CFTC Brings First Bitcoin Enforcement Action, Further Clarifying U.S. Regulatory Landscape for Virtual Currencies

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On September 17, 2015, the Commodity Futures Trading Commission settled its first **enforcement action** involving an unregistered Bitcoin derivatives trading platform. Coinflip, Inc. operated an online trading platform called Derivabit, which connected buyers and sellers of Bitcoin option contracts. Between March and August 2014, Derivabit had approximately 400 users. The settlement order states that Coinflip, Inc. and its founder and CEO, Francisco Riordan, violated provisions of the Commodity Exchange Act and CFTC regulations governing transactions in commodity options, including provisions that require trading platforms that offer swaps to register with the CFTC. Coinflip and its operator were ordered to cease and desist from future violations of the CEA and CFTC regulations, although the order carried no monetary penalties.

The order confirms the regulatory treatment of Bitcoin (and other "virtual currencies" as defined in the order[1]) under CEA and CFTC regulations, consistent with positions taken informally by the CFTC. In line with the view of **CFTC Chairman Massad** and **other CFTC Commissioners**, the order states that Bitcoin and other virtual currencies are "commodities" under the CEA. Based on this characterization, the order applies CEA provisions and CFTC regulations that apply to transactions in commodity options and swaps to the Derivabit trading platform, in offering trading of Bitcoin options. In addition, and also consistent with the treatment of Bitcoin derivatives offered by other trading platforms, the CFTC appears to have taken the position that Bitcoin is not a "currency," such that CEA and CFTC **regulatory requirements for foreign currency transactions** would not apply to Bitcoin derivatives. The CFTC has granted temporary registration to **TeraExchange** and **LedgerX** as swap execution facilities and reviewed and did not object to a **filing** in which LedgerX stated that a USD/Bitcoin swap would not be "an FX transaction since bitcoin is not a currency." [2]

As is made clear by the order, a wide variety of activities involving virtual currency derivatives, which could include futures, swaps or options referencing virtual currencies, could cause a firm to be subject to registration and regulation by the CFTC and its self-regulatory organization, the National Futures Association. In addition to trading platforms that may need to register as swap execution facilities or designated contract markets, firms that provide referral or advisory services with respect to virtual currency derivatives or that operate pooled investment vehicles that trade these derivatives may need to register with the CFTC and the NFA. In short, any business involved in virtual currency derivatives–including foreign businesses that solicit or provide services to U.S. customers–must consider whether its activities require it to register with the CFTC. The process of registering with the CFTC and building the

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[1] The order defines 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. 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."

[2] On September 24, 2015, the CFTC entered into a separate **settlement order** with TeraExchange for organizing a wash trade between the first two traders qualified to trade on the exchange. The CFTC noted that a press release issued by TeraExchange "intended … to create the impression of actual trading interest in the Bitcoin Swap." The settlement carried no monetary penalties, although CFTC Commissioner Sharon Bowen **dissented**, noting that "fictitious trading deserves a penalty."

infrastructure necessary to ensure compliance with applicable regulatory requirements can be time-consuming and costly, and firms whose virtual currency derivatives activities trigger CFTC registration requirements should take into consideration the time and resources for completing the registration process before offering those services.

However, the order leaves uncertain the treatment under the CEA and CFTC regulations of some types of virtual currency products. For example, the order does not clarify whether nominal amounts of virtual currencies used to represent non-financial information (for example, the way the company **Tierion** does) or to represent ownership of another asset (for example, cars, mortgages or other financial assets, the way Digital Asset Holdings, a company run by Blythe Masters, **does**) would be "commodities" under the CEA. By contrast, **New York's BitLicense** excludes from regulation in certain situations transactions undertaken "for non-financial purposes [that do] not involve the transfer of more than a nominal amount of Virtual Currency." Nor does the order clarify whether smart contracts (i.e., those that trade, clear and settle without intermediaries) that are created on the Bitcoin "blockchain" or similar distributed ledger platforms are "commodities" under the CEA.[3]

In addition, the order has no direct impact on–and likely will not significantly affect–the approach of other U.S. regulators to virtual currencies and firms involved in offering virtual currency related services. For example, a determination that Bitcoin is a commodity does not preclude the Securities and Exchange Commission from regulating investment schemes that involve Bitcoin. The position taken in the order is consistent, however, with the implicit position taken by the SEC to date that Bitcoin itself will not be treated as a security for purposes of U.S. federal securities laws.[4] Similarly, the order will likely have no impact on the positions of federal and state regulators that have classified Bitcoin as property for tax purposes or as money, funds or value for anti-money laundering purposes.

The order also leaves open questions relating to the treatment of Bitcoin and other virtual currencies under other U.S. regulatory regimes. For example, it is not at this time clear whether the CFTC's regulations would preempt state-specific virtual currency regimes such as **New York's BitLicense** (which has no exclusion for CFTC-registered entities), leaving the possibility that trading platforms or other businesses registered with the CFTC may also have to apply for virtual currency-specific state licenses to conduct certain virtual currency activities.[5] More information on the regulation of Bitcoin and other virtual currencies is available on our resources website, **bitcoin-reg.com**.

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[3] See Houman B. Shadab, "Regulating Bitcoin and Block Chain Derivatives," written statement to the CFTC Global Markets Advisory Committee (Oct. 9, 2014), available **here**.

[4] SEC Chairman Mary Jo White **stated** in 2014 Congressional testimony that the SEC has not concluded that Bitcoin is a security. Additionally, in the Bitcoin related matters that the SEC has brought (for example, the **Trendon Shavers ponzi scheme case**, and the recent **enforcement action** against Sand Hill Exchange, Gerrit Hall and Elaine Ou), the SEC has not taken the position that Bitcoins themselves are securities. See SEC v. Shavers, 2014 WL 4652121 (E.D. Tex. Sept. 18, 2014) and SEC Motion for Summary Judgment (Mar. 3, 2014) (arguing in part that Bitcoins are a legally sufficient investment of "money" to qualify interests in a Ponzi scheme as investment contract securities), available **here**. See also Davis Polk Client Memorandum "SEC and CFTC Turn to Swaps and Security-Based Swaps Enforcement" (June 24, 2015), available **here**.

[5] New York is currently the only state that has created a regime specifically for virtual currency businesses. California was considering creating such a regime, but the **bill was shelved**. Many states have regulated virtual currency businesses under their money transmitter regimes, although many states' money transmitter regimes contain explicit exclusions for entities registered with the CFTC. See, e.g., California Financial Code, Division 1.2, Section 2010(f)("This division does not apply to [a] board of trade designated as a contract market under the federal Commodity Exchange Act….").

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