

REGULATION OF BITCOIN: THE ROLE OF THE CFTC

The remarkable growth and volatility of Bitcoin and other virtual currencies has raised the question of how these markets are regulated. The CFTC has emerged as "the federal overseer of digital currencies like bitcoin," according to Bloomberg.¹ Other federal regulators, such as the SEC and bank regulators, supervise specific institutions and discrete activities, and state regulators have jurisdiction in their states over money transmission. However, the CFTC is the only federal regulator of virtual currency markets. (For purposes of this article, we do not view tokens issued in Initial Coin Offerings as virtual currencies.)

What does CFTC regulation mean? It means that virtual currencies are treated as a "commodity"² under the Commodity Exchange Act ("CEA")³ over which the SEC does not have direct oversight, and not as a "security" under the securities laws.⁴ The CFTC has limited jurisdiction over spot markets in virtual currencies – in which participants buy and sell virtual currencies for prompt delivery – while it has broad jurisdiction over derivatives markets, including futures, in such currencies. We discuss the CFTC's regulation of virtual currency spot and derivatives markets in greater detail below.

¹ Robert Schmidt and Benjamin Bain, *Who Wants to Be Bitcoin's Watchdog?* BLOOMBERG (Jan. 12, 2018), <https://www.bloomberg.com/news/articles/2018-01-12/who-wants-to-be-bitcoin-s-watchdog>

² 7 U.S.C §1a(9) (2012).

³ See, e.g., Complaint, *CFTC v. My Big Coin Pay, Inc., Randall Crater, and Mark Gillespie*, Case 1:18-cv-1007-RWZ (D.Mass. filed Jan. 16, 2018) (the "MBCP Complaint").

⁴ However, the SEC reserves the right to regulate those cryptocurrencies which meet the definition of a "security." See Jay Clayton and J. Christopher Giancarlo, *Regulators are Looking at Cryptocurrency – At the SEC and CFTC, we take our responsibility seriously*, THE WALL STREET JOURNAL (Jan. 24, 2018) ("[S]ome products that are labelled cryptocurrencies have characteristics that make them securities. The offer, sale and trading of such products must be carried out in compliance with securities law.").

I. SPOT MARKETS

According to the CFTC, the general rule is that "US law does not provide for direct, comprehensive Federal oversight of underlying Bitcoin or virtual currency spot markets,"⁵ though the two critical qualifications are "Federal" – as state banking regulators may have jurisdiction over virtual currency spot exchanges under state money transfer laws – and "comprehensive." The CFTC exercises *limited* jurisdiction over commodity spot markets, primarily restricted to preventing fraud and manipulation. The CFTC also has the power to distinguish between spot and derivatives markets and has done so for certain retail exchanges.

(a) Anti-Fraud Enforcement Activity

The CFTC has recently brought two cases alleging fraudulent activities in virtual currency spot markets. In *My Big Coin Pay, Inc. et al.* (2018),⁶ the defendants solicited potential customers to purchase MBC (My Big Coins), a virtual currency, ultimately obtaining over \$6 million in customer funds for that purpose. The defendants claimed MBC was actively traded on "several currency exchanges... for dollars, euros, and more," that MBC was the only virtual currency backed by gold,⁷ and that they had partnered with MasterCard, when in fact, MBC was not actively traded on any currency or other exchange, MBC was not backed by gold, and there was no partnership with MasterCard.⁸ The price or value displayed on the website was not, in fact, based on actual trading. The defendants simply misappropriated most of the over \$6 million in customer funds they raised selling MBC.

In the case of *Patrick K. McDonnell and CabbageTech, Corp., d/b/a Coin Drop Markets* (2018)⁹ the defendants advertised membership in Internet Bitcoin and Litecoin trading groups using social media, which purportedly would allow customers to receive expert trading advice and continuous, ongoing monitoring from the defendants' "dedicated team of digital asset trading specialists" leading to up to 300% returns on virtual currency trading in less than a week, in one case. However, instead of providing any of the contracted-for trading and advisory services after receiving customer funds, the defendants simply broke off communications with the customers to whom the funds belonged and absconded with their money. To conceal their scheme, the McDonnell Defendants allegedly deleted their websites and social media posts. The customers allegedly defrauded lost most if not all their funds.

(b) Retail Virtual Currency Transactions

On December 15, 2017 the CFTC released "Retail Commodity Transactions Involving Virtual Currency" (the "[2017 Interpretation](#)"),¹⁰ which proposes an interpretation that regulates certain leveraged retail transactions in virtual

⁵ Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets, January 4, 2018, http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf (the "Futures Backgrounder").

⁶ See *supra* n.3.

⁷ MBCP Complaint, at 7.

⁸ MBCP Complaint, at 9.

⁹ Complaint, *CFTC v. Patrick K. McDonnell, and CabbageTech, Corp. d/b/a Coin Drop Markets*, Case No. 18-CV-0361 (E.D.N.Y. filed Jan. 18, 2018).

¹⁰ Retail Commodity Transactions Involving Virtual Currency, 82 Fed.Reg. 60335 (Dec. 20, 2017), <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2017-27421a.pdf>

currencies as futures. Under §2(c)(2)(D) of the CEA, certain provisions of the CEA apply to any commodity transaction (a "retail commodity transaction") involving a retail investor that is financed by the offeror or the counterparty, or entered into on a leveraged or margined basis, unless the transaction results in "actual delivery" within 28 days.¹¹ If §2(c)(2)(D) applies, then the transaction is subject to regulation as if it were a futures contract, meaning it must be entered into on or subject to the rules of a CFTC-registered futures exchange. In the 2017 Interpretation, the Commission pointed out that delivery of a virtual currency to a buyer's digital wallet would not constitute "actual delivery" if the rights of the wallet holder were restricted by the provider of the wallet, the virtual currency exchange, or the seller. The lack of actual delivery would mean, as a practical matter, that the system providing the wallet or facilitating the transaction would be in violation of the CEA if the transaction was leveraged. The CFTC provided several detailed examples of what would constitute "actual delivery" in the context of delivering virtual currency to digital wallets.

II. FUTURES/DERIVATIVES MARKETS

The CEA gives the CFTC wide powers over all participants in futures/derivatives markets, including exchanges and intermediaries, as well as companies and individuals who handle customer funds or provide derivatives trading advice.

(a) Listing Virtual Currency Derivatives – CFTC's "Heightened Review"

Under the CEA, futures exchanges may list new products by "self-certifying" i.e. submitting a certification that the futures contracts meet the requirements of the CEA. Both the Chicago Mercantile Exchange ("CME") and the Chicago Board Options Exchange ("CBOE") used self-certification for their listing of Bitcoin futures.¹² Self-certification was also used by TeraExchange, the first cryptocurrency exchange to register with the CFTC, to list its first Bitcoin non-deliverable forwards on September 12, 2014.¹³

The CME and the CBOE voluntarily chose to give the CFTC the chance to review the proposed terms of their respective Bitcoin futures contracts months before filing their self-certifications. As an extension of this practice, for all future applications by derivatives exchanges to list virtual currency derivatives, the CFTC will institute a regime known as "heightened review", in which it will request voluntary compliance by applicant derivatives exchanges with several criteria, including "substantially high" initial and maintenance margins, information sharing agreements, and coordinating product launches with the CFTC's market surveillance branch to enable the CFTC to monitor "minute by minute developments."¹⁴

For its part, the CFTC plans to closely monitor both virtual currency derivatives markets as well as underlying settlement reference rates through the collection of

¹¹ 7 U.S.C. §2(c)(2)(D)(ii)(III)(aa).

¹² Futures Backgrounder at 2.

¹³ See Press Release, *TeraExchange Launches First Regulated Bitcoin Derivatives Trading* (Sep. 12, 2014), https://www.teraexchange.com/news/2014_09_12_Launches%20First%20Regulated%20Bitcoin%20Derivatives.pdf

¹⁴ Futures Backgrounder at 3.

trade- and counterparty-level data, and to coordinate with other federal regulatory agencies.¹⁵

(b) New NFA Reporting Requirements

Set forth in a wave of releases in mid-December 2017, the National Futures Association ("NFA"), which has delegated authority from the CFTC, set out new reporting requirements for NFA members who are commodity pool operators or commodity trading advisors that execute transactions involving either underlying virtual currency spot/cash contracts or virtual currency futures, options, or swaps on behalf of a commodity pool or managed account,¹⁶ introducing brokers that solicit or accept orders for virtual currency futures, swaps, or options,¹⁷ and futures commission merchants that offer customers or non-customers the ability to trade virtual currency futures only.¹⁸

(c) Virtual Currency Derivatives: CFTC Enforcement Activity

The CFTC has brought a number of enforcement actions in respect of virtual currency derivatives. In the case of Dillon Michael Dean and The Entrepreneurs Headquarters Limited (2018),¹⁹ the defendants engaged in a fraudulent scheme to solicit at least \$1.1 million worth of Bitcoin from more than 600 members of the public to participate in a pooled investment vehicle supposedly for trading binary options, i.e. derivatives, on a range of commodities on the Nadex exchange. The defendants allegedly misappropriated the customers' funds, and then lied to customers that their funds had been stolen by hackers in an attack on defendants' website. The CFTC charged the defendants with engaging in a business of the nature of an investment trust or syndicate that received customer property – Bitcoin – for the purpose of trading in commodity options, without registering with the CFTC as a commodity pool operator, as well as with fraud.

In the case of Coinflip, Inc., d/b/a Derivabit *et al.* (2015),²⁰ the defendants' web-based trading platform allowed traders to post (and accept) bids and offers on Bitcoin option contracts. Traders would deposit Bitcoin into an account on defendants' website, and use Bitcoin to pay premiums and settlement payments to the other party. The CFTC charged the defendants with operating a facility for the trading, processing, and execution of swaps without registering with the CFTC as a swap execution facility ("SEF").

¹⁵ J. Christopher Giancarlo, Remarks of Chairman J. Christopher Giancarlo to the ABA Derivatives and Futures Section Conference, Naples, Florida, (Jan. 19, 2018), http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo34#P96_20693

¹⁶ NFA Notice I-17-28, December 14, 2017, Additional reporting requirements for CPOs and CTAs that trade virtual currency products, <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4974>. See also, NFA Notice I-18-03, January 18, 2018, Additional questions for CPOs on the annual pool financial statement, <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4982>

¹⁷ NFA Notice I-17-27, December 6, 2017, Additional reporting requirements regarding virtual currency futures products for FCMs for which NFA is the DSRO, <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4973>

¹⁸ NFA Notice I-17-29, December 14, 2017, Additional reporting requirements for IBs that solicit or accept orders in virtual currency products, <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4975>

¹⁹ Complaint, CFTC v. Dillon Michael Dean and The Entrepreneurs Headquarters Limited, Case 18-cv-00345 (E.D.N.Y. filed Jan. 18, 2018).

²⁰ Order, In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29 (C.F.T.C. Sep. 17, 2015), <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>

In the case of TeraExchange (2015),²¹ the defendants operated a platform for the online trading of non-deliverable forward contracts based on the relative value of the U.S. dollar and Bitcoin. At the time of the enforcement action, TeraExchange was provisionally registered with the CFTC as a SEF, and on September 11, 2014 it filed a self-certification with the CFTC to list Bitcoin swaps. A month later, on October 8, 2014, a TeraExchange employee arranged for a pair of offsetting transactions between unaffiliated counterparties to be executed on TeraExchange in order to "test the pipes by doing a round-trip trade with the same price in, same price out, (i.e. no P/L [profit/loss] consequences."²² The CFTC charged TeraExchange with conducting a pre-arranged "wash trade" involving counterparties who took no bona fide market risk, in violation of rules prohibiting wash trading.

III. CONCLUSION

The CFTC has emerged as the primary federal regulator of virtual currency markets but its jurisdiction is surprisingly limited, particularly with respect to spot markets. As the markets grow, and if disruptions occur, the CFTC and other federal regulators may feel pressure to expand their supervision of these markets.

²¹ Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, In the Matter of TeraExchange LLC, CFTC Docket No. 15-33 (C.F.T.C. Sept. 24, 2015) (the "TeraExchange Order").

²² TeraExchange Order at 2.

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