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Court confirms CFTC jurisdiction over cryptocurrency fraud and that virtual currencies are commodities

By Daniel McAvoy, Christopher Queenin and Brian Becker

On March 6, 2018, the Eastern District of New York ordered [a preliminary injunction](#) in favor of the Commodity Futures Trading Commission, or the CFTC, over an allegedly fraudulent virtual currency scheme. While the arguments made in this case are similar to those made by the CFTC in a number of other recent enforcement actions over the past six months—most notably in an [action against Gelfman Blueprint, Inc.](#), a New York-based company alleged to have bilked \$600,000 from customers in what the CFTC described as a “Bitcoin Ponzi scheme”—this is the first case in which a court has affirmatively held that cryptocurrencies are commodities and that the CFTC has jurisdiction over virtual currencies.

According to the allegations, a firm doing business as Coin Drop Markets purported to offer cryptocurrency trading and investment services, promising a fast and easy 300% return through joining various membership groups that would trade cryptocurrencies on spot markets. Shortly after investors obtained a membership, the principals of Coin Drop Markets stopped responding to investor requests and their Internet presence disappeared. When investors asked for their money back, the principals refused.

As it long has asserted, the CFTC argued that cryptocurrencies are commodities and that, accordingly, it has jurisdiction over frauds committed in the cryptocurrency spot markets. The court agreed. First, the Court found that the Commodity Exchange Act, or CEA, should be construed liberally, and that cryptocurrencies have many of the same qualities as traditional commodities such as gold. Second, it found that Section 2(c)(2)(C)(i)(II)(bb)(AA) of the CEA grants the CFTC jurisdiction over cryptocurrency spot markets involving the scienter-based crimes of fraud or manipulation, even though the CFTC does not have jurisdiction over these markets in the absence of manipulation or fraud. Third, the Court found that the CFTC has concurrent jurisdiction over these types of crimes with other regulatory agencies.

The decision also contained potentially significant dicta. First, it stated that, as a factual matter, the CFTC has exclusive jurisdiction over cryptocurrency futures markets. Whether this means the Securities and Exchange Commission, or SEC, will refrain from asserting jurisdiction as a ‘hybrid security’ remains to be seen. Second, before arriving at its conclusion that the CFTC has concurrent

jurisdiction over these types of matters, the Court discussed other regulatory agencies that the Court believes may have jurisdiction over virtual assets, including:

- The SEC, to the extent a token or cryptocurrency is a security under the Howey Test (test created by the Supreme Court for determining whether an arrangement qualifies as “investment contract” that is deemed to be a security).
- The Department of Justice and state criminal authorities where fraud or other crimes are involved.
- The Treasury Department’s Financial Enforcement Network, or FinCEN, in connection with violations of money laundering laws.
- The Internal Revenue Service, or IRS, on gains and losses pertaining to virtual currencies and failures to properly report that income.
- Self-regulatory organizations, or SROs, such as stock exchanges, that can help self-police virtual currency markets.
- State regulators, including under money transmitter laws, where spot transaction exchanges may be required to register with agencies such as the New York Department of Financial Services.
- Any combination of the above.

There are three key takeaways from this case. First, investors should be extremely wary of any offering, whether of cryptocurrencies, coins, tokens, securities, commodities or other investment opportunities, where the sponsor is offering quick and outsized returns—the biggest tell of a fraudulent scheme in the eyes of any regulator or prosecutor. Second, going forward, courts are likely to adopt the CFTC’s long-held position that virtual currencies are commodities. Last, this decision highlights the current uncertain regulatory landscape. On the federal level alone, cryptocurrencies are considered property by the IRS, money by the Treasury Department, and commodities by the CFTC. In short, cryptocurrencies are potentially subject to regulation by numerous state and federal agencies, and without Congressional action, it is unlikely that the regulatory landscape will clear up in the United States anytime soon.

Separately, the SEC also [issued a statement](#) regarding potentially unlawful exchange platforms for cryptocurrencies. Consistent with the SEC Staff’s view that most coins are indeed securities, they have issued an advisory that is intended to both warn investors of the risks of making investments through cryptocurrency spot markets and provide legal guidance to those who are already operating virtual currency exchanges. This guidance may hasten attempts to develop a formal registered exchange for cryptocurrencies, although even the development of a self-regulatory organization is not likely to put virtual currencies outside of the CFTC’s jurisdiction. The statement also indicated that the SEC is probably looking into whether digital wallet platforms might be subject to registration as a broker-dealer, transfer agent or clearing agency.

The decision, *Commodity Futures Trading Commission v. Patrick K. McDonnell and Cabbagetech Corp. d/b/a Coin Drop Markets*, is available [here](#). For more information on the content of this alert, please contact your Nixon Peabody attorney or:

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