

The current environment of U.S. cryptocurrency regulation

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As regulators grapple with how — or whether — to apply federal securities and commodities laws and regulations to cryptocurrencies and related products and entities, the regulatory framework continues to evolve quickly. This expert analysis is intended to serve as general guidance on the current regulatory environment within this new asset class.

COMMODITY FUTURES TRADING COMMISSION

The Commodity Futures Trading Commission was among the first regulatory authorities to assert jurisdiction over cryptocurrency-related products.

In September 2015 the CFTC concluded in *In re Coinflip Inc.*, CFTC No. 15-29, 2015 WL 5535736 (Sept. 17, 2015), that cryptocurrencies such as Bitcoin fit within the definition of “commodity” under the Commodity Exchange Act. Thus, derivatives markets in cryptocurrency are subject to the CFTC’s supervision.

The U.S. District Court for the Eastern District of New York affirmed the CFTC’s view in *CFTC v. McDonnell et al.*, No. 18-cv-361, 2018 WL 1175156 (E.D.N.Y. Mar. 6, 2018). The court also held in *McDonnell* that the CFTC can use its enforcement powers to police fraud and market manipulation in cryptocurrency spot markets.

The CFTC has continued to focus on cryptocurrency and related derivatives products since those decisions were issued. It has taken action against unregistered cryptocurrency contract markets, disseminating warnings related to virtual currency markets and proposing interpretations related to its treatment of virtual currency transactions.

For example, the CFTC on Dec. 15, 2017, issued a proposed interpretation to inform the public of the agency’s views as to the meaning of “actual delivery” within the specific context of retail commodity transactions in virtual currency.¹

Also, on May 21 the CFTC staff issued an advisory providing guidance to exchanges and clearinghouses on listing virtual currency derivative products.² The advisory clarifies the staff’s priorities and expectations in its review of such listings in an

effort to help the subject entities meet their statutory and self-regulatory obligations.

The CFTC also launched a virtual currency resource webpage in December 2017. The page is designed to educate the public about virtual currencies, including by providing information about the potential risks of investing or speculating in cryptocurrencies or related products.

It contains links to CFTC primers on virtual currency and related topics and podcasts featuring CFTC staff discussing virtual currency and customer advisories — among other resources.

SECURITIES AND EXCHANGE COMMISSION

While the SEC staff has opined informally that certain popular cryptocurrencies such as Bitcoin and Ethereum are not securities, the agency and its staff have also provided statements and guidance on initial coin offerings, online trading platforms, cryptocurrency and exchange traded funds, among other things.

INITIAL COIN OFFERINGS

Companies and individuals are increasingly using ICOs to raise capital. ICOs typically involve investors exchanging either traditional fiat currency or cryptocurrency for a digital asset called a coin or token, which affords them certain rights or interests.

In July 2017 the SEC issued a report concluding that certain ICO tokens constituted investment contracts and therefore were securities under the federal securities laws.³

Under the “Howey test” set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), a coin or token constitutes an investment contract when there is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

Many ICOs promote the prospective increase in value of the tokens they offer and the ability to potentially trade those tokens on a secondary market, which gives them the characteristics of a security.

SEC Chairman Jay Clayton stated during congressional testimony earlier this year his belief that every ICO token he had seen up to that time constituted a security. If an ICO involves an offering of securities, the entity conducting the ICO must follow all the processes and requirements mandated by the federal securities laws for registration, offering, and disclosure unless it qualifies for an exemption from registration.

The SEC has already launched investigations and brought enforcement actions against companies and individuals whose ICOs constituted an unregistered offering and sale of securities in violation of the federal securities laws.⁴

To date, no ICOs have been successfully registered with the SEC, although the Praetorian Group became the first to file a registration statement for an ICO on March 6.

Some market professionals have restructured their tokens to provide some utility and rebranded them as “utility tokens” to prevent them from being deemed securities. The SEC has rejected this approach, believing it elevates form over substance. Such tokens will likely still be considered securities if they incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others.

ONLINE TRADING PLATFORMS

Online trading platforms have emerged to allow investors to buy and sell the digital assets — coins and tokens — initially sold in ICOs.

The SEC staff released a statement in March⁵ warning that such platforms may have to register as national securities exchanges or operate pursuant to an exemption from registration, such as the exemption for alternative trading systems.

The statement added that online trading platforms that do not operate as an exchange under the federal securities laws, but offer digital wallet services or transact in digital assets that qualify as securities, may still be subject to other registration requirements such as those applicable to broker-dealers, transfer agents or clearing agencies.

CRYPTOCURRENCY ETFS

The SEC has repeatedly rejected proposals by securities exchanges to list ETFs linked to cryptocurrency and related products.⁶

The SEC has disallowed both ETFs that track the value of a cryptocurrency through investments in the spot market and ETFs that track the value of a cryptocurrency by investing in cryptocurrency futures contracts.

In so doing, it has expressed concern about the increased potential for fraud and manipulation associated with the spot markets for these products.

An SEC staff letter, issued in January by Dalia Blass, director of the SEC’s division of investment management, reflected the same concerns.

The letter also said it would be inappropriate for the agency to allow registration of cryptocurrency ETFs until outstanding questions as to how the products would satisfy the requirements of the Investment Company Act of 1940 are answered.⁷ Blass identified key outstanding questions relating to the valuation, liquidity and custody of cryptocurrency.

FINANCIAL INDUSTRY REGULATORY AUTHORITY

The 2018 regulatory and examination priorities letter released Jan. 8 by the Financial Industry Regulatory Authority, the self-regulatory organization responsible for overseeing broker-dealers, reflected the organization’s growing concern about the role broker-dealers play in cryptocurrency transactions and ICOs.

FINRA stated that “where such assets are securities or where an ICO involves the offer and sale of securities, FINRA may review the mechanisms — for example, supervisory, compliance and operational infrastructure — firms have put in place to ensure compliance with relevant federal securities laws and regulations and FINRA rules.”

On July 6, FINRA issued a regulatory notice requesting that member firms notify the agency if they currently engage, or intend to engage, in activities related to cryptocurrency.

The types of activities of interest to FINRA if undertaken (or planned) by a member, its associated persons or affiliates include, among other things, accepting cryptocurrency from customers, maintaining custody or similar arrangements of digital assets, managing a cryptocurrency fund, participating in ICOs and offering advice relating to cryptocurrency.⁸ This request signals increased scrutiny by FINRA of its members’ involvement in cryptocurrency-related endeavors.

STATE REGULATORS, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

State securities regulators also have the authority to bring enforcement actions against companies or individuals who make unregistered state securities offerings. These regulators have been investigating offerings and cryptocurrency exchanges in their states.

The North American Securities Administrators Association has issued statements warning investors of the risks of cryptocurrency-related investment products, and several

states have brought enforcement actions regarding unregistered ICOs and related fraud. These states include Alabama, California, Massachusetts, New Jersey, North Carolina, South Carolina and Texas.

In April the New York Attorney General's Office launched a virtual markets integrity initiative aimed at investigating the policies and practices of cryptocurrency exchanges.⁹

On May 21, NASAA announced a new initiative called Operation Crypto-Sweep.¹⁰ State and provincial securities regulators from over 40 jurisdictions participated in this effort to crack down on cryptocurrency-related fraud, resulting in nearly 70 inquiries and investigations as well as 35 enforcement actions in the sweep's first few weeks.

NASAA also entered into a memorandum of understanding with the CFTC in May to increase coordination and information-sharing between state securities regulators and the CFTC. The MOU is intended to assist the participating regulators in enforcing the Commodity Exchange Act, particularly in relation to cryptocurrency derivatives.

CONCLUSION

Regulators are faced with the challenge of developing a balanced approach to cryptocurrency that protects investors without stifling innovation and the development of new technology. For now, cryptocurrency regulation remains a work in progress.

But, in light of the continued focus on cryptocurrency by federal and state regulators, market participants and their counsel should pay close attention to the regulatory requirements and continue to diligently monitor new developments. Additional initiatives, regulatory guidance and enforcement actions are sure to materialize in the coming year.

NOTES

¹ Commodity Futures Trading Comm'n, Retail Commodity Transactions Involving Virtual Currency, 82 FR 60335 (Dec. 20, 2017), <https://bit.ly/2O4Jik1>.

² Commodity Futures Trading Comm'n, Advisory With Respect to Virtual Currency Derivative Product Listings, CFTC Staff Advisory No. 18-14 (May 21, 2018), <https://bit.ly/2s97Lsv>.

³ Sec. & Exch. Comm'n, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (July 25, 2017), <https://bit.ly/2uySAZs>.

⁴ See, e.g., Press Release, Sec. & Exch. Comm'n, Company Halts ICO After SEC Raises Registration Concerns (Dec. 11, 2017), <https://bit.ly/2z1zcbq>; Press Release, Sec. & Exch. Comm'n, SEC Halts Alleged Initial Coin Offering Scam (Jan. 30, 2018), <https://bit.ly/2DVU3An>; Jean Eaglesham & Paul Vigna, Cryptocurrency Firms Targeted in SEC Probe, WALL ST. J. (Feb. 28, 2018), <https://on.wsj.com/2HQfYla>.

⁵ Sec. & Exch. Comm'n, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets: Joint Public Statement of Divisions of Enforcement and Trading and Markets (Mar. 7, 2018), <https://bit.ly/2Fm6T8s>.

⁶ See Bats BZX Exch. Inc., Exchange Act Release No. 34-83723 (July 26, 2018), <https://bit.ly/2zqlQFT>; NYSE Arca Inc., Exchange Act Release No. 34-83904 (Aug. 22, 2018), <https://bit.ly/2w7rYkf>; NYSE Arca Inc., Exchange Act Release No. 34-83912 (Aug. 22, 2018), <https://bit.ly/2lcFzvt>; CBOE BZX Exch. Inc., Exchange Act Release No. 34-83913 (Aug. 22, 2018), <https://bit.ly/2Mr8npj>.

⁷ Dalia Blass, Dir., Sec. & Exch. Comm'n, Div. of Inv. Mgmt., Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), <https://bit.ly/2DpXsaj>.

⁸ Fin. Indus. Regulatory Auth., Digital Assets: FINRA Encourages Firms to Notify FINRA if They Engage in Activities Related to Digital Assets, Regulatory Notice 18-20 (July 6, 2018), <https://bit.ly/2lbnE8n>.

⁹ Press Release, N.Y. Atty. Gen.'s Office, A.G. Schneiderman Launches Inquiry Into Cryptocurrency "Exchanges" (Apr. 17, 2018), <https://on.ny.gov/2ERCFJn>.

¹⁰ Press Release, N. Am. Sec. Admin'rs Ass'n, State and Provincial Securities Regulators Conduct Coordinated International Crypto Crackdown (May 21, 2018), <https://bit.ly/2IVARFF>.

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