

Cryptocurrency as a Commodity: The CFTC’s Regulatory Framework

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Introduction

Since Bitcoin emerged onto the scene more than 10 years ago, multiple attempts have been made by U.S. regulators to categorise Bitcoin, as well as other cryptocurrencies, virtual currencies and digital tokens. Are instruments that take the form of peer-to-peer, open-source ledger technology securities, commodities, or assets that cannot be defined using existing regulatory definitions?

In this chapter, we examine how the U.S. Commodity Futures Trading Commission (CFTC), a regulator historically involved in the oversight of physical commodity markets – although since the advent of more esoteric commodity-linked products, such as listed derivatives (also known as futures) and over-the-counter swaps, also responsible for the oversight of those markets – determined that intangible cryptocurrency was a commodity. We view this move as prompted by a desire to police old-world commodity scams in nascent cryptocurrency markets. Over time, the CFTC’s enforcement actions have targeted activity ranging from the failure to register entities selling cryptocurrency-related products to scams involving a Bitcoin thief impersonating a federal employee. If the CFTC is to increase regulation of this evolving space, it will need both increased data on the cryptocurrency spot market (a point of the emphasis that is directly in conflict with virtual currencies’ structural emphasis on individual privacy) and greater delegation of power from legislators in order to keep up with technological shifts and new products, like Facebook’s proposed Libra currency.

The advent of CFTC regulation of cryptocurrencies

Cryptocurrency history

Bitcoin, the first implementation of a peer-to-peer, distributed ledger currency, was introduced in 2009. Unlike traditional fiat currencies, Bitcoin and similar cryptocurrencies such as Ether do not require a centralised authority to issue the new currency or confirm payment activities; instead, the network as a whole is involved in authorising transactions and generating new currency. Furthermore, the individuals trading the cryptocurrency on the blockchain may be anonymous (or at least “pseudonymous”, in that real-life identities are not disclosed).

From inception, the relative security and privacy offered by virtual currencies fuelled the illicit use of cryptocurrency as a mechanism to facilitate money laundering, trafficking, and sanction violations. In addition to the illicit use of cryptocurrencies, there was increasing scope to make money through market manipulation of these virtual currencies; for example, through classic “pump-and-dump” and fraudulent misselling schemes.

As they became aware of the need to regulate to protect investors and stifle money laundering and other criminal activity, U.S. regulators moved in a stop-start fashion to regulate

cryptocurrency. In 2015, the CFTC came forward and defined Bitcoin and other virtual currencies as commodities under the U.S. Commodity Exchange Act (the **CEA**).¹

Defining cryptocurrency as a commodity

The CFTC was established in 1974 to provide oversight of markets previously under the jurisdiction of the U.S. Department of Agriculture. The CFTC has stated that to foster public interest and financially sound markets, it will act to “prevent price manipulation or any other disruptions to market integrity” and to “protect all market participants from fraudulent or other abusive sales practices”.² As a matter of jurisdiction, the CFTC is empowered to regulate “commodities” under the CEA, and has exclusive jurisdiction over “accounts, agreements [...] and transactions involving swaps or contracts of sale of a commodity for future delivery”. 7 U.S.C. § 2. The CFTC has also asserted jurisdiction over fraud and manipulation involving spot market transactions relating to commodities which underlie futures or swaps.

The CFTC first determined that Bitcoin and other virtual currencies are properly defined as “commodities” under the CEA in 2015 in an enforcement action, *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29*.³ In its settlement order, the CFTC stated that individuals who had created a platform for the purchase and sale of Bitcoin options were in fact operating a facility for the trading or processing of swaps without being registered as a swap execution facility or designated contract market. In doing so, the CFTC applied the broad definition of commodity as laid out in the CEA and found that the scope of that definition included Bitcoin: “The definition of a “commodity” is broad [...] Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.” In October 2019, CFTC Chairman Heath Tarbert stated his view that Ether, the world’s second-largest cryptocurrency by market capitalisation, is a commodity and would therefore fall under the CFTC’s jurisdiction together with Bitcoin.⁴

CFTC enforcement actions

Alan Greenspan once noted that: “corruption, embezzlement, fraud, these are all characteristics which exist everywhere. It is regrettably the way human nature functions, whether we like it or not. What successful economies do is keep it to a minimum. No one has ever eliminated any of that stuff.”⁵ Having found Bitcoin and similar virtual currencies to be “commodities”, the CFTC’s initial enforcement actions focused on classic fraud cases.

Early enforcement actions

The CFTC defined the scope of its cryptocurrency regulatory span with some early legal victories: *CFTC v. Dillon Michael Dean and The Entrepreneurs Headquarters Limited*;⁶ *CFTC v. Patrick K. McDonnell and CabbageTech, Corp. d/b/a Coin Drop Markets*; and *CFTC v. My Big Coin Pay, Inc.*⁸

In *Dean*, the CFTC’s complaint targeted an alleged Ponzi scheme for options fraud, failure to register as a Commodity Pool Operator (**CPO**) and as an Associated Person of a CPO, and CPO fraud. Dean and associates solicited investor funds (in the form of Bitcoin) by promising to deliver “a set return rate of 11%–17.5%/week depending on how much you invest” and to pay commissions for new investor referrals. The funds were not invested in the promised “binary option” investments, and no trading profits were made. When investors sought withdrawals, Dean alternately ignored requests, claimed the investor website had been hacked and infected by ransomware, and that the blockchain was just “SLOWWW”. While addressing a classic, common Ponzi scheme, the CFTC’s enforcement action also put trusts, syndicates, and similar actors in trading virtual currency derivatives or other

commodity interests via pooled investor funds on notice that they need to register with the CFTC as a CPO.

The *McDonnell* litigation also related to Ponzi scheme activity. *McDonnell* was litigated as a bench trial in federal court in the Eastern District of New York, and featured similar facts to *Dean* (though *McDonnell* did not have the same creative excuses for failure to return investor funds). The *McDonnell* court reaffirmed the *Derivabit* holding, applying deference to the Commission's interpretation of its jurisdictional statute ("The court generally defers to an agency's interpretation of a statute that the agency is responsible for administering") and re-affirming the CFTC's position that virtual currencies are commodities (citing, among other support, an *amicus* brief from the Chicago Mercantile Exchange). The court also reaffirmed that the CFTC may take enforcement action over virtual currency fraud even where no derivatives are present, on the basis that 17 CFR 180.1 grants the CFTC anti-fraud authority over any "contract of sale of any commodity in interstate commerce" – not just futures contracts or swaps.

Finally, the determination in the *My Big Coin Pay, Inc.* case was a further step in reaffirming earlier decisions and action. The *Big Coin Pay* court found the CEA's text supports the CFTC's position, as the CEA defines "commodity" generally and categorically, "not by type, grade, quality, brand, producer, manufacturer, or form". Thus, the court reasoned that the CFTC's "broad approach" to its anti-fraud jurisdiction over virtual currencies is in sync with Congress's goal of "strengthening the federal regulation of the ... commodity futures trading industry".

Recent enforcement actions

Recent fraud actions have addressed even more brazen activity and highlight the need for continued enforcement action.

Perhaps the boldest fraud case to date involved Morgan Hunt and Kim Hecroft,⁹ who misrepresented their ability to invest and trade in commodity interests. Furthermore, the CFTC's complaint alleged that both defendants supplied their victims with phoney documents in furtherance of their fraud, including altered versions of a publicly available CFTC memorandum. This alteration was intended to mislead the defendants' victims into believing that they were required to pay a "tax obligation" to the CFTC if they wished to withdraw funds from their Bitcoin accounts. This "tax obligation" was, of course, payable in Bitcoin (that the defendants kept). Hecroft and Hunt even arranged for an agent to impersonate a fake CFTC employee to attest to the validity of the tax and sent forged documents purportedly authored by the CFTC's general counsel. A federal court ultimately ordered Hunt and Hecroft to pay nearly \$400,000 in civil monetary penalties.¹⁰

A further example of CFTC enforcement actions of outright fraud related to cryptocurrency is the injunction order and final judgment against Patrick K. McDonnell and his company doing business as Coin Drop Markets (**CDM**). McDonnell's and CDM's scheme induced customers to send both money and virtual currencies, supposedly in exchange for real-time virtual currency trading advice and virtual currency purchasing and trading carried out on behalf of the customers. However, the allegedly expert advice was never provided, and funds that were delivered to McDonnell and CDM to purchase or trade on customer's behalf simply disappeared.¹¹ McDonnell and CDM were ordered to pay over \$1.1 million in civil monetary penalties in view of what the court characterised as a "vicious defrauding of customers".¹² The CFTC filed a similar complaint against Jon Barry Thompson for allegedly inducing two customers to send roughly \$7 million to fund the purchase of Bitcoin and making false representations related to the safeguarding of those funds. Instead, Thompson

transferred customer funds to third-party accounts, including to accounts of at least one company affiliated with Thompson.¹³

The Ponzi and pyramid schemes identified by the CFTC for recent enforcement actions have grown in scale. The trading firm Gelfman Blueprint, Inc. and its CEO Nicholas Gelfman were ordered to pay over \$2.5 million for their Bitcoin Ponzi scheme. This scheme targeted and defrauded at least 80 people for more than \$600,000. The customers' funds were supposed to be placed in a pooled commodity fund that allegedly employed a high-frequency, algorithmic trading strategy executed by the defendants' computer trading program called "Jigsaw". In reality, the strategy was fake, the purported performance reports were also falsified, and the payouts of the supposed profits to customers were in actuality the misappropriated funds from other customers.¹⁴ The CFTC filed a complaint against Control-Finance Limited (**Control-Finance**) and its principal, Benjamin Reynolds, for allegedly inducing nearly 1,000 customers to purchase and transfer Bitcoin to them by falsely representing that they employed expert virtual currency traders who earned guaranteed daily trading profits on all Bitcoin deposits. Control-Finance and Reynolds marketed on social media using an elaborate pyramid scheme whereby customers could refer friends and family in return for Bitcoin credit. Customers were provided with sham account balances, non-existent profit figures and fabricated trade reports.¹⁵

Failure to register under the CEA

In addition to outright fraud and other manipulative actions, the CFTC has also sought to prevent entities from operating without the proper registration. Enforcement actions related to failure to register as a regulated exchange (e.g., either a swap execution facility or a designated contract market) or as a registered intermediary (e.g., a futures commission merchant (**FCM**)) are often brought in connection with other frauds (in line with the early *Coinflip* action). Two of these actions include the foreign trading platform 1Pool Ltd. and the Bitcoin exchange Bitfinex.

1Pool Ltd. was found to have illegally offered customers retail commodity transactions that were margined in Bitcoin and in doing so failed to register as an FCM. Furthermore, it did not have the required anti-money laundering procedures in place.¹⁶

Similarly, Bitfinex operated as a platform of illegal off-exchange retail commodity transactions in Bitcoin and other cryptocurrencies, and failed to register as an FCM as required by the CEA.¹⁷

Bitfinex's platform allowed for spot and forward trading in Bitcoin; however, the platform also allowed users to borrow funds from other platform users in order to trade Bitcoin on a leveraged basis. Under the CEA, the CFTC has jurisdiction over such leveraged retail commodity transactions, unless "actual delivery" occurs within 28 days of execution. See 7 U.S.C. § 2(c)(2)(D). The CFTC noted that each Bitfinex customer interest relating to leveraged transactions was held for the benefit of the customer in an omnibus settlement wallet and "accounted for in real time on Bitfinex's database. However, the omnibus settlement wallet was owned and controlled by Bitfinex and Bitfinex held all "private keys" associated with its omnibus settlement wallet". As a result, the CFTC found that no "actual delivery" occurred and that Bitfinex had violated the retail commodity transaction rules by providing for the execution and confirmation of leveraged retail commodity transactions without having such transactions occur on or subject to the rules of a CFTC-regulated exchange.

The Bitfinex enforcement is also an example of a regulator stretching to deal with novel regulatory issues and the market subsequently being forced to adjust. In the aftermath of the Bitfinex enforcement action, the CFTC received requests from market participants for

guidance around the meaning of “actual delivery” in the specific context of virtual currency transactions. In response, the Commission issued a “final interpretation” of the term “actual delivery” consistent with the position it had taken in Bitfinex, with “actual delivery” occurring when the customer takes “possession and control” of the virtual currency.¹⁸

Future of CFTC enforcement relating to cryptocurrencies

While CFTC anti-fraud enforcement actions are on the rise, we expect the limits of the CFTC’s jurisdiction over spot cryptocurrency transactions to be tested in the coming years. As former CFTC Commissioner Timothy Massad has noted, there is “a problem for oversight generally and for the quality of crypto derivatives: if the underlying cash market is susceptible to (or characterized by) fraud and manipulation, then what confidence can one have in the derivatives?”¹⁹ In a recent op-ed, CFTC Chairman Heath Tarbert supported a “principles-based approach” to digital assets regulation rather than using a prescriptive “rules-based approach”. He emphasised that such an approach would afford greater flexibility to the tech sector and enable the CFTC to stay ahead of the curve by reacting more quickly to changes in technology.²⁰ He cautioned, however, that the CFTC’s willingness in allowing innovation to develop “should not be confused with a tolerance of fraudulent behaviour or a so-called light-touch approach”.

As it moves forward, the CFTC is increasingly liaising with other regulators, including the Securities and Exchange Commission (**SEC**), to bring enforcement actions. SEC Commissioner Jay Clayton has agreed that “[f]raud and manipulation involving Bitcoin traded in interstate commerce are appropriately within the purview of the CFTC, as is the regulation of commodity futures tied directly to Bitcoin”.²¹ In certain circumstances, the SEC has brought cases around violations of the securities laws (e.g., sales of “tokens” or security-based swaps without registration), including where the CFTC has also brought virtual currency actions for breach of the commodities laws.²² It seems, at least for now, that both regulators will continue to enforce their rules separately, without a single U.S. regulator taking precedence in the virtual currency space.

Priorities for new derivative product listings

The CFTC’s existing rules allow exchanges to “self-certify” new products for listing.²³ As a result, a number of cryptocurrency-related products have been launched with relatively limited public input. (By contrast, the SEC has moved relatively slowly with respect to cryptocurrency-linked securities and has not approved Bitcoin-linked ETFs for trading on regulated exchanges.)

In response, on May 21, 2018 the CFTC issued a staff advisory (CFTC Letter No. 18-14)²⁴ providing guidance for registered entities (e.g., designated contract markets and swap execution facilities) interested in listing virtual currency derivative products. In the advisory, the CFTC acknowledged that virtual currencies are “unlike any commodity that the CFTC has dealt with in the past”. In particular, the advisory noted that “it is more difficult to provide context or a frame of reference for the prices of virtual currency that are quoted on the spot markets. While prices and transactions on those spot markets can be observed, the connection of these prices to any commercial market, intrinsic value, or supply and demand is less clear than for other commodities”.

As a result, the CFTC stated that it believes that virtual currency exchanges will need to establish an “information sharing arrangement with the underlying spot market(s)” for virtual currencies in order to establish whether any pricing anomalies or market manipulation may be occurring. The CFTC also recommended that exchanges set large trader reporting thresholds

at five Bitcoin and noted in a footnote that “traders subject to large trader reporting are subject to possible reporting of spot market activity”.

The advisory clearly indicates that the CFTC is increasingly looking for ways to obtain information around spot market activity in cryptocurrencies. If it obtains such information, cases around “spoofing” or market manipulation in the spot markets may be soon to follow.²⁵

Facebook’s Libra cryptocurrency

At the same time that the CFTC is looking for linkages between fraudulent cryptocurrency activity in the spot and futures/swaps markets, new products are forcing a re-evaluation of the Commission’s jurisdictional reach.

Facebook has announced plans to launch its own cryptocurrency, originally targeting 2020 for its debut. The company intends to share control of the cryptocurrency with a consortium that includes venture capital firms, credit card companies, and other tech giants including Visa, Mastercard, Paypal and Uber.²⁶

The stated mission of Libra is “a simple global currency and financial infrastructure that empowers billions of people”. In its white paper, Libra is described as a secure, scalable, and reliable blockchain, backed by a reserve of assets designed to give intrinsic value,²⁷ and governed by the independent Libra Association tasked with evolving its financial ecosystem.²⁸

In response to the June 18, 2019 Facebook White Paper on Libra, former CFTC Chairman Christopher Giancarlo said the agency was in the “very early stages of conversations” with Facebook. At these early stages, it is unclear if Libra would fall under the CFTC’s jurisdiction given its linkage to existing, regulated fiat currency and securities. Giancarlo noted that “if the cryptocurrency could be backed by the U.S. dollar, then there might be less of a need for derivatives tied to it...That’s very clever”.²⁹ One key question posed by regulators, which remains unanswered, is whether and how Facebook will put in place and follow anti-fraud, anti-money laundering and know-your-customer measures, and whether a truly supranational virtual currency like Libra could be structured outside of the U.S.’s regulatory reach. As of March 2020, in response to resistance by regulators, Facebook was reportedly reconsidering its plans so that its digital asset network would accept multiple coins, including those issued by central banks such as the U.S. dollar and Euro.³⁰

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Endnotes

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22. 1Pool Ltd., discussed *supra* endnote 11 above is an example; the SEC complaint relating to 1Pool Ltd. offering security-based swaps in violation of the securities laws is available here: <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-218.pdf>.
23. See 17 CFR 40.2.
24. https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/2018-05/18-14_0.pdf.
25. See also the CFTC’s interpretation around “actual delivery”, 82 *Fed. Reg.* 60,335 (*proposed Dec. 15, 2017*), at p. 60338 for an indication of the type of behaviour in the spot market that has garnered CFTC attention (“[T]he emergence of these nascent markets has also been negatively marked by a variety of retail customer harm that warrants the Commission’s attention, including, among other things, flash crashes and other market disruptions, delayed settlements, alleged spoofing, hacks, alleged internal theft, alleged manipulation, smart contract coding vulnerabilities, bucket shop arrangements and other conflicts of interest” (internal citations omitted)).
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