

Alert

CFTC Determines That Bitcoin and Other Virtual Currencies Are Commodities

September 18, 2015

On Sept. 17, 2015, the Commodity Futures Trading Commission issued an order against an online platform (and against its sponsor) for facilitating the trading of Bitcoin options contracts.¹ The Order is based on the activities of Francisco Riordan, the chief executive officer of Coinflip Inc., and of Coinflip itself in operating an unregistered online trading platform that enabled trading in Bitcoin-based derivatives.

Background

Beginning in March 2014, the “Derivabit” platform was made available to users as a “risk management platform” that enabled transactions in “standardized Bitcoin options and futures contracts.”² Coinflip, as the operator of the platform, designed and made available for trading numerous put and call options contracts. Bitcoin was the reference asset for the options contracts, and the strike and delivery prices were denominated in U.S. dollars. Premiums and settlement payments, however, were to be made in Bitcoins at a spot exchange rate.³

Resolution of the Action

Holdings and Findings

In the Order, the CFTC sets forth a number of holdings and findings that serve to establish its formal position on the regulatory characterization of virtual currencies such as Bitcoin:

- *First*, the CFTC defined the term “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 does not have legal tender status in any jurisdiction.”⁴

¹ *In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (Sept. 17, 2015) (the “Order”). The Order is available on the [CFTC’s website](#).

² Apparently, futures contracts were never actually offered on the Derivabit platform.

³ While this was not directly addressed for purposes of sanctions, the CFTC also noted that the Derivabit facility made “OTC Bitcoin Forward Contracts” available for trading. Derivabit users were, through the facility, to be matched with other users to execute a contract to exchange U.S. dollars for Bitcoin at a fixed price and date. Initial and maintenance margin was to be calculated, collected and held by Coinflip through the Derivabit platform, and final settlement payments, in Bitcoin, were similarly to be facilitated by the platform.

⁴ Order, at n.2.

- *Second*, the CFTC distinguished — with particularity — virtual currencies from “real” currencies, which it defined as “coin and paper money of [a sovereign state] ... that are designated as legal tender, circulate, and are customarily used and accepted as a medium of exchange in the country of issuance.”
- *Third*, the CFTC held that “Bitcoin and other virtual currencies are encompassed in the definition [of a “commodity”⁵] and [are] properly defined as commodities.”

Given a determination that virtual currencies are commodities, options contracts that reference a virtual currency, therefore, are “commodity options” and “commodity option transactions.” The Order accordingly held that: (1) by offering and entering those contracts on the Derivabit platform, Coinflip violated Section 4c(b) of the Commodity Exchange Act and CFTC Regulation 32.2; and (2) the Derivabit platform constituted an (improperly) unregistered swap execution facility,⁶ in violation of Section 5h(a)(1) of the CEA and Regulation 37.3(a)(1). The CFTC also held that Riordan, as a controlling person of Coinflip, was personally liable for Coinflip’s violations.

Sanctions

The sanctions in this matter were non-monetary⁷ and included a cease and desist order and an undertaking to cooperate with the CFTC and any other governmental agency in future investigations or litigation related to the facts of this action.

Certain Implications

The CFTC’s position, while it is not statutory law and not binding on other regulators,⁸ may be the final word on the regulatory categorization of virtual currencies, particularly with respect to whether virtual currency units are securities or commodities.⁹ It is, however, important to note that nothing in this decision imposes standards or regulation directly on virtual currencies; the regulation of virtual currencies themselves (as opposed to virtual currency derivatives), and certain activities involving virtual currencies, remains outside of the CFTC’s scope of authority. The actual creation, distribution, transmission and trading of virtual currency units remains as regulated (or as unregulated) as it was a week ago.¹⁰

⁵ As the CFTC noted in the Order, Section 1a(9) of the Commodity Exchange Act defines “commodity” to include, among other things, “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.”

⁶ The CEA’s definition of “swap” includes option contracts.

⁷ The lack of monetary sanctions likely reflects both the novel subject matter as well as the fact that Riordan and Coinflip cooperated with the CFTC’s investigation.

⁸ Note that other U.S. federal and state regulators have already established formal positions on the regulation of activity involving virtual currency, and some regulators may still reach different conclusions. For example, the Financial Crimes Enforcement Network, a bureau of the U.S. Department of Treasury, categorizes virtual currency as “a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency” and requires “administrators” and exchangers” of certain types of virtual currency to adopt anti-money laundering programs and abide by the Bank Secrecy Act and its implementing regulations. See FIN-2013-G0001, “[Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies](#)” (Mar. 18, 2013). Further, on June 24, 2015, the New York Department of Financial Services adopted a formal regulatory and licensing framework for businesses that engage in virtual currency business activity involving New York or a New York resident. See [23 N.Y.C.R.R. Part 200](#).

⁹ This conclusion is consistent with informal positions taken by the Securities and Exchange Commission staff.

¹⁰ For example, the Order has no applicability to the anti-money laundering and consumer protection regulations and state licensing requirements that apply to businesses that buy and sell certain types of virtual currencies or engage in the acceptance and transmission of certain types of virtual currencies.

Obviously, managers currently holding virtual currency derivatives in client accounts will need to consult with counsel to determine their rights in these assets, as these arrangements are directly implicated by the CFTC Order. The impacts on the broader community of private fund managers include the following:

- Client accounts that hold actual Bitcoins or other virtual currency units (as distinguished from Bitcoin or other virtual currency *derivatives*) are not directly affected by this matter's resolution; this decision does not directly impose CFTC reporting or similar obligations for direct holdings of virtual currency units.
- Derivatives (including futures, options and swaps) referenced to virtual currency units, however, now need to be considered "commodity interests." This has reporting and recordkeeping implications for managers and may also trigger certain mandatory clearing, swap execution facility trading and minimum initial margin requirements.
- In addition, as a result of this decision, it is clear that virtual currency unit derivatives will continue to count against the CFTC Rule 4.13(a)(3) de minimis exemption.

For other financial industry participants that are seeking to design or market products linked to virtual currencies, the Order is instructive on the extent to which they will need to account for CFTC regulatory oversight. It is important to note, however, that the banking regulators and other authorities (both U.S. and foreign) may have supplemental or differing views on this product.

It is possible that the clarity of this decision will spur greater adoption of standardized Bitcoin-based derivatives by mainstream participants in the futures, options and swaps markets; at the same time, however, is also possible that the lack of understanding and control over the "physical" Bitcoin market, as well as the lack of clarity from other regulators, may continue to constrain the development and use of virtual currency products.

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