

## Analysis of the legal qualification of cryptocurrency derivatives

In response to the cryptocurrency boom, many platforms offering forex derivatives have expanded their product ranges. AMF staff have noted the launch of new instruments, including options, contracts for difference (CFDs) and rolling spot forex (margin trading) products, whose underlyings are cryptocurrencies such as bitcoin, ether and ripple. These products are being marketed by platforms conducting business in France through a European passport, either as branches or under the freedom to provide services' framework.

The AMF has conducted a legal analysis to determine whether these participants need to comply with the regulations applicable to financial instruments. If these products are classified as financial instruments, they become subject to the rules of the Monetary and Financial Code (MFC) as regards with regard to authorisation to provide investment services and business conduct requirements, to obligations under the European Market Infrastructure Regulation (EMIR) of 4 July 2012 (particularly the obligation to report transactions to a trade repository) and to the provisions of MFC Article L. 533-12-7, which bans the advertising of certain financial contracts.

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Under French law, a cryptocurrency cannot be considered to be legal tender, a foreign currency, electronic money or even a financial instrument<sup>1</sup>. However, while cryptocurrencies do not fall under existing banking and financial classifications, they can be treated as intangible movable property under a civil law analysis<sup>2</sup>.

A two-stage approach is necessary to conclude that these new types of products do indeed qualify as derivatives under financial law: (I) on the one hand, determining the legal definition of the notion of derivative, and (II) on the other, considering whether a cryptocurrency can be legally regarded as an eligible underlying.

### **I. DEFINING DERIVATIVES: PRIMARY IMPORTANCE OF THE FORWARD COMMITMENT IN RELATION TO THE UNDERLYING**

There is no defined notion for what is meant by a derivative. European lawmakers have simply drawn up a list (MiFID, Annex 1, Section C), which French lawmakers replicate in MFC Articles L. 211-1 III and D. 211-1 A. What is more, the terminology is not harmonised, since European legislation uses a variety of terms such as "*derivative instrument*", "*derivative*" and "*derivative contract*", while MFC Article L. 211-1, III uses "*financial contract*", "*financial futures*" and "*futures contract*".

The law gives a list of contract types (options, forwards, swaps and "*all other futures contracts*") followed by a list of eligible underlyings. This two-part construction reflects the economic nature of derivatives, that is, their value depends on ("is derived from") that of an underlying.

<sup>1</sup> See F. Lacroix, *Les places financières alternatives : propos relatifs aux approches réglementaires concernant les plateformes de crowdfunding et d'échange de bitcoins*, Internet, espace d'interrégulation, Dalloz, 2016; H. de Vauplane, *L'analyse juridique du bitcoin – Rapport moral sur l'argent dans le monde*, 2014, p. 351 and seq.; T. Bonneau, *Analyse critique de la contribution de la CJUE à l'ascension juridique du bitcoin*, Liber amicorum Blanche Soussi, *L'Europe bancaire et financière*, p. 295 and seq.; D. Geiben, O. Jean-Marie, T. Verbiest, J-F Vilotte, *Bitcoin et Blockchain : vers un nouveau paradigme de la confiance numérique*, RB Edition, 2016, p. 73 and seq.; M. Roussille, *Le bitcoin : objet juridique non identifié*, Banque & Droit, No. 159, Jan-Feb 2015.

<sup>2</sup> M. Roussille, *Le bitcoin : objet juridique non identifié*, op.cit.; T. Bonneau, *Analyse critique de la contribution de la CJUE à l'ascension juridique du bitcoin*, op. cit.

While the maturity may be fixed or open, execution takes place after the initial trade. This mechanism, based on a future commitment, is inherent to each of the three contract types mentioned above and is at the heart of the definition of a derivative: without a future commitment, there is no derivative. This means that there is a time-lag between the conclusion and execution of the contract, whether the execution date is agreed beforehand or not.

Based on this reading, the definition of what constitutes a derivative must be treated separately from the nature of the underlying<sup>3</sup>: a derivative must necessarily refer to an underlying, but the legal nature of the latter does not interfere with the definition of the former. This should not be interpreted as a principal/accessory legal relationship. However, in seeking a definition, there are grounds to mention the primary importance of the contract with the forward commitment in relation to the underlying. Consequently, marketed products must have the structure of one of the three types of contracts listed in the legislation (future, option or swap) to be considered as financial contracts.

This is true of the products being offered by the identified platforms, which currently include binary options and CFDs, whose features are described in Article 314-7 of the AMF General Regulation<sup>4</sup> concerning financial contracts that may be not advertised.

Some authors have reached the same conclusion about these new products by classifying them as financial contracts<sup>5</sup>. This position supports the idea of an unlimited list of eligible underlyings<sup>6</sup>. However by acknowledging the unlimited nature of underlying this is merely the corollary to the above analysis, which establishes the primary importance of the future commitment relative to the underlying.

These basic components thus appear to constitute a futures contract for these new types of products. Yet from a strictly legal point of view, this is far from satisfactory. Since lawmakers have drawn up a list with reference to a list of underlyings, it would seem necessary that the selected underlying be on the list given in MFC Article D. 211-1 A, I (II).

## **II. ARE CRYPTOCURRENCIES ELIGIBLE UNDERLYINGS?**

By choosing the list approach, European lawmakers have provided themselves with leeway to expand the list of eligible underlyings, and by referring to notions of increasingly broader scope, this enables them to keep in step with innovation in the industry.

MFC Article D.211-1 A, I, which was a result of the transposition of MiFID, contains eight sections. The reasoning behind the construction of this list is based on whether underlyings come from within or from outside the sphere of finance. The list can thus be divided into two categories: financial underlyings and non-financial underlyings.

On the one hand, in the case of contracts involving financial underlyings, their inherently financial nature is sufficient to assume that they belong to the list of financial contracts, and lawmakers do not

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<sup>3</sup> See in particular F. Auckenthaler, *Instruments financiers à terme ou contrats financiers*, JurisClasseur Banque-Crédit-Bourse, § 10; Th. Bonneau, F. Drummond, *Droit des marchés financiers*, Economica, 3<sup>rd</sup> ed., § 150 and 158.

<sup>4</sup> Binary options are defined as follows: "depending on whether a condition specified in the contract is met or not, they give rise upon the contract's expiry either to the payment of a predetermined gain or the partial or total loss of the amount invested"; CFDs, meanwhile: "give rise to the payment of a positive or negative differential between the price of an underlying asset or basket of assets at the time the contract has been entered into and the price at which the position is closed out".

<sup>5</sup> See F. Lacroix, *Les places financières alternatives : propos relatifs aux approches réglementaires concernant les plateformes de crowdfunding et d'échange de bitcoins*, op.cit., p. 66: "le bitcoin pourrait toutefois être l'objet d'un contrat financier tel un swap, par exemple. [...] Le bitcoin peut parfaitement être une mesure financière ou encore un indice financier"; F. Drummond, *Bitcoin : du service de paiement au service d'investissement*, Bull. Joly Bourse, May 2014, p. 249.

<sup>6</sup> F. Auckenthaler, *Instruments financiers à terme ou contrats financiers*, JurisClasseur Banque-Crédit-Bourse, op.cit., § 10; and Th. Bonneau, F. Drummond, *Droit des marchés financiers*, Economica, 3<sup>rd</sup> ed., § 150: "Toutes les choses dont la valeur est susceptible de varier avec le temps peuvent fournir la matière d'un dérivé"; S. Praicheux, *Instruments financiers à terme*, Rép. Sociétés, Dalloz, § 29.

impose any additional criteria. Consequently, the procedure for the settlement of these contracts is irrelevant, i.e. they can be physically delivered or cash-settled.

On the other hand, contracts involving non-financial underlyings may be treated as commercial contracts subject to common law provided they are settled through straightforward physical delivery. However, these are qualified as financial contracts if they are cash-settled (whether on a mandatory or optional basis) or if they are traded on a trading venue. In a sense, these criteria "financial-ise" contracts that would otherwise be treated as commercial contracts.

In the case of commodity derivatives, there is an obvious difficulty in identifying the boundary between the notion of commercial and financial. The AMF took a position on this issue in 2002<sup>7</sup> by establishing the criteria that are now set out by law: specifically, cash settlement is now the main and sufficient criterion for a contract to be classified as a financial contract. As a result, if a contract has to be or may be cash-settled, it is considered as a financial contract from a legal standpoint. If, however, a contract offers the possibility of physical delivery of the underlying, it must be traded on a trading venue to be eligible for classification as a financial contract.

With this in mind, the AMF considers that cryptocurrency derivatives are likely to meet the criteria set out in MFC Article D. 211-1 A, I, which need to be analysed by order of relevance.

### **1. Provisions of Article D. 211-1 A, I, 6**

Eligible underlyings within the meaning of Point 6 of Article D. 211-1 A, I include: "*6. Financial contracts for difference.*"

Point 6 states, without further requirements, that CFDs are financial contracts. This category of derivative was created by MiFID 1 and remains in MiFID 2 (Annex 1, Section C, 9) and in the MFC. However, no reference was made to underlyings of any kind. Following a strict interpretation, it would be possible to consider that all instruments presenting financial flows and eligible for the CFD category are derivatives irrespective of their underlyings. This interpretation is consistent with the primary importance of the basic components of a derivative as mentioned above and would allow cryptocurrency CFDs to be included in the category of financial contracts.

However the AMF considers that the following discussion on underlyings should not be disregarded insofar as a CFD is legally a futures contract, which refers to other sections of Article D.211-1 A, I.

### **2. Provisions of Article D. 211-1 A, I, 8**

Eligible underlyings within the meaning of Point 8 of Article D.211-1 A, I include: "*8. Any other futures contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in Points 1 to 7 above, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, multilateral trading facility or organised trading facility.*"

This category comprises several criteria and needs to be broken down:

#### **2.1 The expression "*any other futures contracts relating to assets, rights* [...]"**

<sup>7</sup> Revue CMF No. 54, Dec. 2002 / Jan. 2003, *Distinction entre les contrats commerciaux à terme et les contrats financiers à terme sur marchandises*; A. Gauvin, Banque stratégie No. 201, Feb. 2003, *Contrats à terme de marchandises et instruments financiers : alignement de la DSI sur la Loi MAF*; S. Praicheux, *Instruments financiers à terme*, op. cit., § 6; F. Auckenthaler, *Instruments financiers à terme ou contrats financiers*, op. cit., § 13.

The provisions of MFC Article D. 211-1 A, I are a literal transposition of Annex 1, Section C of MiFID. It is therefore appropriate to refer to Commission Delegated Regulation (EU) 2017/565<sup>8</sup> of 25 April 2016, which, among other things, clarifies the terms used in the above Annex, to interpret the list in Article D. 211-1 A, I. Article 8 of the Delegated Regulation states that the terms "**assets**" and "**rights**" mean "*any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred*".

A cryptocurrency may be considered as an asset<sup>9</sup>. It is probably "capable of being transferred" within the meaning of French law (which enables swifter and more effective transmission than civil law procedures relating to transfers of claims and the binding nature of exceptions) insofar as it can circulate on a platform. However, legal literature<sup>10</sup> currently classifies cryptocurrencies as non-fungible. On first analysis, then, a cryptocurrency derivative does not seem to meet this definition.

2.2 The expression "*any other futures contracts relating to [...] indices and measures not otherwise mentioned in Points 1 to 7 above, which have the characteristics of other derivative financial instruments*"

This catch-all wording is designed to include derivatives whose underlyings are not inherently financial but whose other qualities somehow give them a financial nature.

#### 2.2.1 "Indices" and "measures"

The Delegated Regulation also provides a definition of the notions of indices and measures. Article 8 (g) states that they should be understood as "*an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation*".

An "index" is commonly defined as "*a number used to summarise and characterise the relative change in a simple or complex value between two situations, one of which acts as a basis (reference time or place)*". Article 3 of the Benchmark Regulation<sup>11</sup> also offers a definition. An index means "*any figure: a) that is published or made available to the public; b) that is regularly determined: i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and ii) on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys*".

A "measure" is commonly defined as "*the action of assessing a value based on its relationship to a value of the same type, which is used as a unit and reference*".

The value of a cryptocurrency as an underlying to a derivative would appear to meet these definitions as well as the criteria established by the Delegated Regulation. This is because such values generally result from an average of prices recorded on one or more platforms, with the price on each platform itself resulting from the matching of supply and demand on the platform. Based on this calculation method, the AMF considers that the value used to assess such an underlying may be considered to be an index or measure of the price or value of, or volume of transactions in that cryptocurrency. Accordingly, the AMF contemplates that a cryptocurrency derivative can be considered to be a

<sup>8</sup> Commission Delegated Regulation (EU) 2017/565 ("**Delegated Regulation**"), Article 8. This article uses the terms in Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC.

<sup>9</sup> "Un actif est l'ensemble des biens et droits évaluable en argent qui constituent les éléments positifs du patrimoine d'une personne", Vocabulaire juridique, G. Cornu, 10th ed.

<sup>10</sup> M. Roussille, *Le bitcoin : objet juridique non identifié*, op.cit.; T. Bonneau, *Analyse critique de la contribution de la CJUE à l'ascension juridique du bitcoin*, op. cit.

<sup>11</sup> Regulation (EU) 2016/1011 ("**Benchmark Regulation**") of 8 June 2016.

"futures contract relating to [...] indices and measures" within the meaning of Point 8 of MFC Article D. 211-1 A, I and of the Delegated Regulation.

2.2.2 The expression "*which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, multilateral trading facility or organised trading facility*"

The MFC does not clarify what is meant by the wording "*having regard to whether, inter alia, they are traded on [...]*". One interpretation would be to suggest that the criteria "traded on [...]" is a requirement to meet the definition of derivatives within the meaning of the MFC. However, the AMF favours a second interpretation, which consists in seeing in this wording merely one characteristic of "*other derivative financial instruments*". This analysis is supported by Article 7 § 3 of the Delegated Regulation, which identifies trading on a trading venue as just one of the possible criteria for an instrument to be considered as having "*the characteristics of other derivative financial instruments*".

Specifically, the Delegated Regulation states that: "[...] a derivative contract [...] shall be considered to have the characteristics of other derivative financial instruments where one of the following conditions is satisfied: **a)** it is settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of a default or other termination event; **b)** it is traded [on a trading venue]; **c)** the conditions laid down in paragraph 1 are satisfied in relation to that contract<sup>12</sup>".

Insofar as the products offered by the platforms are not traded on a trading venue (criteria in sub-paragraphs b and c), it is necessary to check whether the remaining criterion (sub-paragraph a) is met. This raises the question of the settlement procedure for cryptocurrency derivatives, i.e. the ability of such derivatives to be cash-settled.

2.2.3 Cash settlement of cryptocurrency derivatives

Article D.211-1 A, I distinguishes between physical settlement and cash settlement, which are the two possible ways to settle a financial contract. While the practical execution procedures associated with physical settlement are easily understood (delivery of the underlying against payment of a given amount), those associated with cash settlement are not clear from the term itself. There are two reasons for this:

- The term "cash" literally means banknotes and coins, which at a first reading would exclude other payment instruments such as credit transfers, although these are widely used. This wording has no legal basis in French law, since the French expression – "*règlement en espèces*" – merely reflects usage in the derivatives industry of the English term "cash settlement";
- Cash settlement is not conducted in lieu of the delivery of the underlying, as the wording might suggest. When the parties to a financial contract choose cash settlement as their execution method, it means that the debtor at the settlement date will have to pay its counterparty the price difference between when the contract was entered into and when it is settled<sup>13</sup>.

In practice, this price difference is settled in euros (or in another currency with legal tender), hence the name "cash settlement", but it could just as easily be settled using another asset, such as a cryptocurrency, without that having any bearing on how the contract is classified. Under French law,

<sup>12</sup> The requirements set out in this paragraph refer to criteria for contract standardisation and the contracts traded on a trading venue.

<sup>13</sup> This difference is determined differently according to the type of financial contract (option, CFD, future/forward) but always gives rise to a single cash flow.

the parties to a contract can provide for the difference to be paid using something other than the agreed-on sum of money, i.e. a payment whereby the debtor discharges its debt by means of an asset other than that which was originally agreed on.

The cryptocurrency derivatives offered by the platforms mentioned above function as a form of binary options, CFDs and, more recently, rolling spot forex products. The economic rationale underpinning these products means that they are designed to be settled based on the price difference:

- ***In the case of CFDs***, their very name – "financial contracts for difference" – indicates that they are exclusively cash-settled. The idea behind these products is to enable investors to gain exposure to the underlying (whatever it may be) without the drawbacks of physical ownership<sup>14</sup>;
- ***Binary options*** resemble short-term or very short-term bets. Physical delivery of the underlying would be at odds with the rationale of such products;
- ***Rolling spot forex products*** have an economic structure that means they are like CFDs.

The AMF considers that these three types of cryptocurrency derivatives are cash-settled.

### 3. Provisions of Article D. 211-1 A, I, 1

Eligible underlying within the meaning of Point 1 of Article D. 211-1 A, I include: "1. *Options, futures, swaps, forward rate agreements and any other futures contracts relating to financial instruments, currencies, interest rates or yields, the units referred to in Article L. 229-7 of the Environmental Code, financial indices or financial measures which may be settled physically or in cash.*"

These new products could additionally satisfy the derivatives definition as contracts relating to financial indices or financial measures, as provided for in the legislation.

As mentioned in the introduction, cryptocurrencies cannot be legally considered to be foreign currencies. This definition must therefore be ruled out.

The same is not true, however, for the definition of contracts relating to financial indices and financial measures. As explained earlier, the adjective "financial" conveys the inherently financial nature of the underlying covered in Point 1. However, these notions are undefined. Besides seeking to broaden the scope of definitions, lawmakers clearly wanted to include stock market indices and indicators such as inflation in the list of eligible underlying, owing to the emergence of these types of derivatives.

If we consider that cryptocurrencies are "indices and measures" as shown above, can we also consider that they are inherently financial? Since the economic functions attributed to cryptocurrencies are very much like those traditionally attributed to foreign currencies (in terms of the payment function, hence the terminological confusion) or to financial instruments (i.e. an asset used to underpin an investment), in other words two components that are included in inherently financial underlyings, cryptocurrencies also appear to be eligible financial assets within the meaning of this legislation.

In summary, the AMF considers that cryptocurrency derivatives meet the criteria established by Point 6 (CFDs), by Point 8 (contracts that are cash-settled and whose underlying may be considered to be a

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<sup>14</sup> See for example the definition from ESMA and EBA: "a *CFD* is an agreement between a 'buyer' and a 'seller' to exchange the difference between the current price of an underlying asset and its price when the contract is closed" (Investor Warning, 28 February 2013).

"measure" or "index" within the meaning of the Delegated Regulation) and, additionally, by Point 1 (inherently financial assets) of MFC Article D.211-1 A, I.

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***In conclusion, a cash-settled derivative whose underlying is a cryptocurrency can be considered to be a financial contract. Consequently, the regulations applicable to the marketing of financial instruments in France apply to cryptocurrency derivatives.***