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Alert

Bitcoin Derivatives and Expanded CFTC Jurisdiction

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Bitcoin derivatives are coming to mainstream exchanges. CME Group, one of the world's largest operators of futures exchanges, recently announced that it intends to offer a Bitcoin futures contract by year-end and publicly released the related contract specifications.[1] This announcement was presaged, earlier this year, by the CBOE announcing that it plans to list Bitcoin-based derivatives contracts and LedgerX[2] commencing trading of a Bitcoin option contract.[3]

As a result of these developments, many asset managers may consider increasing their clients' exposure to Bitcoin. These managers should, however, first evaluate whether and how increased trading in Bitcoin derivatives will affect their relationship with the Commodity Futures Trading Commission.

Effect on the 4.13(a)(3) Exemption

Investment managers that rely on the CFTC Rule 4.13(a)(3) exemption from commodity pool operator registration and that trade digital currency derivatives (whether or not listed) for client accounts should be aware that these derivatives likely need to be included in their "de minimis" calculations.[4] It may be particularly difficult for investment managers attempting to rely on the "initial margin" prong of the test to continue to do so with digital currency derivatives exposure in their portfolios, as many Bitcoin derivatives are fully collateralized (or will presumably require a significant level of initial margin).

[1] CME Bitcoin futures will be cash settled. Each contract unit will be five Bitcoins, with a spot month position limit of 1,000 contracts (i.e., 5,000 Bitcoins) and a 5,000 contract accountability level for both the all months and single month limits. Contracts will have a minimum price fluctuation of $25 (see http://www.cmegroup.com/trading/bitcoin-futures.html).

[2] LedgerX is a futures exchange that was approved by the CFTC in July 2017 and started offering a Bitcoin options contract in October.

[3] LedgerX Bitcoin options are physically settled. Each contract unit is one Bitcoin, with a 50,000 per term position limit and an all-months limit of 250,000 contracts. Contracts have a minimum price fluctuation of $25. These contracts are only available to eligible contract participants (see https://ledgerx.com/wp-content/uploads/2017/07/LedgerX-Options-Contract-Specs-v7.28.17-DRAFT.pdf).

[4] This is based on the CFTC's classification of Bitcoin as well as its general jurisdiction over derivatives. In a 2015 settlement, the CFTC took the position that "Bitcoin and other virtual currencies are encompassed in the definition [of a "commodity"] and properly defined as commodities." See *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29, available at http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf. Section 1(a)(47) of the CEA's definition of "swap" (which is defined as a "commodity interest" by CFTC Rule 1.3(y)(y)) includes most derivatives on, among other things, commodities. Thus, once Bitcoins are classified as commodities, Bitcoin derivatives are considered "commodity interests," instruments that are counted for purposes of determining compliance with the de minimis exemption.

Expanding CFTC Digital Currency Jurisdiction

The CFTC generally asserts jurisdiction over commodity (and similar) derivatives contracts but not over the commodities themselves.[5] At times, however, the CFTC has asserted jurisdiction over trading in commodity spot markets under its general anti-manipulation and anti-fraud authority.[6] These interventions have generally been limited to situations where manipulative trading in the spot market affected the associated derivatives market; however, in September, the CFTC took a step beyond that traditional limit by filing a complaint against the alleged masterminds of a Bitcoin-based Ponzi scheme[7] prior to any Bitcoin-based derivative contracts being traded on a U.S. exchange.

These developments indicate that the direct and indirect influence of the CFTC on managers that trade in exposure to digital currencies is likely to increase. Private fund managers and other advisers that are currently, or expect to begin, trading in these instruments should ensure that they have a firm understanding of how their relationship with the CFTC, both as an overseer of registrants and as an arbiter of marketplace conduct, will affect their investment programs.

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[5] In recent guidance, the CFTC staff has indicated that this approach will continue to apply to virtual currencies. Specifically, the CFTC stated: "Beyond instances of fraud or manipulation, the CFTC generally does not oversee 'spot' or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing." (See SRZ's Oct. 18, 2017 *Alert*, "LabCFTC Releases Primer on Virtual Currencies.")

[6] Section 9(1) of the Commodity Exchange Act and CFTC Rule 180.1(a) make it unlawful to engage in manipulative activity with respect to commodity interests or a commodity in interstate commerce. One example of the CFTC asserting such jurisdiction is in a case brought against Atlantic Bullion & Coin Inc., where the defendant was allegedly running a Ponzi scheme by claiming to have purchased physical silver (i.e., manipulation concerning the spot market). (See *CFTC v. Atlantic Bullion & Coin Inc. and Ronnie Gene Wilson*, Civil Action No. 8:12-1502-JMC, available at http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfatlanticcomplaint060612.pdf).

[7] Complaint, *Commodity Futures Trading Commission v. Gelfman Blueprint, Inc. and Nicholas Gelfman* (see http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfgelfmancomplaint09212017.pdf).