[8]

PROHIBITED ACTIVITIES

The Primer also provides several examples of prohibited activities, including:

- Price manipulation of a virtual currency traded in interstate commerce.

- Pre-arranged or wash trading in an exchange-traded virtual currency swap or futures contract.

- Trading of a virtual currency futures or option contract or swap on a U.S. domestic platform or facility that has not registered as a SEF or a DCM.

- Certain schemes involving virtual currencies marketed to retail customers, such as off-exchange financed commodities transactions with persons who fail to register with the CFTC.

LabCFTC does not call out specific names here. But the references to pre-arranged or wash trading and trading of options on an unregistered domestic platform seem to line up well with the TeraExchange and Coinflip matters discussed previously.

LabCFTC's references to price manipulation may relate to statements made by one or more CFTC Commissioners as far back as 2014. For example, former Commissioner Mark Wetjen

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[8] See *In the Matter of the Application of LedgerX, LLC For Registration as a Derivatives Clearing Organization* (Jul. 24, 2017), available at: http://www.cftc.gov/PressRoom/PressReleases/pr7592-17.

indicated in an article in 2014 that the CFTC would have authority to bring enforcement actions against anyone who attempts to manipulate a virtual currency.[9]

Bitfinex

The Primer's reference to schemes involving virtual currencies marketed to retail customers is based on the Bitfinex matter.[10] Bitfinex was, at the time, a British Virgin Islands company that was not registered in any capacity with the CFTC. Bitfinex was operating an online platform for exchanging and trading virtual currencies. Unlike Coinflip and TeraExchange, which both involved derivatives, Bitfinex did not list or permit the trading of derivatives (such as futures, options or swaps). Rather, Bitfinex facilitated spot transactions in virtual currencies.

The Bitfinex platform permitted users, including those who did not meet the definition of eligible contract participant or eligible commercial entity, to borrow funds from other users on the platform in order to trade Bitcoins on a leveraged, margined or financed basis. The CFTC found that during the relevant period, Bitfinex did not "actually deliver" Bitcoins to the traders who purchased them because the purchased Bitcoins either were held in Bitcoin deposit wallets that Bitfinex owned and controlled until such time as outstanding loans and fees were paid in full or were held in multi-signature wallets established by a third party over which Bitfinex retained control of the private keys until such time as outstanding loans and fees were paid in full. The CFTC also concluded that Bitfinex's accounting for individual customer interests in its own database was insufficient to constitute "actual delivery."

The CFTC's conclusion regarding absence of "actual delivery" is significant because that is the basis for the CFTC's enforcement action against Bitfinex. Section 2(c)(2)(D) of the CEA provides that an agreement, contract or transaction in any commodity that is (i) entered into with, or offered to, a person that is not an eligible contract participant (or eligible commercial entity) and (ii) entered into, or offered, on a leveraged or margined basis, or financed by the offeror, the counterparty or a person acting in concert with the offeror or counterparty on a similar basis, must be executed and effected on a DCO. However, any such agreement, contract or transaction that results in "actual delivery" of the commodity within 28 days from execution is exempt from such provisions, so long as it is not a swap, future or option.

Because the trading platform managed by Bitfinex was not a registered DCO and, as noted above, the CFTC concluded that there was no actual delivery of Bitcoin in a financed transaction executed on such platform, Bitfinex violated section 2(c)(2)(D) of the CEA. The CFTC also

9   See Mark Wetjen, *Bringing Commodities Regulation to Bitcoin*, Wall St. J. (Nov. 3, 2014), available at: http://www.wsj.com/articles/mark-wetjen-bringing-commodities-regulation-to-bitcoin-1415060058.

10 *In the matter of: BFXNA Inc d/b/a Bitfinex*, CFTC Docket No. 16-19 (Jun. 2, 2016), available at: http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf.

found that Bitfinex violated the CEA by failing to register as a futures commission merchant in connection with the solicitation or acceptance of orders for, and the acceptance of money in connection with, retail commodity transactions.

IMPLICATIONS FOR VIRTUAL TOKENS AND ICOS

The Primer references the recent report of the Securities and Exchange Commission (the "SEC") regarding "The DAO" (the "DAO Report").[11] The DAO is an example of a "Decentralized Autonomous Exchange," which is a virtual organization embodied in computer code and executed on a blockchain or other type of distributed ledger. Investors in The DAO exchanged ETHs for virtual "DAO Tokens" to fund projects in which the investors would share in anticipated earnings. The DAO Tokens could be resold on web-based platforms.

The SEC determined that DAO Tokens are securities under the federal securities laws. In reaching that conclusion, the SEC employed a facts-and-circumstances test originally set forth in the U.S. Supreme Court decision in *SEC v. W.J. Howey Co.*[12]

In the Primer, LabCFTC states that there is no inconsistency between the SEC's analysis in the DAO Report concluding that certain virtual tokens (or the arrangements pursuant to which they are offered or issued) are securities 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. As the SEC and the CFTC both have from time to time asserted jurisdiction over a particular financial instrument and they share jurisdiction over certain financial instruments (such as mixed swaps), this statement is not a surprise. Some blockchain tokens will definitely fall under the dual jurisdiction of the CFTC and SEC.

VIRTUAL CURRENCY RISKS

The Primer closes with a summary of risks of virtual currencies, which primarily seems to be aimed at potential investors in virtual currencies and similar investments. These include operational risks, cybersecurity risks, speculative risks and fraud and manipulation risks.[13]

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[11] *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, SEC Release No. 34-81207 (Jul. 25, 2017), available at: https://www.sec.gov/litigation/investreport/34-82107.pdf. For more on recent developments regarding token sales, see Debevoise's client update, "Developments in the Enforcement of Token Sales" (Nov. 13, 2017), available at: http://www.debevoise.com/insights/publications/2017/11/developments-in-the-enforcement-of-token-sales.

[12] 328 U.S. 293 (1946). In summary, *Howey* provides that an investment contract (which is a type of security) is (i) an investment of money, (ii) in a common enterprise, (iii) with profits to come solely from the efforts of others.

[13] In this last category, the Primer includes, among other risks, the risk of Ponzi schemers and other fraudsters seeking to capitalize on the current attention focused on virtual currencies.

Operational Risk

The Primer points out that many of the virtual currency platforms are not subject to the supervision that applies to regulated exchanges. For example, if a platform engages in only certain spot or cash market transactions and does not utilize margin, leverage or financing, such platform may be subject to federal and state money transmission and anti-money laundering laws, but it is not required to follow any of the rules that would apply to the operation of a regulated exchange.

The Primer also notes that some virtual currency platforms may be missing critical system safeguards and customer protection-related systems. As such, customers could lose some or all of their virtual assets.

Cybersecurity Risk

LabCFTC notes that some platforms may commingle customer assets in shared accounts (whether at a bank for fiat currency or a digital wallet for virtual currency), and this may affect whether or how a customer can withdraw currency. The Primer also notes that depending on the structure and security of a digital wallet, some accounts may be vulnerable to hacks, which could result in the theft of virtual currency.

Speculative Risk

The Primer indicates that the virtual currency marketplace has been subject to substantial volatility and price swings, and an individual or coordinated group trading a large amount of virtual currency at once could affect the price. The Primer also notes that periods of high volatility with inadequate trading volume may create adverse market conditions, leading to harmful effects such as customer orders being filled at undesirable prices.

LabCFTC also points to the fact that some advertisements may seem to promise guaranteed returns, and notes that this can be a common tactic with fraudulent schemes.

Fraud and Manipulation Risk

The Primer asserts that unregistered virtual currency platforms may not be able to protect adequately against market abuses by other traders. In this regard, LabCFTC points out that recent news articles discuss potential "spoofing" activity and other manipulative behavior that can affect prices negatively.

The Primer also asserts that some virtual currency platforms may be selling virtual currency directly from the platform's own account. Such transactions may give the platform unfair advantages and sometimes could resemble fraudulent "bucket shop" schemes.

Finally, LabCFTC notes that there is a risk of Ponzi schemers and fraudsters seeking to capitalize on the current attention focused on virtual currencies. Although the Primer does not give specific examples, we note that the CFTC recently issued a press release announcing the filing of its first anti-fraud enforcement action involving Bitcoin.[14] In this action, the CFTC charges a Brooklyn-based company and its CEO with operating a Bitcoin Ponzi scheme in which they fraudulently solicited monies from investors, purportedly for placement in a pooled commodity fund making Bitcoin investments. The CFTC alleges that, in fact, the trading strategy was fake, purported performance reports were false and payouts to investors actually consisted of other customers' misappropriated funds. The press release includes a statement by James McDonald, the CFTC's Director of Enforcement, that part of the CFTC's continued commitment to facilitating market-enhancing FinTech innovation "includes acting aggressively and assertively to root out fraud and bad actors in these areas."

UNRESOLVED AND DEVELOPING POINTS

Another Look at Bitfinex

The Primer was silent on some unresolved points. For example, the Bitfinex matter made it clear that the CFTC intends to assert jurisdiction over certain retail commodity transactions that involve financing, leverage or margin and which do not result in actual delivery of the underlying virtual currency within 28 days. Although the CFTC determined that actual delivery had not occurred in the Bitfinex scenario, the CFTC did not explicitly set forth circumstances that would constitute actual delivery.

This raises questions as to what constitutes actual delivery of Bitcoin or other virtual currencies. For example, does actual delivery occur when ownership of the virtual currency is changed on a third party's books, or only when a transfer happens on the blockchain? If the latter, what constitutes the completion of a transfer on the blockchain in light of the complexities of cryptographic key management? These key questions remain unresolved. But CFTC Commissioner Brian Quintenz recently indicated in remarks at a trade conference that "the CFTC is working very hard to provide a suitable response to that question."[15]

The Bitfinex order suggests that one approach would be to require that the virtual currency be transferred to a deposit wallet for which the recipient controls the private key(s). However, representatives for industry participants have identified potential weaknesses with this

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[14] *CFTC Charges Nicholas Gelfman and Gelfman Blueprint, Inc. with Fraudulent Solicitation, Misappropriation, and Issuing False Account Statements in Bitcoin Ponzi Scheme*, CFTC Release pr7614-17 (Sep. 21, 2017), available at: http://www.cftc.gov/PressRoom/PressReleases/pr7614-17.

[15] *Keynote Remarks of Commissioner Brian Quintenz before the Symphony Innovate 2017 Conference*, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz1.

approach as the sole determinant of delivery.[16] For example, there is no inherent attribute of the blockchain that defines how a private key may be used to authorize or effect a transaction. Instead, private keys are a tool used by the parties to effectuate the parties' contractual agreements when they choose to transfer property using the blockchain.

Coinbase Flash Crash

The Primer also made no mention of an apparent investigation into a June 2017 flash crash on Coinbase's GDAX platform.

Although neither Coinbase nor the CFTC has made the letter public, unofficial sources indicate that the CFTC recently sent a letter to San Francisco-based Coinbase Inc. requesting information about a June 21, 2017 incident on its GDAX platform.[17] On June 21, ETH crashed from $317.81 to $0.10 in milliseconds, before quickly recovering. The crash occurred when a single sell order of approximately $12.5 million initiated a domino effect.

Unofficial sources suggest that among the areas of focus of the CFTC is the role that leverage might have played in this flash crash. Coinbase indicates on its website that it is registered as a money services business with the Financial Crimes Enforcement Network (FinCen) and is licensed to engage in money transmission in most U.S. jurisdictions, but Coinbase currently holds no registrations with the CFTC. Given the CFTC's willingness to assert jurisdiction over spot market transactions that involve leverage, it would not come as a surprise if the CFTC uses this as an opportunity to reinforce or expand its jurisdictional claim.

WRAPPING UP

Although the Primer did not make any new or unsurprising statements regarding the regulatory treatment of virtual currencies, it is useful as a summary of the current state of regulation. It is also indicative of the increased regulatory focus on virtual currencies and related instruments.

As recent events and CFTC commentary suggests, virtual currencies are likely to be a hot topic for regulators in the coming months and years.

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[16] See, e.g., Letter from Steptoe & Johnson LLP to the CFTC (Jul. 1, 2016), available at: https://www.scribd.com/document/318854044/Cftc-Petition?irgwc=1&content=10079&campaign= Skimbit%2C%20Ltd.&ad_group=78380X1529106X5d79c810d1fbf6b32eefd665cd299396&keyword=ft750noi& source=impactradius&medium=affiliate#from_embed.

[17] See, e.g., Lily Katz and Matt Robinson, *Cryptocurrency Flash Crash Draws Scrutiny from Watchdog* (Oct. 2, 2017), available at: https://www.bloomberg.com/news/articles/2017-10-02/cryptocurrency-flash-crash-is-said-to-draw-scrutiny-from-cftc.

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