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Federal Judge Adopts CFTC Position That Cryptocurrencies Are Commodities

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A New York federal judge held that virtual currencies are commodities that can be regulated by the Commodity Futures Trading Commission ("CFTC"), enjoining the defendants, an individual and affiliated entity, from trading cryptocurrencies on their own or others' behalf or soliciting funds from others, and ordering an expedited accounting. CFTC v. McDonnell, No. 18-cv-0361, Dkt. 29 (E.D.N.Y. Filed Jan 18, 2018). While the CFTC announced its position that cryptocurrencies are commodities in 2015, this case marks the first time a court has weighed in on whether cryptocurrencies are commodities. Having answered that question in the affirmative, the court went on to hold that the CFTC has jurisdictional authority over defendants' alleged cryptocurrency fraud under 7 U.S.C. § 9(1), which permits the CFTC to regulate fraud and manipulation in underlying commodity spot markets.

REGULATORY LANDSCAPE

In recent months, regulators have increasingly turned their attention to cryptocurrency. Although Congress has not yet enacted a regulatory regime for virtual currency, the CFTC and the Securities and Exchange Commission ("SEC") have exercised concurrent authority over virtual currency primarily by bringing enforcement proceedings.

In September 2015, the CFTC first announced its view that bitcoin and other virtual currencies are commodities within the meaning of the Commodity Exchange Act ("CEA"). See In the Matter of: Coinflip, Inc., CFTC No. 15-29. Initially, the CFTC targeted its enforcement efforts towards unregistered futures and swap marketplaces in virtual currencies. See, e.g., In Re TeraExchange LLC, CFTC No.15-33, 2015 WL 5658082 (Sept. 24, 2015); In re BXFNA Inc. d/b/a Bitfinex, CFTC No. 16-19 (June 2, 2016). More recently, however, the CFTC has begun targeting alleged Ponzi schemes and other frauds involving virtual currencies, regardless of whether those alleged frauds involve trading in futures or swaps. See, e.g., CFTC v. The Entrepreneurs Headquarters Limited, No. 2:18-cv-00345 (E.D.N.Y. Filed Jan. 18, 2018); CFTC v. My Big Coin Pay, Inc., Case No. 1:18-cv-10077 (D. Mass. Filed Jan. 16, 2018); CFTC v. Gelfman Blueprint, Inc., Case No. 17-7181 (S.D.N.Y. Filed Sept. 21, 2017). These more recent enforcement actions have been pursued under the spot market anti-manipulation authority granted to the CFTC as part of The Dodd–Frank Wall Street Reform and Consumer Protection Act, and codified by 7 U.S.C. § 9(1) and 17 C.F.R. § 180.1(a). While the CFTC has acknowledged that its authority in cash or spot markets is limited, it has asserted authority over alleged fraud or manipulation in those markets. See CFTC v. McDonnell, No. 18-cv-0361, Dkt. 29 at 22 (citing 7 U.S.C. § 2(c)(2)(C)(i)(II)(bb)(AA)); CFTC Launches Virtual Currency Resource Web Page, Press Release, Dec. 15, 2017, available at http://www.cftc.gov/PressRoom/PressReleases/pr7665-17.

Separately, SEC Chairman Jay Clayton issued a statement in December asserting that many products marketed as cryptocurrencies in fact function as securities, requiring registration with the SEC unless exempted. See SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017). Similarly, the SEC has stated that many online platforms for trading cryptocurrencies function in fact as securities exchanges, and must therefore be registered to operate lawfully. See Divisions of Enforcement and Trading and Markets, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (March 7, 2018). To address these concerns, the SEC has formed a new Cyber Unit within its Division of Enforcement and has brought a number of enforcement actions in the past year concerning alleged frauds in the cryptocurrency market. Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC before the Committee on Banking, Housing, and Urban Affairs (Feb. 6, 2018) (statement of Jay Clayton, Chairman of the SEC).

For its part, the Internal Revenue Service ("IRS") asserted in 2014 that virtual currency is "property" and that virtual currency transactions are subject to general tax principles like other kinds of property. Notice 2014-21 (March 25, 2014). To date the IRS has sought trading records from virtual currency exchanges, successfully obtaining a court order compelling the records of roughly 14,000 Coinbase users. See United States v. Coinbase, Inc., No. 17-CV-01431-JSC, 2017

WL 5890052 (N.D. Cal. Nov. 28, 2017).

Other federal and state authorities such as the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCen), the U.S. Department of Justice, and the N.Y. Department of Financial Services have also undertaken regulatory and/or enforcement efforts concerning cryptocurrency. See CFTC v. McDonnell, No. 18-cv-0361, Dkt. 29 at 10-12 (E.D.N.Y. Jan 18, 2018).

CASE BACKGROUND

In January 2018, the CFTC filed a complaint against defendants Patrick McDonnell and his company CabbageTech, Corp., doing business as Coin Drop Markets, alleging that the defendants defrauded virtual currency investors by offering trading and investment services in exchange for U.S. Dollar and cryptocurrency payments, only to close up shop and disappear. Dkt. 1 at 1. Specifically, the CFTC alleged that the defendants inflated their own trading credentials and promised outsized investment returns to induce customers to subscribe to daily investor alerts and hire defendants to trade directly on their behalf. Id. at 1, 4-7. The CFTC alleged that shortly after obtaining payments from numerous customers, defendants shut down the company's website and chatroom, deleted its social media accounts, and cut off communications with customers, misappropriating the funds without providing the promised advice. Id. at 1, 5, 7.

The court ordered briefing on the CFTC's request for a preliminary injunction as well as on the authority of the CFTC to bring the instant action. See Dkt. 9, 10. Subsequently, McDonnell filed a pro se motion to dismiss the CFTC's complaint, arguing in relevant part that the CFTC was politically motivated, and lacked jurisdiction over defendants' virtual currency activities, which McDonnell argued were not advisory in nature. Dkt. 18, 20. McDonnell's motion to dismiss did not argue that cryptocurrencies were not commodities, but rather asserted that because his business provided impersonal investment advice to the general public, and did not manage assets, its conduct was outside the scope of CFTC jurisdiction. Dkt. 18 at 1.

THE DISTRICT COURT'S OPINION

Senior United States District Judge Jack B. Weinstein denied defendants' motion to dismiss and granted the CFTC's motion for a preliminary injunction, holding in relevant part that the CFTC had jurisdictional authority to bring a fraud action against defendants' allegedly deceptive cryptocurrency scheme despite the absence of futures contracts. Dkt. 29 at 28. In so holding, the court concluded that "[v]irtual currencies are 'goods' exchanged in a market for a uniform quality and value," and therefore fall "well-within" the common definition as well as the CEA's definition of commodities. Id. at 24.

The court further explained that although the CFTC has traditionally limited its jurisdictional authority to futures and derivatives markets, under Dodd Frank the CFTC may also exercise authority over fraudulent or manipulative conduct in underlying spot markets. Id. at 25. The court held that because virtual currencies are commodities, the CFTC has authority under 7 U.S.C. § 9(1) and 17 C.F.R. § 180.1 to bring a fraud action against defendants even if futures contracts are not involved. The court did not expressly address defendants' argument that the CFTC lacked jurisdiction over its conduct due to the nature of the advice given, but it necessarily rejected that argument in granting the CFTC's motion.

In reaching its jurisdictional decision, the court noted that the CFTC's authority to regulate cryptocurrencies as commodities does not preclude other agencies from regulating cryptocurrencies when they function differently than derivative commodities, at least until Congress sees fit to enact a more tailored regulatory scheme.