

## Watch For More CFTC Regulation Of Virtual Currencies

Law360, New York (October 23, 2015, 12:50 PM ET) – In another move reflecting its focus on the regulation of trading in Bitcoin and other virtual currencies, the U.S. [Commodity Futures Trading Commission](#) on Sept. 24, 2015, brought and simultaneously settled charges against TeraExchange LLC, a provisionally registered Bitcoin swap execution facility (known as an “SEF”).[1] The charges against Tera, as set forth in the CFTC’s accompanying order (the “Tera order”), stem from a pair of nondeliverable forward contracts executed on October 8, 2014, which constituted “wash trading” and “prearranged trading” in violation of the Commodity Exchange Act (the “CEA”).



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The Tera order comes one week after the CFTC issued an order regarding Coinflip Inc. and its founder and CEO (the “Coinflip order”)[2] in which the CFTC presented — for the first time — its conclusion that Bitcoin and other virtual currencies are encompassed within the CFTC’s broad definition of “commodities.”[3] The San Francisco-based Coinflip, through its online trading facility named “Derivabit,” offered an exchange on which options on Bitcoin were traded without being appropriately registered as an SEF or a designated contract market, in violation of CFTC rules and regulations.

According to the Tera order, on Oct. 8, 2014, two traders (who were the only traders authorized to trade on the Tera SEF at that time) executed a transaction in a nondeliverable forward contract based on the relative value of the U.S. Dollar and Bitcoin. Six minutes later, the same traders executed a transaction in the Bitcoin swap for the same price and notional amount. The two trades — which had the effect of completely offsetting each other — were prearranged (and actively facilitated) by Tera and its employees with the understanding that the traders would execute “a round-trip trade with the same price in, same price out (i.e., no P/L [profit/loss] consequences) no custodian required.” In fact, Tera employees were on calls with the two traders as they executed the transactions to help walk them through the transactions, and they had previously advised the traders that profit/loss consequences would not be an issue.

The two trades did not create any bona fide position in Bitcoin due to the fact that the two trades offset each other. Further, since Tera did not charge a transaction fee or commission to either trader, there were no transaction costs incurred by either trader.

As a result of the foregoing, the CFTC held that the two trades constituted both “wash trading” and “prearranged trading” in violation of the CEA. The active involvement of Tera — a provisionally registered SEF — in arranging the offsetting trades also constituted a violation of Tera’s obligations to establish and enforce rules to prohibit wash trading and prearranged trading on the SEF, as required by Section 5h(f)(2) of the CEA and Section 37.203(a) of the CFTC’s regulations.

Although the purpose of this prearranged transaction was to “test the pipes” of the Tera SEF[4], the next day Tera issued a press release announcing “the first Bitcoin derivative transaction to be executed on a regulated exchange.” On the same day, Tera’s then-president made statements at a meeting of the CFTC’s Global Markets Advisory Committee announcing the transaction. In the case of both the press release and the president’s statements, Tera intended to create the impression of actual trading interest in the Bitcoin swap. Neither the press release nor the president’s statements indicated that the transactions were prearranged wash sales executed solely for the purpose of testing Tera’s systems.

The Tera order made clear that the facts regarding Tera “should be distinguished from a situation where an SEF or other designated contract market runs pre-operational test trades to confirm that its systems are technically capable of executing transactions and, to the extent that these simulated transactions become publicly known, makes it clear to the public that the trades do not represent actual liquidity in the subject market.”

The CFTC ordered Tera to refrain from further violations of the CEA. No monetary penalty was levied against Tera. However, Commissioner Sharon Bowen issued a dissent in which she questioned the CFTC’s decision not to seek a monetary penalty against Tera. Specifically, Commissioner Bowen said in a statement: “I believe fictitious trading deserves a penalty. TeraExchange facilitated wash trading and prearranged trading in violation of the Commodity Exchange Act. That is why we brought this case. I fundamentally disagree with the notion that they deserve no penalty. Accordingly, I dissent.”

As a result of the Tera order — which comes only one week after the CFTC’s finding in the Coinflip order that Bitcoin falls within its definition of “commodity” — the CFTC has strongly signaled that it is interested, and will be actively involved, in the regulation of the trading of Bitcoin and other virtual currencies. Following these two actions, platforms that deal in Bitcoin and other virtual currencies must be mindful of the CFTC’s rules and regulations — including the CFTC’s registration requirements — when structuring and conducting their operations. The failure to do so could have serious consequences for both the platform and its principals. These consequences could become even greater if the CFTC adopts the position expressed by Commissioner Bowen in her dissent and determines that these types of violations deserve more significant penalties.

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