

Cryptocurrencies Are Commodities: CFTC's First Bitcoin Enforcement Action

In the absence of specific CFTC regulations regarding Bitcoin, the order helps clarify the CFTC's positions on cryptocurrency derivatives.

On September 17, 2015, the US Commodity Futures Trading Commission (CFTC) issued an order filing (Derivabit Order), and simultaneously settling charges, against Coinflip, Inc. (Coinflip) and Francisco Riordan, its chief executive officer, with respect to Coinflip's operation of a Bitcoin options trading platform (Derivabit).¹ Specifically, the Derivabit Order finds that Coinflip and its principal violated the Commodity Exchange Act (CEA) by operating a facility for the trading or processing of commodity options without registering as a swap execution facility (SEF) or as a designated contract market (DCM).² The order marks the CFTC's first enforcement action involving Bitcoin derivatives and serves as a formal CFTC pronouncement that Bitcoin and other cryptocurrencies are properly classified as "commodities" under the CEA, providing a preview of the scope of future CFTC regulation of the cryptocurrency market.

Summary

The products listed on Derivabit were designated put and call options contracts (Bitcoin Options) for which (i) the underlying asset was Bitcoin, (ii) the strike and delivery prices were denominated in US Dollars and (iii) premiums and payments of settlement were to be paid using Bitcoin (at a spot rate determined by a designated third-party Bitcoin currency exchange). Derivabit users were able to post bids and offers on Derivabit for the Bitcoin Options. Such bids and offers were matched by Coinflip through the website.³

Under the CEA, the term "swap" is defined very broadly to include, among other things, "[an] option of any kind that is for the purchase or sale, or based on the value, of 1 or more...commodities...."⁴ Section 5(h)(a)(1) of the CEA, in turn, provides that any person operating a facility for the trading or processing of "swaps" is required to register with the CFTC as a SEF or as a DCM.⁵ In the Derivabit Order, the CFTC stated (albeit without any detailed analysis) that Bitcoin and other cryptocurrencies are encompassed in the definition of, and are properly classified as, "commodities." The CFTC concluded, therefore, (i) that any options on Bitcoin or other cryptocurrencies are to be regulated as "swaps," (ii) that Coinflip should have registered Derivabit as a SEF or as a DCM and (iii) that the failure of Coinflip to do so constituted a violation of the CEA and the CFTC regulations promulgated thereunder.⁶

The Derivabit Order mandated the immediate cease and desist of violations under the CEA, but did not impose any sanctions or penalties against Coinflip and Riordan.

Key Takeaways

Though Chairman Massad, Commissioner Wetjen and others have opined publicly on the CFTC's regulatory authority over Bitcoin and other cryptocurrencies,⁷ the CFTC had not previously formalized any regulatory position on such products. By issuing the Derivabit Order, the CFTC has clarified its position on Bitcoin and other cryptocurrency derivative products, namely:

- Bitcoin and other cryptocurrencies are “commodities” as defined in Section 1a(9) of the CEA⁸; accordingly, cryptocurrency derivatives, including futures, options, or swaps are subject to CFTC jurisdiction.⁹
- Any platform for trading or executing cryptocurrency swaps must be registered as a SEF or as a DCM under Section 5h(a)(1) of the CEA.¹⁰

Further, though Derivabit was advertised as also facilitating the execution of Bitcoin forward and futures contracts, the CFTC declined to address whether this aspect of Derivabit's business violated the CEA, given that Coinflip did not offer any forward or futures contracts during the time period at issue in the Derivabit Order.¹¹

Finally, while the Derivabit Order clarifies the CFTC's position on Bitcoin and other cryptocurrency derivatives – *i.e.*, Bitcoin and other cryptocurrencies are “commodities” – market participants should be mindful that numerous regulators, such as the US Securities and Exchange Commission, the Internal Revenue Service and New York State Department of Financial Services, have claimed enforcement jurisdiction over such cryptocurrencies.¹² Importantly, the SEC won a ruling in 2013 that Bitcoin is “currency” and, consequently, Bitcoin-denominated investments are “securities” that can be regulated under the US securities laws.¹³ Thus, market participants should continue to be aware that the regulatory landscape for cryptocurrencies is far from complete and will likely result in the attention of multiple regulators on the very same conduct for the foreseeable future.

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Endnotes

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- ¹ *In re Coinflip, Inc., d/b/a/ Derivabit, et al.*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 15-29 (Sept. 17, 2015), available at <http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf> (Derivabit Order).
 - ² Coinflip has consented to the CFTC's entry of the Derivabit Order, without admitting or denying any of the findings or conclusions therein.
 - ³ Derivabit Order at 2-3.
 - ⁴ 7 U.S.C. § 1a(47)(A)(i); see Further Definition of "Swap," "Security-Based Swap" and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (Aug. 13, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf>.
 - ⁵ 7 U.S.C. § 7b-3(a)(1); 17 C.F.R. § 37.3(a)(1).
 - ⁶ Derivabit Order at 3-4.
 - ⁷ See CFTC's Chilton on Possible Regulation of Bitcoin (May 7, 2015), available at <http://www.bloomberg.com/news/videos/b/c20c06f-d406-4e30-995b-4d0bc748b4af>; CFTC Commissioner: Market Manipulation Could Shape Bitcoin's Future, CoinDesk (Jan. 8, 2015), available at <http://www.coindesk.com/cftc-commissioner-mark-wetjen-bitcoin/>; Testimony of Chairman Timothy Massad before the US Senate Committee on Agriculture, Nutrition & Forestry (Dec. 10, 2014), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6>; Mark Wetjen, Bringing Commodities

Regulation to Cryptocurrency, Wall St. J. (Nov. 3, 2014), available at <http://www.wsj.com/articles/mark-wetjen-bringing-commodities-regulation-to-bitcoin-1415060058>.

- ⁸ Derivabit Order at 3; see 7 U.S.C. § 1a(9); see also *Board of Trade of City of Chicago v. SEC*, 677 F.2d 1137, 1142 (7th Cir. 1982) (the definition of a “commodity” is very broad).
- ⁹ Derivabit Order at 3; see 7 U.S.C. §§ 1.3(hh) (definition of “commodity option transaction”), 1a(47)(A)(i) (definition of “swap” includes option contracts); 17 C.F.R. § 32.2 (it is unlawful for any person to conduct activity related to a commodity option transaction unless such activity complies with the CEA or CFTC Regulation 32.3).
- ¹⁰ Derivabit Order at 3; see 7 U.S.C. § 7b-3(a)(1) (a person may not operate a facility for trading or processing swaps unless such facility is registered as a SEF or as a DCM); 17 C.F.R. § 37.3(a)(1) (a facility offering a trading system or platform for market participants to execute or trade swaps with other market participants on such system or platform must be registered as a SEF under Part 37 or a DCM under Part 38). Further, the CFTC noted that the Bitcoin Options did not qualify for the exemption under CFTC Regulation 32.3 for trade options (the Trade Option Exemption). Derivabit Order at 4, n. 5; see 17 C.F.R. § 32.3(a). The CFTC did not, however, provide any explanation as to *why* the Trade Option Exemption would not apply; as such, it is unclear whether the CFTC would consider *all* cryptocurrency derivative products to be ineligible for the Trade Option Exemption (e.g., deeming cryptocurrency swaps not to be “exempt commodities”) or whether the particular facts and circumstances surrounding the Bitcoin Options did not meet the requirements for the Trade Option Exemption.
- ¹¹ See Derivabit Order at 2-3, n. 3-4.
- ¹² Note that the US Internal Revenue Service (IRS) considers Bitcoin to be “property” for US federal tax purposes, the US Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) treats virtual currency as “money” for purposes of the money services business (MSB) regulations and the US Securities and Exchange Commission (SEC) has previously (successfully) argued that Bitcoin is a currency or form of money and that Bitcoin investments are “securities.” See Request for Administrative Ruling on the Application of FinCEN’s Regulations to a Virtual Currency Trading Platform, FIN-2014-R011 (Oct. 27, 2014), available at http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R011.pdf (citing Application of FinCEN’s Regulations to Persons Administering, Exchanging or Using Virtual Currencies, FIN-2013-G001 (March 18, 2013), available at http://fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf); Final Judgment Entered Against Trendon T. Shavers, a/k/a “Piratreat40” - Operator of Bitcoin Ponzi Scheme Ordered to Pay More than \$40 Million in Disgorgement and Penalties, SEC Litigation Release No. 23090 (Sept. 22, 2014), available at <https://www.sec.gov/litigation/litreleases/2014/lr23090.htm>; IRS Virtual Currency Guidance, IRS Notice 2014-21 (March 25, 2014), available at <http://www.irs.gov/pub/irs-drop/n-14-21.pdf>. **Please note, however, that this *Client Alert* focuses solely on the applicability of CFTC regulation to cryptocurrencies; the regulatory framework for Bitcoin and other cryptocurrencies with respect to state money transmitter laws, SEC regulation, prudential regulation or tax is outside the scope of this *Client Alert*.**
- ¹³ *SEC v. Shavers and Bitcoin Savings and Trust*, Case No. 4:13-CV-416 (E.D.Tex.) (Aug. 6, 2013).