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CFTC Reasserts its Role in Virtual Currency Regulation with Enforcement Actions and Joint Statement with SEC

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On January 19, 2018, the Commodity Futures Trading Commission (CFTC or the Commission) filed separate enforcement actions against two individuals and their respective companies for fraudulent activity involving virtual currencies.¹ The next day, shortly after announcing the charges publicly, the CFTC released a statement with the Securities and Exchange Commission (SEC) reiterating their joint commitment to stopping and preventing fraud in the offer and sale of digital instruments. Then, on January 24, the Commission announced that it had unsealed charges against a virtual currency exchange website and its controlling individuals. Collectively, these actions confirm a regulatory environment of increased oversight of this emerging asset class.

This article provides an overview of the CFTC's virtual currency enforcement efforts, including potential areas of overlap with the SEC, as well as take-aways for market participants.

Overview

The CFTC's authorizing statute, the Commodity Exchange Act, broadly defines a commodity to include "goods and articles . . . and all services, rights and interests" in which futures contracts are or may be traded.² Given this broad authority, it is not surprising that the CFTC was one of the first regulatory agencies to assert oversight over market activity involving virtual currencies. In December 2014, then-CFTC Chairman Timothy Massad announced that virtual currency derivatives "represent one area within [the Commission's] responsibilities."³ In September 2015, the Commission brought its first enforcement action against an unregistered trading platform (Coinflip, Inc.), which allowed users to buy and sell bitcoin options.⁴ In that case, the CFTC issued an order stating that "[b]itcoin and other virtual currencies are . . . properly defined as commodities."⁵ Because commodity-based derivatives contracts are subject to the CFTC's comprehensive regulatory regime — which includes registration, reporting, business conduct, and other requirements — the Commission charged that Coinflip unlawfully offered commodity options without being properly registered with the agency.⁶ Just a week later, on September 24, 2015, the CFTC brought an action against a registered bitcoin/dollar exchange (TeraExchange), alleging that the company had failed to enforce the

¹ The CFTC defines virtual currency as a "digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction." LabCFTC, A CFTC Primer on Virtual Currencies 11 (2017) [hereinafter "CFTC Primer"]. Virtual currency is often referred to as cryptocurrency.

² 7 U.S.C. § 1a(9). Under the CEA, the CFTC has jurisdiction over commodity transactions if they involve derivatives or if there is fraud or manipulation involving a commodity traded in interstate commerce.

³ Testimony of CFTC Chairman Timothy Massad before the U.S. Senate Committee on Agriculture, Nutrition and Forestry (Dec. 10, 2014), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6>.

⁴ In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29, available at <http://www.cftc.gov/idx/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

⁵ *Id.* at 3.

⁶ *Id.* at 3–4.

Commission's prohibition on wash trading.⁷ Since then, the Commission has maintained a steady presence in the virtual currency space. For example:

- In June 2016, the Commission filed and settled charges against Bitfinex, a major exchange platform for virtual currencies.
- In May 2017, the Commission launched an initiative, LabCFTC, to serve as “the focal point of CFTC [financial technology] policy consideration and development,” specifically addressing the growing need to adapt regulations to fit emerging virtual markets.⁸
- In September 2017, the CFTC brought its fourth virtual currency enforcement action, charging Nicholas Gelfman and his company with fraud, misappropriation, and issuing false account statements in connection with solicited investments in bitcoin. The defendants were accused of operating a Ponzi scheme, whereby investors were encouraged to place their funds in a pool that would be managed by advanced trading strategies.⁹
- In October 2017, LabCFTC issued its inaugural publication, titled “[A Primer on Virtual Currencies](#),” to provide additional guidance to market participants about the CFTC's oversight of and interest in virtual currency.
- In December 2017, the CFTC launched a dedicated virtual currency resource webpage.¹⁰ In early January 2018, the webpage featured a “backgrounder” on virtual currency futures markets, emphasizing the Commission's role in regulating virtual currency exchanges and setting forth its approach to enforcement.¹¹

The Commission's recent enforcement efforts have proceeded on a parallel track with those of the SEC, which announced in July 2017 that digital tokens issued in the context of initial coin offerings (ICOs) may be securities and has since filed a number of enforcement actions on this basis. The CFTC has explained that “[t]here is no inconsistency between the SEC's analysis and the CFTC's determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.”¹² To the extent that the CFTC and SEC may have overlapping jurisdictions, the CFTC is arguably better positioned to fight virtual currency fraud given its expansive anti-fraud and anti-manipulation authority, as established by Dodd-Frank and implemented by CFTC Rule 180.1. Although Rule 180.1 is modeled on SEC Rule 10b-5, it has a broader reach. For example, Rule 180.1 extends to any “manipulative or deceptive conduct” that has a relationship to a commodity in interstate commerce.¹³ In contrast, Rule 10b-5 applies only to activity in connection with an actual transaction involving the purchase and sale of a security. Against this backdrop, recent developments suggest that the CFTC may increase its regulatory oversight of virtual currency fraud in the future.

⁷ In re TeraExchange LLC, Dkt. No. 15-33 (CFTC Sept. 24, 2015), <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf>.

⁸ Sharon Y. Bowen, Commissioner, CFTC, Statement on the Launch of LabCFTC (May 17, 2017), <http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement051717>.

⁹ Press Release, CFTC, CFTC's LabCFTC Releases Primer on Virtual Currencies (Oct. 17, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7631-17>.

¹⁰ Press Release, CFTC, CFTC Launches Virtual Currency Resource Web Page (Dec. 15, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7665-17>.

¹¹ CFTC, CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets (Jan. 4, 2018), http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

¹² CFTC Primer at 14. The CFTC has also recently asserted that digital tokens issued in connection with ICOs may be commodities. *Id.*

¹³ Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41405 (Jul. 14, 2011) (noting that Rule 180.1 should be read “broadly, not technically or restrictively” and is intended to “reach all manipulative or deceptive conduct in connection with the purchase, sale, solicitation, execution, pendency, or termination of any swap, or contract of sale of any commodity in interstate commerce[.]”).

Focusing on Fraud

On January 18, 2018, the CFTC filed two lawsuits in federal court arising from alleged fraud schemes involving virtual currencies. In one case, *CFTC v. McDonnell, et al.*, the CFTC brought charges against Patrick McDonnell and his company CabbageTech, which advertised trading advice and investment services to individuals interested in virtual-currency trading in exchange for payment in both virtual and fiat currency.¹⁴ According to the CFTC, the services were never provided. Instead, McDonnell allegedly misappropriated the funds, ceased communicating with customers, and wiped the company's websites and social media presence off the internet.¹⁵ In the other case, *CFTC v. Dean, et al.*, the Commission alleged that, among other things, Dillon Michael Dean and his UK-registered company, Entrepreneurs Headquarters Ltd, operated a Ponzi scheme in which Dean solicited virtual currency contributions from hundreds of investors based on a promise that their cash would be pooled and invested.¹⁶ The CFTC asserted that "defendants misappropriated their customers' funds (including by using them to pay other customers, in the manner of a Ponzi scheme), and then lied to customers about their account balances in order to conceal defendants' misappropriation."¹⁷

The next day, on January 19, the CFTC and SEC released a joint statement regarding their commitment to combating fraud relating to virtual instruments. The statement reads in full:

*When market participants engage in fraud under the guise of offering digital instruments — whether characterized as virtual currencies, coins, tokens, or the like — the SEC and the CFTC will look beyond form, examine the substance of the activity and prosecute violations of the federal securities and commodities laws. The Divisions of Enforcement for the SEC and CFTC will continue to address violations and bring actions to stop and prevent fraud in the offer and sale of digital instruments.*¹⁸

On January 24, the CFTC revealed that it had filed a third enforcement action under seal the previous week. The complaint, filed in federal court on January 16, alleges that My Big Coin Pay and associated individuals solicited customers to buy "My Big Coin," a virtual currency supposedly backed by gold, actively traded worldwide, and associated with payment services such as MasterCard.¹⁹ According to the CFTC, none of these claims was true. The complaint asserts that once customers bought into the scheme, defendants posted arbitrary and false prices for the currency, the website did not allow customers to trade the currency or withdraw their funds, and defendants perpetuated this fraud to misappropriate millions of dollars of funds.²⁰ In a related press release, the Commission's Director of Enforcement James McDonald said, "the CFTC is actively policing the virtual currency markets and will vigorously enforce the anti-fraud provisions of the Commodity Exchange Act. In addition to harming customers, fraud in connection with virtual currencies inhibits potentially market-enhancing developments in this area."²¹

Looking Ahead

¹⁴ Complaint, Commodity Futures Trading Commission v. McDonnell et al, No. 1:18-cv-361 (E.D.N.Y. Jan. 18., 2018).

¹⁵ *Id.* at ¶¶ 23–26.

¹⁶ Complaint, Commodity Futures Trading Commission v. Dean et al., No. 2:18-cv-345 (E.D.N.Y. Jan. 18, 2018).

¹⁷ *Id.* at ¶¶ 19, 43–51.

¹⁸ Press Release, CFTC, Joint statement from CFTC and SEC Enforcement Directors Regarding Virtual Currency Enforcement Actions (Jan. 19, 2018), <http://www.cftc.gov/PressRoom/SpeechesTestimony/mcdonaldstatement011918>.

¹⁹ Sealed Complaint, CFTC v. My Big Coin Pay, Inc., et al., No. 1:18-cv-10077 (D. Mass. Jan. 16, 2018).

²⁰ *Id.*

²¹ Press Release, CFTC, CFTC Charges Randall Crater, Mark Gillespie, and My Big Coin Pay, Inc. with Fraud and Misappropriation in Ongoing Virtual Currency Scam (Jan. 24, 2018), <http://www.cftc.gov/PressRoom/PressReleases/pr7678-18>.

Market participants should be mindful of the CFTC's regulatory reach and the likelihood of additional enforcement actions in the future. As a preliminary matter, the Commission has permitted exchanges under its jurisdiction to self-certify listings of virtual currency derivatives, which has substantially encouraged the development of virtual currency markets under its purview. Moreover, given its historical (and in many ways, pioneering) interest in this space, the CFTC is likely to make robust use in the future of its broad authority to combat fraud and other misconduct related to virtual currencies. For example, the CFTC may invoke Rule 180.1 to bring insider trading cases based on the purchase and sale of virtual currencies. Finally, the CFTC and SEC appear to be willing to work cooperatively to police this space.