



Commodity Futures Trading Com'n v. McDonnell 287 F.Supp.3d 213 (E.D.N.Y. 2018)

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Recommended Citation

Zach Johnston, *Commodity Futures Trading Com'n v. McDonnell 287 F.Supp.3d 213 (E.D.N.Y. 2018)*, 29 DePaul J. Art, Tech. & Intell. Prop. L. 149 (2019)
Available at: <https://via.library.depaul.edu/jatip/vol29/iss1/6>

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**COMMODITY FUTURES TRADING COM'N V.
McDONNELL**

287 F.SUPP. 3D 213 (E.D.N.Y. 2018)

*Zach Johnston**

I. INTRODUCTION

Plaintiff Commodity Futures Trading Commission (“CFTC”) brought suit against Patrick McDonnell (“McDonnell”) and CabbageTech, Corp. d/b/a Coin Drop Markets (“CDM”) (jointly, “Defendants”) alleging that the Defendants operated a deceptive and fraudulent virtual currency scheme, as well as misappropriated investor funds¹; violating the Commodity Exchange Act (CEA).² This case is particularly important as it is the first federal court ruling to adopt the CFTC’s determination that virtual currencies³ are

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¹ *Commodity Futures Trading Com'n v. McDonnell*, 287 F.Supp. 3d 213 (E.D.N.Y. 2018).

² The Commodity Exchange Act (CEA) regulates the trading of commodity futures and designates the CFTC as its regulatory authority power. Commodity futures are financial contracts, which bind a buyer and seller of a commodity to a fixed price, to be delivered and paid at a later date.

³ A virtual currency is a digital asset which gives its bearer a store of value and acts as a medium for exchange over virtual currency networks.

commodities.⁴ Additionally, the case gives significant weight to the CFTC's persistent stance against fraud and manipulation by acknowledging the CFTC's authority to protect virtual currency derivative markets from abusive practices.⁵ Rather than impeding the growth of virtual currencies and related derivative markets, "[l]egitimization and regulation of virtual currencies has followed from the CFTC's allowance of futures trading on certified exchanges."⁶ Going forward, this case paints the CFTC in a positive light as a patron of innovation and a protector from manipulation in the virtual currency derivative market space.

II. BACKGROUND

Defendant McDonnell founded and operated CDM, as a result he controlled bank and virtual currency accounts which were utilized by CDM customers to send money to McDonnell for his so-called "professional trading" services.⁷ In April 2017, Defendant McDonnell solicited customers to engage in virtual currency consulting services and trading advice, which McDonnell advertised could offer as much as 300% return on investment.⁸ By July 2017, McDonnell had offered no consulting services, had ceased communications with customers, and had misappropriated the investors' funds.⁹ In January 2018, the CFTC brought action against McDonnell, alleging fraud and misappropriation of funds in violation of the CEA.¹⁰ The CFTC has been given exclusive

⁴ *McDonnell*, 287 F.Supp. 3d at 213 (2018).

⁵ *Id.* at 222.

⁶ *Id.*

⁷ *Id.* at 233

⁸ *Id.* at 232.

⁹ *Id.*

¹⁰ *Commodity Futures Trading Com'n v. McDonnell*, 287 F.Supp. 3d at 213 (2018).

jurisdiction by Congress via the CEA over transactions conducted on futures markets.¹¹ Additionally, under 17 C.F.R. §180.1¹², the CFTC has authority to enforce its directives in cases which do not directly involve futures trades, but do involve an element of manipulation, deceit, or fraud associated with a commodity exchange.¹³ The CFTC specifically relied on Title 7 U.S.C. § 13a-1(a) and Title 7 U.S.C. § 9(1) to bring this suit.¹⁴ § 13a-1(a) states that the CFTC is entitled to seek injunctive or other relief in cases involving suspected violations of the CEA.¹⁵ § 9(1) of the CEA makes it unlawful for any person to engage in manipulative or deceptive schema in connection with any contract of sale of any commodity in interstate commerce, regardless of whether the conduct involves a futures trade.¹⁶ This tactic to achieve jurisdictional standing was first employed in *CFTC v. Gelfman Blueprint, Inc.*, a case which did not involve futures contracts in which the CFTC alleged a Bitcoin Ponzi scheme.¹⁷

Given the open debate regarding virtual currencies being classified as a commodities and that Congress has yet to devise a regulatory scheme to oversee virtual currencies, McDonnell filed a motion to dismiss the case for lack of jurisdiction on the belief that virtual currencies were not commodities and therefore were not

¹¹ *Id.* at 228.

¹² 17 C.F.R. § 180.1 establishes that employment of fraud, manipulation, or misrepresentation are unlawful when dealing with the contract of sale of any commodity in interstate commerce. The CEA and this regulation grant the CFTC authority to bring suit against such violators.

¹³ *McDonnell*, 287 F.Supp. 3d 213, 227 (E.D.N.Y. 2018).

¹⁴ *Id.* at 223; *Id.* at 226.

¹⁵ *Id.* at 223.

¹⁶ *Id.* at 226.

¹⁷ *CFTC v. Gelfman Blueprint, Inc.*, Case No. 17-7181, 2017 WL 4228737 (S.D.N.Y. Filed Sept. 21, 2017).

subject to the authority of the CFTC.¹⁸ In response, the CFTC asserted itself as “one of the federal administrative bodies currently exercising partial supervision of virtual currencies” and affirmed that it first classified virtual currencies as commodities in 2015.¹⁹ In response, the CFTC asserted itself as “one of the federal administrative bodies currently exercising partial supervision of virtual currencies” and affirmed that it first classified virtual currencies as commodities in 2015.²⁰ Following its approach in *Gelfman*, the CFTC assumed authority to pursue CEA violators involved in the exchange of commodities, regardless of futures or derivative status.²¹ Prior to this case, no federal court had reviewed or adopted the CFTC’s determination that virtual currencies should be classified as commodities.

Ultimately, the Court denied the Defendant’s motion to dismiss and found that the CFTC had jurisdiction over the case because, “(1) virtual currencies are commodities” subject to the CFTC’s regulatory protections,” and (2) the amendments under the Dodd-Frank Act²² and 17 C.F.R. §180.1 enables the CFTC “jurisdiction over fraud that does not directly involve the sale of futures or derivative contracts, including fraud related to virtual currencies sold in interstate commerce.”²³ Given these findings, the CFTC has standing to bring the claim against McDonnell, and after a finding of fact, the CFTC made a prima facie showing of fraud

¹⁸ *McDonnell*, 287 F.Supp. 3d 213, 220 (E.D.N.Y. 2018).

¹⁹ *Id.* at 221-222; *Id.* at 226.

²⁰ *Id.* at 222; *Id.* at 226.

²¹ *Id.* at 227.

²² The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted as a result of the aftermath of the 2008 financial crisis. It established the CFTC’s authority to regulate swap dealers and increased transparency and improved pricing regulation in the derivatives marketplace.

²³ *Commodity Futures Trading Com’n v. McDonnell*, 287 F. Supp. 3d 213 (E.D.N.Y. 2018).

committed by McDonnell, entitling the CFTC to a preliminary injunction pursuant to Title 7 U.S.C. §13a-1(a).²⁴

III. LEGAL ANALYSIS

The first two items the Court analyzes is the primary issue of the case: whether the CFTC has standing to bring its suit.²⁵ The first item the Court addressed was whether virtual currencies are commodities subject to the CFTC's regulatory regime.²⁶ Second, the Court reviewed the CFTC's assertion of authority and jurisdiction as it relates to cases of fraud "that do[] not directly involve the sale of futures or derivatives contracts."²⁷ Lastly, and contingent on the Court's holding on the antecedent issues, the Court determined whether the CFTC established a prima facie showing of fraud by the Defendant meriting injunctive relief.²⁸

A. *Virtual Currencies Are Commodities*

In its analysis on whether virtual currencies should be classified as commodities, the Court provided a concise overview of: (1) what virtual currencies are; (2) how they are valued in the marketplace; and (3) how they are currently regulated.²⁹ Virtual currencies "are more popularly referred to as cryptocurrencies because the technology that allows for transfer of these assets

²⁴ *Id.*

²⁵ *Id.* at 217.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Commodity Futures Trading Com'n v. McDonnell*, 287 F. Supp. 3d 213, 218-23 (E.D.N.Y. 2018).

utilizes “cryptographic protocols”³⁰ From an economic standpoint, virtual currencies are viewed as commodities because of a capacity to provide a store of value³¹ and an ability to serve as a vehicle of monetary exchange.³² Virtual currencies are similar to traditional commodities, because they vary in price according to their supply

³⁰ Cryptographic protocols are security protocols which utilize advanced algorithms to provide non-repudiation, encryption protection, and secured application-level data transportation. R.C. Merkle, “Protocols for public key cryptosystems,” In *Proc. 1980 Symposium on Security and Privacy*, IEEE COMPUTER SOCIETY, page 122-133 (April 1980), <http://www.merkle.com/papers/Protocols.pdf>.

³¹ An analogy can be drawn between virtual currencies and gold. Gold provides a store of value which can be represented by paper money or dollars. Imagine you bet your friend five dollars’ worth of gold (represented here by a five-dollar bill) that a single coin flip will land on heads. The coin lands on heads. Your friend, sitting across from you at a table, slides the five-dollar bill over to you as a result of losing the bet. In this example, the paper money is the medium of exchange and the gold is the commodity it represents. Virtual currencies also provide a store of value. Imagine you bet your friend five units of virtual currency for the same bet. The coin lands on heads again, except this time your friend, sitting five thousand miles away from you, sends the five units of virtual currency across the blockchain network. In this analogous example, the cryptographic protocol (a single block on the blockchain) which you receive, acts as the medium of exchange and the virtual currency is the commodity it represents. The value of the gold and virtual currency in these examples will be determined by the marketplace as a result of simple supply and demand, in other words, they are worth what the market will pay for them. *Mining digital gold – Virtual currencies*, THE ECONOMIST (April 13, 2013), <https://www.economist.com/finance-and-economics/2013/04/13/mining-digital-gold>.

³² *McDonnell*, 287 F.Supp. 3d 213, 224-25 (E.D.N.Y. 2018).

and demand³³, making the digital asset “worth whatever someone is willing to pay for it.”³⁴

Putting the economic and technical aspects aside, the CFTC first ordered “that virtual currencies can be classified as commodities” in 2015.³⁵ The CFTC issued this order relying on its interpretation of Title 7 U.S.C. § 1(a)(9) of the CEA, the regulatory regime on which the CFTC operates, which “defines ‘commodities’ as...goods and articles...and all services, rights, and interests...in which contracts for future delivery are presently or in the future dealt in.”³⁶ Subsequently, the CFTC enabled the first virtual currency futures option to be listed on the Chicago Mercantile Exchange and the Chicago Board Options Exchange in Dec. 2017.³⁷ The Court in *McDonnell* noted that “[t]he CEA and its ‘remedial statutes’ are to be ‘construed liberally’ to allow for broad market protection,” and that “the court generally defers to an agency’s interpretation of a statute ‘that the agency is responsible for administering.’”³⁸

The Court deferred to the CFTC’s opinion in its holding that virtual currencies are commodities stating that “[t]hey fall well-within the common definition of ‘commodity’ as well as the CEA’s definition of ‘commodities’.”³⁹ The Court rested its holding on the

³³ Like traditional commodities, virtual currencies have a fixed supply, which is self-regulated through what is known as mining. Due to the exponential increase in computing power it takes to mine virtual currencies there is a finite amount that can be created or mined. *Mining digital gold – Virtual currencies*, THE ECONOMIST (April 13, 2013), <https://www.economist.com/finance-and-economics/2013/04/13/mining-digital-gold>.

³⁴ *Commodity Futures Trading Com'n v. McDonnell*, 287 F.Supp. 3d 213, 225 (E.D.N.Y. 2018).

³⁵ *Id.* at 226.

³⁶ *Id.* at 225.

³⁷ *Id.* at 222.

³⁸ *Id.* at 223-24.

³⁹ *Id.* at 228.

similarities that virtual currencies have to traditional commodities and upheld precedent by awarding deference to the CFTC's broad interpretation of Title 7 U.S.C. § 1(a)(9).⁴⁰ Additionally, the Court noted that the determination of virtual currencies as commodities does not impede on the concurrent authority that other agencies have in regard to virtual currency regulation.⁴¹ This section of the holding enables the CFTC regulatory authority over virtual currencies as commodities, therefore satisfying the agency's first step toward jurisdiction over the Defendant's fraudulent conduct in this case.⁴²

B. Futures or Not . . . The CFTC Has Jurisdiction Over Fraud

The Court next looked to whether the CFTC has jurisdiction over "fraud that does not directly involve the sale of futures or derivative contracts."⁴³ In its step through analysis, the Court stated that the CEA establishes the CFTC as the sole authoritative agency regulating commodity futures exchanges, granting it "[e]xclusive jurisdiction" over such contracts.⁴⁴ The Court points out that the "CFTC does not have regulatory authority over simple quick cash or spot transactions that do not involve fraud or manipulation. Title 7 U.S.C. § 2(c)(2)(C)(i)(II)(bb)(AA)." At this point it appears that the CFTC will simply not have jurisdiction as facts of the case do not deal with commodity futures. However, the Court rests on the relevant portion of the Dodd-Frank Act, codified by 17 C.F.R. § 180.1, which gives authority to the CFTC over the actions involving

⁴⁰ *Commodity Futures Trading Com'n v. McDonnell*, 287 F.Supp. 3d 213, 228 (E.D.N.Y. 2018).

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.* at 217.

⁴⁴ *Id.* at 223.

fraudulent practices in “‘*contract of sale of any commodity in interstate commerce.*” (emphasis added).⁴⁵ This amendment enables the CFTC to secure jurisdiction over the case as it gives authority to the agency in cases of fraud involving commodities, even where commodity futures are not involved.⁴⁶ The Court held that the “CFTC has jurisdictional authority to bring suit against defendants utilizing a scheme to defraud investors through a ‘contract [for] sale of [a] commodity in interstate commerce” “even if the fraud does not involve [futures] based on cryptocurrencies.”⁴⁷

C. Prima Facie Fraud and Injunctive Relief

After the Court established that the CFTC had true authority and standing in the case, the Court reviewed whether a prima facie showing of fraud was present to merit the injunctive relief sought.⁴⁸ “Liability, under the CEA, for commodity fraud, is shown by: ‘(1) the making of a misrepresentation, misleading statement, or a deceptive omission; (2) scienter; and (3) materiality.’”⁴⁹ The Court held that the CFTC had made a prima facie showing of fraud in the Defendant’s conduct. The Defendant mislead consumers by offering fraudulent and non-existent virtual currency trading consulting services and promised false investment returns.⁵⁰ After the Defendant had successfully onboarded customers, he completely ceased communications and following a request for refunds, refused the requests and misappropriated investor funds.⁵¹

⁴⁵ *Id.* at 227.

⁴⁶ *Commodity Futures Trading Com'n v. McDonnell*, 287 F.Supp. 3d 213, 227 (E.D.N.Y. 2018).

⁴⁷ *Id.* at 229.

⁴⁸ *Id.* at 213.

⁴⁹ *Id.* at 226.

⁵⁰ *Id.* at 217.

⁵¹ *Id.* at 218.

The Court ruled that these factual findings satisfied the CEA requirements to find liability and held that the CFTC had made a prima facie showing of fraud.

Finally, the Court reviewed whether the case was deserved of the injunctive relief sought by the CFTC. “Under Title 7 U.S.C. § 13a-1(a) the CFTC may seek injunctive or other relief when it concludes that a person or entity is in violation of the CEA.”⁵² The Court ruled that a preliminary injunction in favor of the CFTC was appropriate and that without the injunction, there was a reasonable belief that the Defendant would continue the fraudulent conduct in violation of the CEA.⁵³

IV. CRYPTO-LIBERTY AND JUSTICE FOR ALL

While the holding in *McDonnell* involves ground-breaking and innovative technology products within the derivatives marketplace, its primary focus is on a routine consumer protection issue.

“The mission of the CFTC is to foster open, transparent, competitive, and financially sound markets. By working to avoid systemic risk, the Commission aims to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to

⁵² *Commodity Futures Trading Com'n v. McDonnell*, 287 F.Supp. 3d 213, 228 (E.D.N.Y. 2018).

⁵³ *Id.* at 230.

derivatives and other products that are subject to the Commodity Exchange Act (CEA).”⁵⁴

In one light, the Court in *McDonnell* makes it certain that the CFTC has no regulatory authority over spot markets, thus following the CFTC’s autonomy granting approach to virtual currency adoption and development. With that said, the Court does make sure to provide the CFTC a vehicle to control abusive practices in commodities markets, regardless of any futures contracts being involved.

The underlying technology that virtual currencies utilize, called blockchain or distributed ledger technology⁵⁵, has immense potential to disrupt financial market infrastructure. Bitcoin, “a peer-to-peer electronic version of cash” is one of the types of virtual currency platforms revolutionizing electronic payment solutions by solving the “double-spending problem”, “without going through a

⁵⁴ *Mission and Responsibilities*, U.S. COMMODITY FUTURES TRADING COMMISSION, <https://www.cftc.gov/About/MissionResponsibilites/index.htm> (last visited Nov. 17, 2018).

⁵⁵ Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electron Cash System*, <https://bitcoin.org/bitcoin.pdf> (last visted Oct. 31, 2018) (Distributed ledger technology is a system which provides trustless integrity verification of transactions or datasets. Rather than a central authority, such as a bank, verifying that transactions are legitimate and that funds are truly available, a decentralized approach allows for a community to review and verify transaction legitimacy. An abstract illustration, but nonetheless an example of a decentralized ledger, is the English alphabet. There is no centralized authority that verifies that the English alphabet consists of 26 letters or that it is ordered from a to z, the community of English speakers automatically verifies and approves of the count of letters in and the order of the English alphabet. This community does not rely on trust, but on the consensus that the order of the alphabet consists of 26 letters and it ordered from a to z.).

financial institution.”⁵⁶ In 2017, the CFTC supported the first bitcoin futures option to be listed on the Chicago Mercantile Exchange (CME) and the Chicago Board Options Exchange (Cboe).⁵⁷ “The CFTC’s current product self-certification framework has long been considered to function well and be consistent with public policy that encourages market-driven innovation that has made America’s listed futures markets the envy of the world.”⁵⁸ This market enablement enshrines that the CFTC is committed to a “do no harm” regulatory approach in allowing the evolution of virtual currencies and their associated markets.⁵⁹ The CFTC paints itself as a patron of innovation, however, it is important to note that the bitcoin derivatives listed with CME and Cboe⁶⁰ “allow settlement in lieu of delivery”⁶¹, meaning that investors engaging with these products never actually hold the underlying commodity in their respective portfolios. Nonetheless,

⁵⁶ *Id.* (The double spending problem is a potential flaw of digital cash solutions. It exists when a system is unable to verify whether digital assets have been used in two separate, authorized transactions, thus creating a scenario where a user is able to spend the same asset twice. Nakamoto offers a solution to the double-spend problem by proposing “a peer-to-peer network using proof-of-work to record a public history of transactions that quickly becomes computationally impractical for an attacker to change if honest nodes (ledger verifiers) control a majority of CPU power.”).

⁵⁷ Ken Sweet and Alexandra Olson, *Bitcoin futures debut on CME, taking bigger Wall Street stage*, CHICAGO TRIBUNE (Dec. 18, 2017), available at <https://www.chicagotribune.com/business/ct-biz-bitcoin-futures-cme-group-20171218-story.html>.

⁵⁸ *Commodity Futures Trading Com’n v. McDonnell*, 287 F.Supp. 3d 213, 253 (E.D.N.Y. 2018).

⁵⁹ *Id.* at 259.

⁶⁰ See *XBT-Cboe Bitcoin Futures*, CBOE, <http://cfe.cboe.com/cfe-products/xbt-cboe-bitcoin-futures>.

⁶¹ See *Basics of Futures Trading*, CFTC, <https://www.cftc.gov/ConsumerProtection/EducationCenter/FuturesMarketBasics/index.htm>.

the CFTC has made it clear that it supports the adoption of virtual currencies so long as necessary safeguards are implemented.

The holding in *McDonnell* provides the CFTC just the safeguard it desires: the ability to intervene when abusive practices are employed in commodity markets. The legislation which grants the CFTC this authority, known as the Dodd-Frank Act, was enacted as a result of the 2008 Global Financial Crisis. Ironically, Satoshi Nakamoto's whitepaper on Bitcoin was also published in 2008 as a result of the distrust of financial institutions following the subprime mortgage bubble catastrophe. While many crypto-currency enthusiasts may see this case as an infringement on their anti-financial institution and anti-regulatory virtues, the holding may support both crypto-enthusiast and regulator interests. On one hand, the virtual currency marketplace is free to continue its development and enjoy independence in the spot market, while on the other hand, the CFTC has an avenue to prevent virtual currency related fraud, which may lead to increased adoption of virtual currencies in the long run.