The Cryptos Are Here: Consumer Protection In Virtual Currency Markets Under The CFTC's Watch

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Background

Since the introduction of Bitcoin in 2009, digital assets known as crypto-currencies ("cryptos") have become increasingly commonplace, with more than one new coin being introduced daily. This nascent asset class poses considerable regulatory challenges as statutes written decades ago make no reference to virtual currencies. Instead, regulators must apply existing statutes by interpreting them appropriately and "keeping pace with technological change." *Derivatives Regulatory Reform: A Principles-based Software Upgrade*, Remarks of Chairman J. Christopher Giancarlo before the Sims Lecture At Vanderbilt Law School, Apr. 13, 2018. As of yet, there is no "direct, comprehensive Federal oversight of underlying Bitcoin or virtual currency spot markets." *CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets*, Jan. 4, 2018.

The Commodity Futures Trading Commission ("CFTC"), whose mission includes protecting "market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act (CEA)" has emerged as the main federal regulator of virtual currencies. LabCFTC, *A CFTC Primer on Virtual Currencies*, Oct. 17, 2017.

The CEA interprets the term "commodity" broadly to include "traditional agricultural commodities, metals, and energy, [and] …Treasury securities, interest rate indices, stock market indices, currencies, electricity, and heating degree days, to name just a few underlying products." CFTC Chairman Timothy Massad's testimony before the U.S. Senate Committee on Agriculture, Nutrition and Forestry, Dec. 10, 2014.

In 2015, the CFTC held that Bitcoin and other virtual currencies are properly defined as commodities covered by the CEA, resulting in its first action against an unregistered bitcoin options trading platform operated by Coinflip, Inc. d/b/a Derivabit (Coinflip) and its chief executive officer. CFTC, Release Number 7231-15, Sept. 17, 2015. Since then the CFTC has emerged as the primary *federal* regulator of digital currencies.

In this article we describe the CFTC's actions to regulate virtual-currency spot markets (in which virtual currencies are traded for immediate delivery) as well as virtual-currency derivative markets (e.g., futures swaps, and options related to such currencies).

CFTC's regulatory activity in virtual currency *spot* markets

Although the CFTC's jurisdiction over commodity spot markets is limited relative to its jurisdiction over commodity derivative markets, it has regulatory authority in commodity spot markets in instances pertaining to: (i) fraud, (ii) price manipulation, or (iii) certain retail commodity transactions, which may lie within an ambiguous intersection between spot markets and derivatives markets. We discuss these three types of CFTC actions related to transactions in virtual currency spot markets below.

(i) **Anti-fraud enforcement actions**

On September 21, 2017, in its first anti-fraud enforcement action involving Bitcoin, the CFTC charged Nicholas Gelfman and Gelfman Blueprint, Inc. with running a Bitcoin Ponzi scheme and misappropriating over $600,000. The defendants were alleged to have fraudulently solicited investments from approximately 80 persons for algorithmic trading in virtual currency, circulated false performance reports, and distributed alleged profits from other customers' misappropriated funds. CFTC, Release Number 7614-17, Sept. 21, 2017.

This action is noteworthy because it reiterated the CFTC's view that Bitcoin and other virtual currencies are commodities under the CEA. Furthermore, this action demonstrated the CFTC's broad jurisdiction (under CEA section 6(c)(1) and CFTC Regulation 180.1) to combat fraudulent activity in *all* interstate commerce transactions involving commodities, which includes fraudulent transactions in the commodity (virtual currency) itself in addition to the fraudulent and manipulative behaviors that affect the pricing or trading of derivative securities related to the commodity.

In January 2018, the CFTC filed two other anti-fraud enforcement actions in connection with the Division of Enforcement's new Virtual Currency Task Force. On January 16, 2018, the CFTC charged Randall Crater, Mark Gillespie, and My Big Coin Pay, Inc. with fraud and misappropriation in an ongoing virtual currency scam. CFTC, Release Number 7678-18, Jan. 24, 2018. The defendants were alleged to have fraudulently solicited over $6 million dollars from customers for investment in a virtual currency known as My Big Coin, falsely claiming that it was actively traded, backed by gold, and endorsed by MasterCard. Defendants subsequently put customers' funds into their personal bank accounts, and used these funds to pay for their own private expenses.

Two days later, the CFTC filed a federal civil enforcement action against Defendants Patrick K. McDonnell, of Staten Island, New York, and CabbageTech, Corp. d/b/a Coin Drop Markets (CDM), charging them with commodities fraud and misappropriation. CFTC, Release Number 7675-18, Jan. 19, 2018. The CFTC alleged that the defendants had induced customers to send them money and virtual currencies by promising real-time Bitcoin and Litecoin trading advice as well as purchasing and trading services, which the defendants never intended to provide.

Notably, on March 6, 2018, a judge in the Eastern District of New York granted the CFTC's request for a preliminary injunction to halt allegedly fraudulent trading of virtual currencies. In doing so, the court adopted the CFTC's interpretation that virtual currencies, such as Bitcoin, are "commodities." *See CFTC v. McDonnell, et al*., No. 1:18-cv-00361 (E.D.N.Y. Mar. 6, 2018). As a result, the CFTC's anti-fraud and manipulation enforcement authority under the CEA covers not only derivatives transactions in virtual currencies, but also spot transactions in virtual currencies.

(ii) Actions concerning price manipulation

In October 2017, the CFTC issued warnings about inflated valuations and volatility in virtual currency spot markets. LabCFTC, *A CFTC Primer on Virtual Currencies*, Oct. 17, 2017. Then, on

February 15, 2018, the CFTC issued its first pump-and-dump virtual currency Customer Protection Advisory after receiving several complaints about pump-and-dump schemes involving new or thinly traded virtual currencies. The advisory explained that such schemes can commence and end within minutes and typically occur on platforms that offer a wide array of coin pairings for traders to buy and sell. Overall, the CFTC warned customers to conduct their own research and to avoid purchasing virtual currencies, digital coins, or tokens based on social media tips or sudden price spikes. The CFTC also offered a bounty to whistle-blowers for information leading to a successful enforcement action and a monetary sanction of $1 million or more.

On May 24, 2018, the Department of Justice, together with the CFTC, opened a criminal probe to investigate whether traders were manipulating the price of Bitcoin and other digital currencies through illegal practices such as spoofing and wash sales. In spoofing, a trader submits a host of orders with no intention of executing, simply to deceive other traders (such as bots) into buying or selling. The spoofer then cancels the orders after the price has moved in the desired direction. Wash trades involve self-trading, whereby the same trader takes both sides of a transaction to give a false impression of market demand that lures others to also trade.

(iii) "Retail commodity transactions" and the determination of "actual delivery"

CEA Section 2(c)(2)(D) defines when a retail commodity transaction is subject to the rules of a CFTC-registered futures exchange. Specifically, this section applies to any commodity transaction involving a retail investor that is financed by the offeror or the counterparty, or entered into on a leveraged or margined basis, unless the transaction results in "actual delivery" within 28 days. *See* 7 U.S.C. § 2(C)(2)(D)(ii)(III). In 2013, the CFTC issued an interpretation of the term ''actual delivery'' in the context of CEA section 2(c)(2)(D), providing several examples of what may and may not satisfy the actual delivery exception. *See Retail Commodity Transactions Under Commodity Exchange Act*, 78 FR 52426 (Aug. 23, 2013).

On June 2, 2016, the CFTC found that BitFinex*,* a Hong Kong-based online bitcoin exchange, had illegally allowed users to conduct retail commodity transactions in bitcoin and other cryptocurrencies, and was in violation of CEA sections 4(a) and 4(d) because the unregistered entity ''did not actually deliver bitcoins purchased on a leveraged, margined, or financed basis to the traders who purchased them'' as prescribed within the actual delivery exception. *See In re BFXNA INC. d/b/a BITFINEX,* CFTC Docket No. 16–19. Instead, the entity ''held the purchased bitcoins in bitcoin deposit wallets that it owned and controlled.'' Subsequently, following several requests, the CFTC issued another interpretation of the "actual delivery" exemption specifically related to virtual currencies on December 20, 2017. *Retail Commodity Transactions Involving Virtual Currency*, 82 Fed. Reg. 60335.

CFTC's regulatory activity in virtual currency *derivatives* markets

The CFTC has brought a number of enforcement actions related to virtual currency derivatives. As discussed earlier, in September 2015 the CFTC ordered Coinflip, Inc. d/b/a Derivabit (Coinflip), a Bitcoin options trading platform operator, and its CEO to cease illegally offering bitcoin options and to cease operating an unregistered swap execution facility (SEF). CFTC, Release Number 7231-15.

On September 24, 2015, the CFTC settled with TeraExchange LLC, a SEF, for failing to enforce prohibitions on wash trading and prearranged trading in Bitcoin swaps. CFTC, Release Number 7240-15, Sept. 24, 2015. On October 8, 2014, Tera employees had allegedly facilitated a prearranged wash trade (a U.S. dollar – Bitcoin swap transaction) for the only two market participants authorized at that time to trade on Tera's SEF, informing one that the trade would test the SEF system. Each participant's transaction was for the same notional amount, price, and tenor, and thus completely offset each other. At the time, these were the only transactions on Tera's SEF. However, after the wash trade, Tera issued a press release announcing the transaction "was the first Bitcoin derivative transaction to be executed on a regulated exchange" without disclosing that it was a pre-arranged wash trade that did not represent actual liquidity.

Conclusion

Crypto-currencies are a growing asset class, and vary considerably in their intended purposes. Some qualify as virtual currencies, which are considered "commodities" by the CFTC and subject to its oversight. As the primary federal regulator of virtual currency markets, the CFTC has taken actions to prevent fraud and price manipulation in virtual currency spot and derivatives markets. As the crypto-currency universe expands, this asset class is likely to face growing regulatory scrutiny from the CFTC and other regulators.