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## Federal Judge Issues Unusual Invitation to CFTC to Comment on SEC Enforcement Action

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In an unusual development, Judge P. Kevin Castel of the US District Court for the Southern District of New York issued an order in an enforcement action brought by the Securities and Exchange Commission (“SEC”) inviting the General Counsel of the Commodity Futures Trading Commission (“CFTC”) “to express [the CFTC’s] views on the issues presently before the Court.” This is unusual because the CFTC is not a party to this case. The case, *SEC v. Telegram*, involves the SEC’s allegations that distributed ledger tokens called “Grams” that the defendants were developing – and purchase agreements entered into with investors to buy the tokens – constitute “securities” so their sale and distribution violate the prohibition on the sale of unregistered securities under Section 5 of the Securities Act. Judge Castel’s action does have the virtue of seeking to have the views of both Commissions before it in deciding issues of first impression relating to the reach of the SEC and CFTC over virtual currencies.

### I. Background on *SEC v. Telegram*

Telegram developed and launched a message application, Telegram Messenger, which allows users to communicate through chats and phone calls in 2013.<sup>1</sup> In 2017, to maintain Telegram Messenger as a free service without advertising, Telegram initiated a plan to raise money to support the system through the sale of purchase agreements which could be converted to Grams, digital tokens, which would be issued when a distributed ledger system, the TON Network, was operational and integrated into the Telegram Messenger system. When the TON Network becomes operational, Telegram asserts that it will be a decentralized distributed ledger operating on an open source system. Telegram raised \$1.7 billion through the sale of the purchase agreements.<sup>2</sup>

The SEC argues that the sale of the purchase agreements constituted a sale of unregistered securities which did not qualify for an exemption from the Securities Act of 1933 registration requirements, which essentially would require Telegram to sell the purchase agreements pursuant to a prospectus.

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1 SEC Memorandum of Law in Support of its Motion for Summary Judgment, 1:19-cv-09439 Doc. No. 79 at 3.

2 *Id.* at 4-6.

The SEC also contends that the Grams to be issued when the TON Network is launched are investment contracts under *SEC v. W.J. Howey*, and as a result, are also securities in and of themselves.<sup>3</sup>

Telegram concedes that the initial sale of the purchase agreements constituted the sale of securities, but that the sale was exempt from Section 5's registration requirement under either Regulation D or Regulation S.<sup>4</sup> Telegram did file a Form D with respect to at least a portion of the offering. Telegram pointedly denies that the issuance of Grams, when the TON Network launches, will constitute the sale or distribution of securities. Rather, Telegram argues that Grams are either a commodity or a currency subject to the CFTC's anti-fraud jurisdiction.

After extensive expedited discovery, the court has before it dueling, fully-briefed motions for summary judgment from both the SEC and Telegram. Given Telegram's arguments that Grams should be subject to the CFTC's anti-fraud jurisdiction and not the SEC's jurisdiction over securities, Judge Castel issued his order inviting the CFTC's General Counsel to express the CFTC's views of the issues before the court.

## II. The Invitation of the CFTC General Counsel to express CFTC's views on the issues

The CFTC general counsel certainly has the authority to submit the CFTC's views on the subject matter of the litigation. The CFTC has submitted amicus curiae briefs in numerous cases over the years. The question of how it would proceed to do so in this case is an interesting one. There is often an impetus for inter-agency cooperation between the SEC and the CFTC. Policy decisions that touch both agencies have been worked out in the past by negotiations between the chairs of the two commissions. One example is the Shad Johnson Accord, which established jurisdictional lines between cash-settled equity index options and futures. In this case, it will be interesting to see how the CFTC proceeds.

## III. Substantive Issues: Do Grams Constitute a kind of "Commodity"?

Assuming that the CFTC and the General Counsel decide to provide the CFTC's views on the issues pending before Judge Castel, the question arises what those views might be. The CFTC has issued two speaking orders in which it has asserted that "Bitcoin and all other virtual currencies" are commodities.<sup>5</sup> It has also brought a handful of enforcement actions in federal court asserting that, because the virtual currency at issue in those cases are "commodities," it can apply its cash market anti-fraud authority to prosecute the alleged fraud in those cases. In addition, while speaking at a public event in October 2019, CFTC Chairman Heath Tarbert pronounced Ether to be a commodity even though

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3 328 U.S. 293 (1946) (in *Howey*, the Supreme Court held that an "investment contract" involves: (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others).

4 See, e.g., 17 C.F.R. § 501 et seq.

5 *In re BFXNA Inc., d/b/a Bitfinex*, CFTC Docket No. 16-19 (2016); *In re Coinflip Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (Sept. 17, 2015).

there are no Ether futures.<sup>6</sup> On February 11, 2020, the CFTC and SEC brought parallel anti-fraud cases in the Southern District of New York, *CFTC v. Ackerman*<sup>7</sup> and *SEC v. Ackerman*.<sup>8</sup> Both complaints allege that the defendants embezzled funds raised from investors for Ackerman to use to trade virtual currencies. The CFTC complaint, which does not specify the virtual currencies involved, alleges that the unnamed virtual currencies “are encompassed within the definition of ‘commodity’ under Section 1a(9)” of the CEA, thus implicating the CFTC’s cash market anti-fraud authority. The SEC complaint alleges that Ackerman’s fraudulent misrepresentation in the sale of investment units constituted securities fraud. This record would suggest that the CFTC may take the view that Grams constitute a “commodity” over which it has cash market anti-fraud authority.

The CFTC’s authority over “all” virtual currencies, however, has been challenged. In *CFTC v. My Big Coin Pay, Inc.*,<sup>9</sup> the defendants challenged the CFTC view that the virtual currency at issue was a “commodity.” They pointed out that “commodity” is a defined term under the CEA, which Congress amended in 1974 to make the definition dynamic to expand and contract based on which products have futures contracts trading on them.<sup>10</sup> The defendants in *My Big Coin* argued that, because no futures covered the virtual currency, there was not a “commodity”, and, therefore, the CFTC’s anti-fraud authority over fraud in cash market transactions in commodities did not apply.

Judge Rya Zobel denied the motion reasoning:

the amended complaint alleges that My Big Coin is a virtual currency and it is undisputed that there is futures trading in virtual currencies (specifically involving Bitcoin). That is sufficient, ***especially at the pleading stage***, for plaintiff to allege that My Big Coin is a “commodity” under the Act.<sup>11</sup>

Although the CFTC’s *Ackerman* complaint does not name the specific virtual currencies involved in the case, the complaint alleges that the defendants had accounts at four cryptocurrency exchanges, Kraken, Gemini, Coinbase and Bitfinex.<sup>12</sup> Given that these exchanges trade only fairly established and well decentralized virtual currencies it is unlikely the case involves a new or as yet unlaunched virtual currency such as Grams. The CFTC may be reluctant to declare Grams to be commodities as they have yet to be launched, and notwithstanding Telegram’s claims that immediately upon launch Grams will be a widely distributed and decentralized virtual currency, it is not clear that Grams will

6 CFTC Press Release 8015-19 (Oct. 10, 2019).

7 *CFTC v. Michael Ackerman, et al.*, Docket No. 1:20-cv-01183, Complaint Doc. 1 (S.D.N.Y. Feb. 11, 2020).

8 *SEC v. Michael W. Ackerman*, Docket No. 1:20-cv-01181 (S.D.N.Y. Feb. 11, 2020).

9 Docket No. 18-10077-RWZ (D. Mass. January 16, 2018).

10 In 1974, it had become clear that the previous method, used from 1922 to 1968, of declaring individual products to be commodities was not working: half of the futures in the United States were not regulated under the CEA. As a result, in the Commodity Futures Trading Commission Act of 1974 (which created the CFTC and transferred to it the Agriculture Department’s previous responsibility to administer the CEA), Congress added to the thirty-odd enumerated agricultural commodities the phrase “all other goods and articles, . . . or services rights and interests in which contracts for future delivery are presently or in the future dealt in.” The Chairman of the House Agriculture Committee explained that the law was designed so that “[a]ll commodities trading in futures will be brought within federal regulation under the aegis of the new Commission.”

11 *CFTC v. My Big Coin Pay, Inc.*, 334 F. Supp.3d 492, 498 (D. Mass. 2018) (emphasis added).

12 *CFTC Ackerman*, Complaint at ¶ 20.

be widely distributed and decentralized which SEC staff have stated are characteristics of a digital asset that is not a security.<sup>13</sup>

We think that it would be highly unlikely for the CFTC to take on an adversarial posture in this SEC enforcement proceeding. With the filing of their parallel fraud cases against Ackerman, it is clear that the two agencies are working together in a cooperative fashion. If the SEC and CFTC cannot reach a consensus on how to approach the *Telegram* case, we think the likely outcome will be for the CFTC to decline to present its views to Judge Castel. We believe that Judge Castel's order may, however, serve as a catalyst for further discussions between the SEC and CFTC, in an effort to establish regulatory consistency in this area. The markets could benefit from more clarity in this evolving area of activity.

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<sup>13</sup> W. Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (SEC June 14, 2018). Available at: <https://www.sec.gov/news/speech/speech-hinman-061418>