Client Update
In Two Recent Orders, CFTC Holds that Bitcoins Are Commodities

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On September 17, 2015, the Commodity Futures Trading Commission (the "CFTC") issued an order (the "Derivabit Order"), holding that virtual currencies, including Bitcoin, are commodities subject to the Commodity Exchange Act (the "CEA")[1] and finding that, from March 2014 to August 2014, Coinflip, Inc. ("Coinflip") and its CEO, Francisco Riordan, operated an online trading facility named Derivabit that offered commodity options without registering as a designated contract market ("DCM") or swap execution facility ("SEF") under the CEA and CFTC regulations.

On September 24, 2015, the CFTC issued an order (the "Tera Order"),[2] holding that TeraExchange LLC ("Tera"), a provisionally registered SEF, by actively facilitating the execution of a Bitcoin swap, had violated its obligation under the CEA and the CFTC regulations to enforce rules prohibiting wash trading and prearranged trading on its SEF platform.

These orders are noteworthy because they are the first enforcement actions taken by the CFTC with respect to Bitcoin transactions and because the orders and related comments of CFTC staff suggest the agency will closely monitor such transactions. For instance, commenting on the Derivabit Order, the CFTC's Director of Enforcement, Aitan Goelman, said: "While there is a lot of excitement surrounding Bitcoin and other virtual currencies, innovation does

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[1] *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/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf.

[2] *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.

not excuse those acting in this space from following the same rules applicable to all participants in the commodity derivatives markets." [3]

BACKGROUND

The Derivabit Order finds that Coinflip and Riordan operated Derivabit as an online trading platform that offered to connect buyers and sellers of Bitcoin option contracts. Derivabit designated numerous put and call options for the delivery of Bitcoins as eligible for trading on the Derivabit platform, allowing its approximately 400 users to post bids and offers for the Bitcoin option contracts, [4] which were confirmed by Coinflip by communicating the bids and offers to all users through its website.

The Tera Order finds that, on October 8, 2014, two traders on Tera executed a non-deliverable forward based on Bitcoin and U.S. Dollars, and six minutes after the execution of such trade, the same traders executed a fully offsetting second non-deliverable forward, which effectively cancelled the first trade without resulting in any P/L consequences to the two traders. As facilitated by Tera's employees, the two traders prearranged the two trades with the understanding that the parties would be matched to result in no net financial result. The two traders were the only market participants on Tera who had completed the membership process and received trading privileges on the SEF at that time. Because the two transactions offset each other, they did not create any bona fide position in Bitcoin; further, Tera did not charge any transaction fee or commission to either trader, so there were no transaction costs associated with these two transactions.

BITCOIN AND VIRTUAL CURRENCIES AS COMMODITIES

In the Derivabit Order, the CFTC defines virtual currencies, such as Bitcoin, as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction." The Derivabit Order distinguishes these virtual currencies from "real" currencies, defined as "the coin and paper money of the United States or

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[3] CFTC Press Release (Sep. 17, 2015), available at: http://www.cftc.gov/PressRoom/PressReleases/pr7231-15.

[4] Beginning in July 2014, Coinflip offered "OTC Bitcoin Forward Contracts," whereby a Derivabit user would be matched through competitive bidding with a counterparty to execute a contract to exchange U.S. Dollars for Bitcoins at a predetermined price and date. While the Derivabit Order indicates that such activities may have violated or led to violations of the CEA, the CFTC declined to settle this question in the Derivabit Order.

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."

Without providing a detailed legal analysis, the CFTC holds that Bitcoin and other virtual currencies fall within the definition of "commodity" under section 1a(9) the CEA, which definition includes, among other things, "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." In support of this holding, the CFTC also points to the broad definition of the term "commodity" under the CEA, citing a 1982 Seventh Circuit Court of Appeals case[5] which held that the CFTC (rather than the Securities and Exchange Commission) has jurisdiction over trading in options on Government National Mortgage Association ("GNMA") mortgage-backed pass-through securities, thereby resolving an inter-agency dispute on whether such instruments are both "commodities" under the CEA and "securities" under the Securities Exchange Act. The Seventh Circuit in that case noted that under the CEA's expansive definition of the term "commodity," "literally anything other than onions could become a 'commodity' and thereby subject to CFTC regulation simply by its futures being traded on some exchange." At the time this case was decided in 1982, GNMA futures were being traded on the Chicago Board of Trade.

While there are currently no Bitcoin futures traded or listed on any DCM operating in the United States, Bitcoin futures contracts are traded outside of the United States.[6] Traditionally, despite the definition of "commodity" under section 1a(9) of the CEA, the CFTC has taken the position that an asset, interest or other item becomes a commodity only when futures trading on such asset, interest or other item has commenced. In the Derivabit Order and the Tera Order, the CFTC reached the conclusion that Bitcoins are "commodities" despite the absence of Bitcoin futures being listed or traded in the United States (and without reference to the trading of Bitcoin futures on foreign boards of trade). In light of recent remarks by CFTC Commissioners regarding Bitcoin and other virtual currencies,[7] it should come as no surprise that the CFTC has determined

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[5] *Board of Trade of the City of Chicago v. SEC*, 677 F. 2d 1137 (7th Cir. 1982).

[6] For example, the China-based Bitcoin exchange OKCoin offers Bitcoin-USD futures, but we note that as of August 2015 it has stopped accepting deposits from U.S. customers. See http://www.coindesk.com/okcoin-restricts-bitcoin-deposits-us-customers/.

[7] For instance, in testimony before the U.S. Senate Agriculture Committee in December 2014, Chairman of the CFTC Timothy Massad stated that "derivative contracts based on a virtual currency represent one area within [the CFTC's] responsibility."

that it has a regulatory interest in Bitcoin trading; however, the CFTC has not shed much light on its legal reasoning in these two orders concluding that Bitcoins and virtual currencies are "commodities."

VIOLATIONS

The Derivabit Order finds that the Bitcoin options contracts offered and confirmed by Coinflip were not conducted in compliance with section 5h(a)(1) of the CEA and section 37.3(a)(1) of the CFTC regulations, which prohibit a person from operating a facility for the trading or processing of swaps unless the facility is registered as a SEF or DCM.

The Derivabit Order also finds that the absence of registration of Derivabit as a SEF or DCM triggered other violations of the CEA and the CFTC regulations. Specifically, the Derivabit Order finds that Coinflip[8] violated section 4c(b) of the CEA and section 32.2 of the CFTC regulations, which 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[9] without either (1) complying with the CEA and applicable CFTC regulations and orders thereunder (in this case, section 5h(a)(1) of the CEA and section 37.3(a)(1) of the CFTC regulations) or (2) conducting the transaction pursuant to the "trade option" exemption under section 32.3 of the CFTC regulations. [10]

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[8] The Derivabit Order also finds Riordan personally liable for Coinflip's violations of the CEA and the CFTC regulations based on his (direct or indirect) control of Coinflip and his failure to act in good faith or his knowing inducement of Coinflip's violations. Section 13(b) of the CEA provides that "any person who, directly or indirectly, controls any person who has violated any provision of [the CEA] or any of the rules, regulations, or orders issued pursuant to[the CEA] may be held liable for such violation in any action brought by the [CFTC] to the same extent as such controlled person."

[9] The terms "commodity option" and "commodity option transaction" are defined in section 1.3(hh) of the CFTC regulations to mean "any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'call,' 'put,' 'advance guaranty,' or 'decline guaranty,' and which is subject to regulation under the [CEA] and [the CFTC regulations]." The Derivabit Order finds that because Bitcoin and virtual currencies are commodities, the option contracts offered by Coinflip were "commodity option transactions" and "commodity options" under the CEA and the CFTC regulations.

[10] For additional information on the CFTC's "trade option" exemption, see our client memorandum, "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. The Derivabit Order finds that the Bitcoin option contracts did

The Tera Order finds that the two offsetting non-deliverable forwards based on Bitcoin and U.S. Dollars constituted both wash trades and prearranged trades in violation of Section 4c(a) of the CEA. Based on this finding and the finding that Tera actively arranged the offsetting trades, the Tera Order holds that Tera failed to meet its obligation, under section 5h(f)(2) of the CEA and section 37.203 of the CFTC regulations, to establish and enforce rules prohibiting wash trading and prearranged trading on its SEF platform.

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not comply with the trade option exemption, which requires that the offeror of the option be an eligible contract participant (as defined in section 1a(18) of the CEA) or a producer, processor, or commercial user of, or a merchant handling the commodity, and have a reasonable basis to believe that the offeree is a producer, processer, or commercial user of, or a merchant handling the commodity underlying the option or the products or by-products thereof, and such offeree is offered or entering into the commodity option transaction solely for purposes related to its business as such.