

# Contemplating Crypto Derivatives?

## Things to Consider in an Evolving Market

**Dan Paulos and Elanit Snow**

June 29, 2022

Proskauer»

# What are Crypto Derivatives?

# What are Crypto Derivatives?

---

- Digital Assets vs. Digital Currency
- Benefits of crypto derivatives
- Current market
  - \$3 trillion in volume globally, larger volumes than spot market
  - Futures contracts, options, perpetual swaps
  - Exchanges (Binance, Deribit, FTX, Bybit, CME Group (US))
  - Nano Bitcoin futures for retail investors
  - Coinbase applied for an FCM license to offer margined futures contracts



# Regulation of Crypto Derivatives

# Regulation of Crypto Derivatives

---

- Executive Order on Ensuring Responsible Development of Digital Assets
- SEC
- CFTC
- Others

# Regulation of Crypto Derivatives - SEC

---

“Investment Contract” – Howey Test (*SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946))

- the investment of money
  - in a common enterprise
  - with a reasonable expectation of profits to be derived from the efforts of others
- Treatment of Bitcoin and Ethereum

# Regulation of Crypto Derivatives - CFTC

---

The Commodity Exchange Act defines a “Commodity” to include:

“all...goods and articles, ... and all services, rights and interests ... in which contracts for future delivery are presently or in the future dealt in.”

- Not limited to tangible commodities
- The Dodd-Frank Act expanded the CFTC’s jurisdiction to include leveraged retail commodity transactions where “actual delivery” is not made within 28 days
  - With respect to digital currency, “actual delivery” means the transfer of possession and control and the ability to use the digital currency freely
  - Not satisfied by a book entry by the seller purporting to show delivery
  - Rolling or offsetting a transaction or settling in cash or another digital asset does not constitute “actual delivery”

# Regulation of Crypto Derivatives

---

- Derivatives referencing BTC, ETH or other cryptocurrencies need to comply with all regulations applicable to derivatives and those who deal in, or help facilitate, derivatives transactions
  - Compliance with Investment Company Act, Investment Advisors Act
  - Registration as Swap Dealer, Major Swap Participant, CPO, CTA
  - Swap reporting
  - Margin Posting



# Tax Issues

# Commodity for Tax Purpose

---

- Trading Safe Harbor
  - Commodities... which are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place
- Trade or business
  - ECI, if US source income
  - Fund structure, gains as foreign source

# Trading Issues

# Trading Issues

---

- Valuation Issues
- Change in Law
- Forks
- Airdrops
- Technological and Market Infrastructure Failures

# Trading Issues – Valuation

---

- No single trading venue
- Unavailability of valuation inputs
- Liquidity issues
- Volatility issues
- Evolving market
- Calculation Agent discretion
- Drafting issues



# Trading Issues – Valuation

---

- Valuation Sources
- Valuation Methodology
- Valuation related Disruption Events
- Fallbacks, termination rights

# Trading Issues – Change in Law

---

- Regulatory restrictions on crypto derivatives
- Regulatory restrictions on related activities (e.g. mining)
- New taxes
- Change in legal nature of underlying asset
- Enforcement action against major exchanges or custodians

# Trading Issues – Forks

---

- Identification of Fork
- Viability of new asset
- Treatment of Fork
  - Split Transaction
  - Adjustment
  - Termination
- Tax Issues

# Trading Issues – Airdrops

---

- Tax Issues
- Impact on Value of Swap
- Treatment of Airdrop
  - Split Transaction
  - Adjustment
  - Termination

# Trading Issues – Technology and Market Infrastructure

---

- Technological Disruption
  - Corruption of protocol
  - Alteration of protocol by developers, miners
  - Technological developments
- Market Infrastructure Disruption
  - Exodus of developers, miners
  - Coordinated attack on major exchanges, custodians
  - Insolvency of market dominant exchange or custodian



# Trading Issues – Technology and Market Infrastructure

---

- When did the event occur?
- Valuation/volatility issues
- Who should bear the risk?

# Proskauer's Global Presence



