

October 19, 2017

LabCFTC Releases Primer on Virtual Currencies

CFTC FinTech Hub Launches Educational Tool for Innovators and Clarifies Jurisdiction Over Virtual Currencies

SUMMARY

On October 17, 2017, LabCFTC, the focal point for the efforts of the Commodity Futures Trading Commission (the “CFTC” or the “Commission”) to promote financial technology (“FinTech”), released an educational primer on virtual currencies. The primer is intended to provide an overview of virtual currencies and distributed ledgers, as well as their respective potential applications, and to explain the CFTC’s role and oversight in the sector. In the primer, the CFTC reaffirmed that many virtual currencies (including bitcoin and ether) are “commodities” for purposes of the Commodity Exchange Act (the “CEA”) and therefore that its jurisdiction extends to derivatives (*i.e.*, futures, swaps and options) on virtual currencies. These derivatives on virtual currencies will be subject to the CFTC’s rules to the same extent as any other derivative on a commodity that is within the CFTC’s jurisdiction. The CFTC also highlighted that there are risks with respect to virtual currencies and noted that its general fraud and manipulation authority extends to any transaction, including “spot” or cash transactions, where a virtual currency is traded in interstate commerce. While seeking to broaden education and understanding, therefore, the primer also acts as a statement by the CFTC of its jurisdiction over transactions in this space.

BACKGROUND

LabCFTC was launched by the Commission in May 2017 to assist CFTC staff, policymakers and market participants to understand the opportunities and risks posed by emerging FinTech technologies. LabCFTC aims to make the CFTC more accessible to the innovator community, leading to a deeper

SULLIVAN & CROMWELL LLP

understanding of how new innovations interact with the CFTC's regulatory and supervisory framework, and to identify areas where the framework could better support responsible innovation.

LabCFTC's goal is to enable the CFTC to proactively engage with FinTech applications as they continue to develop, and to:

- promote responsible FinTech innovation in order to improve the quality, resiliency and competitiveness of markets; and
- accelerate CFTC engagement with FinTech and regulatory solutions that may enable the CFTC to carry out its market responsibilities more effectively and efficiently.

For further information, please see our [earlier report](#) on the launch of LabCFTC.

The primer that LabCFTC released on October 17, 2017 is the first in a series of educational tools it will release in relation to emerging FinTech innovations.

OVERVIEW OF “VIRTUAL CURRENCY”

The primer provides a general overview of the origins and uses of virtual currencies, including bitcoin. It sets out the key characteristics of bitcoin and other common blockchain technologies, including that they:

- are “pseudonymous” (or partially anonymous), in that an individual is usually only identifiable by an alpha-numeric public key/address;
- rely on cryptography (and unique digital signatures) for security based on public and private keys and complex mathematical algorithms;
- run on a decentralized peer-to-peer network of computers and “miners” that operate on open-source software and do “work” to validate and irrevocably log transactions on a permanent and public distributed ledger visible to the entire network;
- resolve issues resulting from the lack of trust between participants (who may be strangers to each other on a public ledger) through the transaction validation work noted above; and
- enable the settlement of ownership transfers without a trusted intermediary.

In addition, the primer also sets forth descriptions of public ledger systems, which operate on public distributed ledgers and capture “blocks” of transactions, and private ledger systems, which allow a network of known participants to share information among themselves more efficiently and rely on a degree of trust among participants.

The primer also reiterated the CFTC's position that bitcoins and other virtual currencies are “commodities” for the purposes of the CEA.¹ As such, derivatives (*i.e.*, futures, options or swaps) thereon are subject to

¹ See *In the Matter of: Coinflip, Inc., d/b/a Derivatbit, and Francisco Riordan*, CFTC Docket No. 15-29, available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

SULLIVAN & CROMWELL LLP

regulation by the CFTC. In addition, the CFTC's fraud or manipulation authority extends to the derivatives on, and cash and spot transactions in, a virtual currency that is traded in interstate commerce. It is important to note, in this regard, that the CFTC generally takes the position that its anti-fraud and anti-manipulation jurisdiction encompasses transactions in the actual commodities underlying the derivatives that it regulates, and not only the derivatives themselves. Extending this position to digital currencies, the CFTC could bring fraud or manipulation actions in connection with actual digital currency transactions, regardless of whether any derivative is involved. Notably, however, beyond its general fraud and manipulation authority, the CFTC does not otherwise generally oversee "spot" or cash market exchanges involving virtual currencies that do not utilize margin, leverage or financing and its regulations would not generally apply to such markets.

USES OF VIRTUAL CURRENCIES

The primer sets forth a number of potential applications for virtual currencies, including:

- as a store of value that is fungible, divisible and portable;
- as a trading mechanism;
- as a platform for payments and transactions in exchange for physical and digital goods; and
- as a cost-effective method of transferring money, both domestically and internationally.

The primer also illustrates the uses of distributed ledger technologies more generally for:

- financial institutions, as a tool to develop trading and payment platforms, a mechanism to assist with monitoring Know-Your-Customer, Anti-Money Laundering and other compliance obligations and in connection with the short-term borrowing of securities pursuant to repurchase agreement transactions;
- governments, as a tool for general public records management, the aggregation and validation of title and ownership records and in connection with regulatory reporting and oversight; and
- market participants within certain industries, as a means to implement self-executing "smart" contracts, resource and asset-sharing arrangements (e.g., allowing a third party to rent excess computer bandwidth or data storage) or as a means to validate a person's digital identity.

In its primer, LabCFTC noted a number of potential applications that would be both permitted and prohibited by laws and regulations within the CFTC's purview. Examples of such permitted uses include the development of a Swap Execution Facility ("SEF") by TeraExchange, LLC., which included a bitcoin swap for trading, and the development of a designated contract market ("DCM") by North American Derivatives Exchange Inc., which listed binary options based on the Tera Bitcoin Price Index for trading by retail customers.

LabCFTC also noted a number of virtual currency activities that are prohibited under current laws, including price manipulation of a virtual currency traded in interstate commerce, pre-arranged or wash

SULLIVAN & CROMWELL LLP

trading in an exchange-traded virtual currency swap or futures contract, a virtual currency futures or option contract or swap traded on a domestic platform or facility that has not registered with the CFTC as a SEF or DCM, and certain schemes involving virtual currencies marketed to retail customers, such as off-exchange financed commodity transactions with persons who fail to register with the CFTC.

LabCFTC also explained that its approach towards Initial Coin Offerings (“ICOs”) is aligned with that of the Securities and Exchange Commission (“SEC”), which has previously deemed the tokens issued in connection with ICOs to be “securities” under federal securities laws. However, LabCFTC emphasized that it intends to look beyond mere form to consider the actual substance and purpose of the activity in question when seeking to apply federal commodities laws and CFTC regulations. Therefore, offerings of ICOs that involve instruments subject to CFTC jurisdiction (*i.e.*, futures, options or swaps) may also be subject to CFTC oversight and regulation.

RISKS OF VIRTUAL CURRENCIES

LabCFTC also analyzed risks related to virtual currencies. The primer sets forth a number of the risks associated with virtual currencies, including with respect to:

- **Operational risk:** Virtual currencies are not subject to regulatory supervision like registered exchanges, and are exempted from many rules applicable to registered exchanges.
- **Cybersecurity risk:** Digital wallets, which are used to hold a customer’s virtual currency, are vulnerable to hacks resulting in the theft of virtual currency, often leaving little recourse for the customer.
- **Speculative and manipulation risk:** Virtual currencies have been subject to substantial volatility, and the risk of manipulation by individuals or coordinated groups trading large volumes of virtual currency.
- **Fraud risk:** Unregistered virtual currency platforms may not be able to adequately protect against market abuses by other traders.

LabCFTC’s full press release is available [here](#).

* * *

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York

Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
Andrew C. Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Kathleen S. McArthur	+1-212-558-4321	mcarthurk@sullcrom.com
John M. Miller	+1-212-558-4839	millerjo@sullcrom.com
Ryne V. Miller	+1-212-558-3268	millery@sullcrom.com
Christine Trent Parker	+1-212-558-3631	parkercc@sullcrom.com
Kenneth M. Raisler	+1-212-558-4675	raislerk@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com

Washington, D.C.

Dennis C. Sullivan	+1-202-956-7554	sullivand@sullcrom.com
--------------------	-----------------	--
