



CFTC Treads Carefully in Bitcoin Market Oversight

By Joanne Morrison

The Commodity Futures Trading Commission is cautiously looking at the Bitcoin market. Top CFTC officials over the past several months have been working to better understand this new method for making payments, particularly as new markets are being developed for Bitcoin derivatives.

In September the agency granted approval for TeraExchange, a swap execution facility, to offer trading in Bitcoin swaps and in October, TeraExchange completed its first trade in the new contract. In December, the CFTC requested public comment on an application submitted by LedgerX, a newly established firm based in New York, to operate as an exchange for Bitcoin options.

The CFTC does not have jurisdiction over trading in Bitcoin itself, but it may have jurisdiction over futures, options, forwards and other derivatives based on Bitcoin to the extent that the virtual currency constitutes a “commodity” under the Commodity Exchange Act. The CFTC has not made a formal determination yet, but the agency has taken several actions that indicate a determination to exercise its authority over this new marketplace.

At a Senate hearing in December, CFTC Chairman Timothy Massad explained that the CEA “defines the term commodity very broadly” and said that derivatives based on virtual currencies “represent one area within our responsibility.” Massad also laid out two principles that are guiding his thinking in this area. On the one hand, the CFTC’s regulatory framework is designed to encourage innovation, he told the lawmakers. On the other hand, the framework is also designed to prevent manipulation and fraud and make sure that markets operate with “transparency and integrity,” he said.

Massad expressed similar views at a meeting of the CFTC’s Global Markets Advisory committee in October. At the direction of CFTC Commissioner Mark Wetjen, the sponsor of that Committee, the meeting devoted a significant part of its day-long discussion to the issues raised by the development of Bitcoin derivatives. Massad identified the cryptocurrency market as an important developing issue for the agency and made it clear that he believes his agency has oversight of Bitcoin derivatives traded on swap execution facilities and designated contract markets. “While the development of digital payment systems raises many issues outside our jurisdiction, one area within our responsibility is derivative contracts traded on SEFs or DCMs that are based on Bitcoin,” Massad said at the October GMAC meeting. “As with all new developments, we must remain vigilant and will continue to evaluate these new contracts over time,” he said.

Bitcoin is a digital payment system that was first created in 2009. It allows transactions to be made between entities without banks or payer services and is therefore considered to be the first decentralized peer-to-peer payment network.

In the last year or so Bitcoin usage has begun to enter mainstream commercial transactions. Several large companies such as Overstock.com and eBay have begun accepting Bitcoin as a

payment for goods and services. Bitcoin experts note there is a now growing need for a derivatives market to hedge against fluctuations in the value of the digital currency. But while this form of payment is becoming increasingly common, how it should be regulated isn't quite so clear.

Regulatory Uncertainty

The Federal Reserve, which generally oversees central payment systems, does not have a clear view as to how Bitcoin should be regulated.

"I think it's not so easy to regulate Bitcoin because there is no central issuer or network operator to regulate," Fed Chairman Janet Yellen told lawmakers at a Senate Banking Committee hearing in February of last year. "There's no intersection at all in any way between Bitcoin and banks that the Federal Reserve has the ability to supervise and regulate. So the Federal Reserve simply does not have authority to supervise or regulate Bitcoin in any way," Yellen said.

On the other hand, the Treasury Department's anti-money laundering division, the Financial Crimes Enforcement Network, has clearly staked out its position. In October FinCEN released two rulings clarifying that Bank Secrecy Act and FinCEN regulations apply to Bitcoin.

In addition, some regulators at the state level have taken some steps, and the Securities and Exchange Commission in December fined a firm and its principal for operating unregulated securities exchanges that used virtual currencies without being registered as broker-dealers or stock exchanges.

But experts say even with the regulatory steps that have been taken thus far, more regulatory certainty is needed to support the further development of this marketplace. Part of the problem is that regulators are still grappling with a comprehensive understanding of what Bitcoin actually is and how it is issued, according to Gary DeWaal, special counsel at the law firm of Katten Muchin Rosenman LLP and the former general counsel for Newedge.

"To date it's tangential regulation at best," said DeWaal. "You have regulators circling the wagons, but nobody dealing with the wagons yet."

Bitcoin's value is determined in the open market and that market is still developing and not very liquid. As a result, Bitcoin's value has been quite volatile, according to Jerry Brito, executive director of the Coin Center, a non-profit research and advocacy center focused on the public policy issues facing cryptocurrency technologies. That has created demand for tools that could be used to manage the risk of that volatility.

"Merchants and merchant processing services exchanges and many other businesses and institutions who want to build on top of the Bitcoin platform are in search of good hedging instruments," he said at the CFTC's GMAC meeting.

Wetjen said he anticipates the CFTC will be reviewing more contract design applications as well as trading venues. "It seems like this protocol, the Bitcoin protocol, or something like it, is very, very likely here to stay. The more information and education we can get on this now to try and stay at an appropriate spot on the learning curve seems to be a very sensible thing to do," he said. ■



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TIMOTHY MASSAD, CFTC



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JERRY BRITO, Coin Center



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Joanne Morrison is deputy editor of *Futures Industry*.

Photos by Joanne Morrison