

Derivatives Alert

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Federal Judge Rules Virtual Currencies Are Commodities Under the Commodity Exchange Act

On March 6, 2018, Judge Jack B. Weinstein of the U.S. District Court for the Eastern District of New York ruled that virtual currencies are commodities under the Commodity Exchange Act (CEA) and therefore subject to the Commodity Futures Trading Commission's (CFTC) anti-fraud and anti-manipulation enforcement authority.¹ Granting the CFTC's request for a preliminary injunction against the defendants who allegedly engaged in deception and fraud involving virtual currency spot markets, Judge Weinstein noted that "[u]ntil Congress clarifies the matter," the CFTC has "concurrent authority" along with other state and federal administrative agencies and civil and criminal courts over transactions in virtual currency.²

In *Commodity Futures Trading Commission v. McDonnell et al.*, the CFTC alleged that the defendants violated the CEA by operating a fraudulent scheme involving virtual currency trading and misappropriating investor funds.³ The primary issue before the court was whether the CFTC had standing to sue the defendants under the CEA. To resolve that issue, the court had to determine whether (1) virtual currency may be regulated by the CFTC as a commodity and (2) the CEA permits the CFTC to exercise jurisdiction over fraud in connection with commodities that do not directly involve futures or derivative contracts.⁴

The court answered both questions in the affirmative and held that the CFTC can pursue fraud and manipulation claims in virtual currency spot markets.⁵ First, the court found that the term "commodity" encompasses virtual currency "both in economic function and in the language of the statute."⁶ According to the court, virtual currencies are "goods' exchanged in a market for a uniform quality and value."⁷ As such, the court reasoned that they "fall well-within" the common definition of commodity as well as

¹ *Commodity Futures Trading Comm'n v. McDonnell*, No. 1:18-cv-00361-JBW-RLM, slip op. (E.D.N.Y. Mar. 6, 2018) (mem.).

² *Id.* at 3.

³ *Id.*

⁴ *Id.*

⁵ Although the court did not address private enforcement, it is worth noting that it does not appear that a private party could bring a claim under the CEA for fraud or manipulation in connection with the purchase or sale of virtual currencies. See 7 U.S.C. § 25(a)(1)(D).

⁶ *McDonnell*, slip op. at 3.

⁷ *Id.*

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the CEA's broad definition of commodity, which includes "all other goods and articles ... and all services, rights, and interests ... in which contracts for future delivery are presently or in the future dealt in."⁸

Second, the court held that the CEA grants the CFTC enforcement authority over fraud or manipulation in both derivatives markets and underlying spot markets. In so ruling, the court nonetheless recognized a significant distinction regarding the CFTC's regulatory authority over derivatives markets on the one hand and over cash or spot transactions on the other. Unlike the full regulatory authority the CFTC exercises over the derivative markets, the court explained that the CFTC's authority over the spot markets extended only to "manipulation or fraud."⁹ For the CFTC's limited spot market authority, the court pointed to the CEA's anti-manipulation and fraud provisions under Section 6(c) and CFTC regulations implementing those provisions that prohibit employing a fraudulent scheme "in connection with ... *a contract of sale of any commodity in interstate commerce.*"¹⁰

Judge Weinstein's ruling is important, as it is the first federal court decision to address — and agree with — the CFTC's determination that virtual currencies are commodities as defined by the CEA. Although the CFTC first made this determination in an enforcement action in 2015¹¹ and had reaffirmed that determination several times since then, all of those matters involved proceedings before the CFTC, and the determination was issued in the context of a CFTC consent order. CFTC Chairman J. Christopher Giancarlo has made a point of taking an aggressive stance against fraud and manipulation in virtual currency spot markets, with the agency filing a number of enforcement actions similar to the fraud case against Patrick K. McDonnell. This decision gives the agency — and Chairman Giancarlo, who has been in the spotlight for allowing the listing of bitcoin futures contracts¹² — a green light to persevere. Chairman Giancarlo's effort to balance the CFTC's goals of promoting innovation while also protecting the derivatives markets from fraud, manipulation and other abusive practices has passed the first significant test.

⁸ *Id.* at 24; 7 U.S.C. § 1a(9).

⁹ *McDonnell*, slip op. at 24 (referring to the limits on CFTC spot market regulatory authority as a "boundary [that] has been recognized by the CFTC").

¹⁰ *Id.* at 25-26; *see* 7 U.S.C. § 9(1) (emphasis added); 17 CFR § 180.1.

¹¹ *See* "CFTC Asserts Jurisdiction in Bitcoin Markets," Skadden client alert, Sept. 30, 2015.

¹² *See McDonnell*, slip op. at 13 ("Legitimization ... of virtual currencies has followed from the CFTC's allowance of futures trading on certified exchanges.").

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