PUBLICATIONS

Virtual Currencies, the Regulators and the Future

March 20, 2018

Thomas O. Gorman

Virtual currencies have risen from a little known tech curiosity to what some see as the next great investment opportunity in contrast to others who see little but fraud. An alphabet soup of regulators are struggling to apply traditional legal and regulatory principles to the new virtual currencies. Those include the Securities and Exchange Commission ("SEC"), the Commodity Futures Trading Commission ("CFTC"), the Department of Justice ("DOJ"), The Financial Crimes Enforcement Network ("FinCEN"), and certain banking agencies.

A fragmented regulatory approach to the new markets has developed. Nevertheless, tech innovators continue to evolve their approach to the new products and market. Fraudsters continue to search for new ways to make a quick buck at the expense of anyone but themselves. Viewed in the context of these conflicting currents, the future of virtual currencies is anything but clear. An examination of the regulatory cross currents and the evolving market, however, suggests the future direction.

II. Overview of the regulators

The SEC and the CFTC have been the most active regulators in the new market. Each has repeatedly warned investors about the lack of investor protections in the virtual currency markets. Each has also focused on the question of whether the transaction involved a security or a commodity and the potential impact of permitting the products to trade in their markets.

At the same time FinCEN announced that in certain circumstances participants in the virtual currency market may be money transmitters. The DOJ has also weighed in by bringing a criminal fraud action.[1]

A. The SEC: Registration, Trading and Professional obligations

The initial approach of the SEC to virtual currencies was an enforcement action alleging a failure to register the instruments involved. *In the Matter of Erik T. Voorhees*, Adm. Proc. File No. 3-15902 (June 3, 2014) (settled administrative proceeding involving the offering of unregistered shares valued in bitcoin). More recently the agency has brought fraud charges coupled with allegations of failure to register the securities involved. Typical of these actions is *SEC v. Plexcorps*, Civil Action No. 1:17-cv-07007 (E.D.N.Y. Filed Dec. 1, 2017). There the action centered on the claimed sale of a cryptocurrency by individuals enjoined from such sales by a Canadian court before bringing their scheme in the U.S., according to the SEC's complaint. The complaint named as defendants the company, an unincorporated entity, and Dominic Lacroix, a securities law recidivist who controlled the entity. Sabrina Paradise-Royer, believed to be a romantic interest of Mr. Lacroix, is also named as a defendant.

Defendants sought investors for their PlexCoin, claimed to be the next cryptocurrency. First, the Defendants tried to sell their product in Canada. In July 2017 the Quebec Financial Markets Administrative Tribunal entered an injunction against Mr. Lacroix, prohibiting him from future violations of the Quebec Securities Act, based on his sales efforts.

Next they tried the U.S. market. Beginning in August 2017, and continuing until the SEC filed suit on December 1, 2017. Defendants engaged in over 1,500 investor transactions, selling about 81 million PlexCoin Tokens for about $15 million. Investors were induced to enter into these transactions through a series of claims which included: a representation that a team of experts around the world was involved; that the firm's executives were hidden to avoid poaching by competitions; that new products were being developed; and the potential returns were enormous.

The representations were false, according to the SEC. Defendants misappropriated much of the investor funds. The complaint alleges violations of Securities Act Sections 5(a), 5(c) for unregistered securities and 17(a) and Exchange Act Section 10(b) for fraud. This case is in litigation.[2]

1. The SEC DAO Report: When registration is required

The SEC defined its primary approach to virtual currencies, and addressed the central question of whether a security is involved, in a Report of Investigation issued in mid-2017. Exchange Act Release No. 81207 (July 25, 2017) ("DAO Report"). The investigation sought to determine if The DAO, an unincorporated organization, Slock.it UG, a German entity, Slock.it's co-founders and certain intermediaries, violated the federal securities laws by selling unregistered securities.

It focused on the sale of tokens by The DAO, an autonomous organization that used block-chain technology to operate as a "virtual entity."

The tokens represented interests in the enterprise that could be paid for with virtual currency. The tokens could also be held as an investment, had certain voting and ownership rights and could be sold on web-based secondary platforms. Based on an analysis keyed to the elements of an investment contract, and focused on the economic reality of the transactions, the Commission determined that the tokens are securities. Specifically, the Commission's analysis centered on whether the tokens were an "investment contract," a form of a security under the definitions in the federal securities laws. The seminal decision in this regard is *SEC v. H.J. Howey Co.*, 328 U.S. 293 (1946). Under that decision four factors are typically considered: 1) an investment of money; 2) in a common enterprise, 3) with the expectation of profits; and 4) from the efforts of others. *See also, United Housing v. Forman*, 421 U.S. 837, 854-55 (1975). The crux of the analysis is whether investors are pooling their money with the expectation of making a profit through the efforts of others

coupled with assessing the economic reality of the transactions. Based on this approach the Commission concluded that The DAO offering was an investment contract and thus a security subject to the federal securities laws.

2. The SEC: Funds, ETFs and trading platforms

Virtual currencies also present questions under the federal securities laws about whether the products can be held by funds or ETFs and traded on an exchange. To date the SEC has not authorized funds to hold virtual currencies as investments or authorized their trading on an exchange. The agency has received a number of applications related to these issues. For example, in March 2017 the Commission denied a request regarding a trading platform from Cameron and Tyler Winklevoss, owners of Gemini Bitcoin exchange. Earlier this year there were about 14 applications for bitcoin ETFs or related products pending, according to a Reuters report dated January 10,2018.

The issues presented by permitting funds to invest in virtual currency are detailed in a letter from the Director of the Division of Investment Management dated January 18, 2018 to the Investment Company Institute and the Securities Industry and Financial Markets Association.[3] The letter discusses a series of issues raised by the prospect of permitting funds or ETFs to invest in virtual currencies. Those include:

Valuation: Mutual funds and ETFs are required to value their assets each business day by determining net asset value. Valuation is important, for example, to determine fund performance and the price paid by investors for fund shares and ETFs. The question here is "Would funds have the information necessary to adequately value cryptocurrencies or cryptocurrency-related products, given their volatility, the fragmentation and lack of regulation of underlying cryptocurrency markets, and the nascent state and current trading volume in the cryptocurrency futures markets?"[4]

Liquidity: A key feature of mutual funds and ETFs is the ability to redeem the shares each day. The applicable rules require that the fund maintain sufficient liquid assets to provide daily redemptions. The question is thus how "funds investing in cryptocurrencies or cryptocurrency-related products . . . [could] assure that they would have sufficiently liquid assets to meet redemptions daily?"

Custody: The Advisers Act imposes certain requirements regarding custody which include verification of holdings. To the extent the fund holds cryptocurrency directly, there is a question about how these requirements would be met: "We note, for example, that we are not aware of a custodian currently providing fund custodial services for cryptocurrencies . . . how would a fund intend to validate existence, exclusive ownership and software functionality of private cryptocurrency keys and other ownership records?"

Arbitrage: ETFs have essentially an arbitrage process that allows for exchange trading of the shares during the day at market prices and redemptions transacted at NAV by authorized participants. There cannot be a material deviation from the market prices and NAV however. The question as to cryptocurrencies is if "this type of process [is] feasible . . . and how would the volatility and trading halts in those markets impact this process?"

Manipulation: The Commission has repeatedly expressed concerns regarding the current operation of the cryptocurrency markets. This is particularly true with regard to the substantially less investor protections available in those markets. There is a significant question regarding how these issues will be resolved and the impact of that solution on the other points listed above.

The Director concluded by noting that the resolution of the issues will inform not just question regarding funds but also registration and trading: "The resolution of many of the questions we have raised in the context of a product seeking registration under the [Investment Advisers Act of] 1940 Act will also be important to the ongoing analysis of filings for exchange-traded products and related changes to

listing standards by the Division of Corporation Finance, the Division of Trading and Markets and the Office of the Chief Accountant." Until "the questions identified above can be addressed satisfactorily, we do not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products."

The SEC's approach to trading platforms is similar. It is reflected in a joint statement issued by the SEC's Divisions of Trading and Markets and Enforcement on March 7, 2018 ("Trading Markets Release"). [5] That Release echoes in part the questions raised by Director Bass in her letter regarding funds and ETFs. In this regard the Trading Markets Release notes, for example, that many digital platforms refer to themselves as "exchanges" which can give "the misimpression to investors that they are regulated or meet the regulatory standards of a national securities exchange." While some platforms may be selective or have strict standards, they "should not be equated to the listing standards of national securities exchanges," according to the Release. Likewise, while some platforms may have trading protocols, "investors should not assume the trading protocols meet the standards of an SEC-registered national securities exchange." And, while some platforms create the impression that they have exchange functions such as order books and updated bid and ask pricing and data, the Release cautions investors that "there is no reason to believe that such information has the same integrity as that provided by a national securities exchange." In view of these cautionary statements and the key questions raised by the Director of the Division of Investment Management there is no reason to assume that any funds, ETFs or platforms will be authorized to deal in cryptocurrencies in the immediate future.

3. Testing the DAO Report: The *Munchee* case

The SEC's approach to cryptocurrencies will be tested in an enforcement action heading for hearing, *In the Matter of Munchee Inc.*, Adm. Proc. File No. 3-18304 (Dec. 11, 2017). The central question in this case is whether the product involved is a security – the critical question on which the SEC's regulatory authority hinges and which the agency addressed in The DAO Report.

Munchee is a privately held firm based in San Francisco. In late 2015 it began developing an iPhone app that was launched two years later. The app allowed users to post photographs and reviews of restaurant meals on-line.

The firm created a plan to improve the app. In part the plan called for raising capital through the sale of tokens or MUN on the Ethereum blockchain. Munchee created 500 million MUN tokens. Overall the plan called for the creation of about $15 million in Ether by selling 225 million MUN tokens out of the 500 million MUN tokens created by the company. The firm marketed the coins through a website, a white paper and other means, promising that as others became involved and the tokens circulated the value would increase. A key part of the plan was the trading of MUN on an exchange. The firm represented that MUN tokens would be available for trading on at least one U.S. based exchange within thirty days of the initial coin offering closing.

The coins were sold to the public beginning on October 17, 2017. Investors were told that they could profit on the investment based on the potential development of the ecosystem, the efforts of the firm and the future exchange listing of the coins. As the ecosystem expanded the value of the coins would increase, according to the firm. Munchee stopped selling the coins on November 1, 2017 after being contacted by the staff.

Echoing The DAO Report, the Commission's Order initiating the proceeding states that under Section 2(a)(1) of the Securities Act, the MUN tokens are securities because they are investment contracts. Accordingly, in offering the tokens for sale in the absence of an effective registration statement, or an exemption from registration, Munchee violated Section 5(a) of the Securities Act.

Munchee is currently being litigated. The registration question, based on The DAO Report, is squarely presented since there is no

fraud claim as in many cases. At the same time the application of the *Howey* test here may differ from that in other cases. Typically the focus in investment contract cases is on the pooling of investor funds and a potential investor profit from the efforts of the enterprise. Beyond putting in capital, the investors may be passive.

In *Munchee*, however, a key to the future success and profits for the investors is the ecosystem. While the company may promote that ecosystem, the increased value of the investment – the coins – may well be largely a function of other investors deciding to purchase a coin and thereby building out the ecosystem and trading in the coins. While it can be argued that these facts fit the *Howey* test, it differs from the more traditional model. Thus the outcome of *Munchee* may hinge on the development of the facts and their presentation at the hearing.

4. The SEC: Protecting investors -- gatekeepers

While the Commission evolves its approach to virtual currencies, the agency and its officials have repeatedly cautioned investors about the lack of protections in these new markets compared to those available in the securities markets while trying to enlist the aid of the market professionals or gatekeepers.[6] In one speech, for example, the Chairman stated flatly that "from what I have seen recently particularly in the initial coin offering ("ICO") space, they [gatekeepers] can do better" in fulfilling their professional obligations. [7]

The Chairman went on to offer two examples of the difficulties investors face in the virtual currency markets. First, while the processes in the markets may be similar to those in the securities markets, the protections are not. ICO, the Chairman stated, "sounds pretty close to an "IPO." Yet there are significant protections for an IPO investor under the securities laws but not necessarily for an ICO. Second, he called out those who would try to take advantage of the current exuberance for all things crypto noting "I doubt anyone in this audience [a group of securities lawyers] . . . would [find it] . . . acceptable for a public company . . . with no experience in virtual currencies to changed its name "to something like 'Blockchain-R-US' and immediately start selling securities without providing adequate protections for investors.

Chairman Clayton then delivered what he called a "simple and a bit stern" message to market professionals: "I have instructed the SEC staff to be on high alert for approaches to ICOs that may be contrary to the spirit of our securities laws and the professional obligations of the U.S. securities bar." Those market professionals and members of the securities bar "need to act responsibly and hold themselves to high standards." Indeed, the securities laws "assume that securities lawyers, accountants, underwriters, and dealers will act responsibly . . ." the Chairman stated. It is simply not acceptable for securities lawyers involved in these transactions to conclude that the ICO is "pretty close" to an IPO and let it go forward. Likewise, assessing the situation and taking an equivocal position is not acceptable. As gatekeepers the securities lawyers and other market professionals have obligations to step forward and ensure that investors are given proper protections.

While the issues posed by virtual currencies, and the hype created in part by social media about them is new, Chairman Clayton's approach is not. The call on gatekeepers – market professionals who can at times control access to such transactions – to act in the highest traditions of their professional obligations traces to the earliest days of the Division of Enforcement. The access theory, as it was known years ago, posits that securities lawyers and other market professionals can aid in the protection of the investors by faithfully implementing their professional obligations.[8] In view of the Chairman's invocation of it, the theory may well form at least part of the predicate for any investigation brought in this area.

B. The CFTC: Virtual currencies are commodities

The CFTC's approach has been similar to that of the SEC, focusing first on its jurisdictional predicate and then on trading. The agency has sought to bolster its approach with repeated public statements – at times in conjunction with the SEC – about investor protections.

1. The CFTC: Virtual currency as a commodity

In 2015 the regulator concluded that virtual currencies are a commodity within the meaning of the Commodity Exchange Act ("CEA"). Accordingly, they are subject to regulation by the agency. The position of the CFTC was recently confirmed in *CFTC v. McDonnell*, Civil Action No. 18-cv-361 (E.D.N.Y. Opinion March 6, 2018).

The action centered on fraud claims. The resolution of those claims hinged in the first instance on the jurisdiction of the agency which is a function of whether a commodity is involved. Named as Defendants in the action are Patrick McDonnell and his firm, Coin Drop Markets. The complaint alleges that the Defendants were marketing access to expert trading advice in virtual currencies that would permit investors to make huge profits. In fact the Defendants did not have the expertise as traders, contrary to their claims, and were misappropriating portions of the investor funds. The CFTC charged fraud in its action.

The Court upheld the jurisdiction of the CFTC, granting a request for a preliminary injunction to halt the transaction, in a memorandum and order per Senior Judge Jack Weinstein. In its opinion the Court stated that the Commodity Exchange Act defines commodity to include "wheat, cotton, rice, corn, oats . . . and all services, rights, and interests . . . in which contracts for future deliver are presently or in the future dealt in." In view of this definition the CFTC issued an order in 2015 stating that virtual currencies can be classified as commodities. *In the Matter of: Coinflip Inc.*, CFTC Docket No. 15-29. That order stated that "'Bitcoin and other virtual currencies are encompassed in the definition [of a commodity] and properly defined as commodities.'" The Court went on to hold that while the CFTC generally cannot regulate the spot market, under an expansion of its authority in the Dodd-Frank Act, the agency can bring an action under Section 9 of the CEA and Rule 180.1 prohibiting fraud involving any "'contract of sale of any commodity in interstate commerce.'"

The CFTC has also brought a number of enforcement actions involving virtual currencies centered on fraud charges and unregistered trading that are similar to those initiated by the SEC. *See, e.g., CFTC v. Gelfman Blueprint, Inc.*, Case No. 17-7181 (S.D.N.Y. Filed Sept. 21, 2017)(action against the firm and its CEO centered on a Bitcoin Ponzi scheme supposedly using a high-frequency, algorithmic trading strategy to trade; case is in litigation); *In the Matter of BFXNA Inc., d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016)(settled administrative proceeding centered on trading or exchanging cryptocurrencies, mainly bitcoins, on an unregistered platform).

2. The CFTC: Virtual currencies and trading

Unlike the securities markets, trading in the commodities markets involving virtual currency products has been permitted by the exchanges. Trading involving virtual currencies is a question initially addressed by the commodity exchanges, rather than the CFTC, a crucial difference from the securities markets.

On December 1, 2017, the Chicago Mercantile Exchange Inc. and the CBOE Futures Exchange self-certified new contracts for bitcoin future products. The Cantor Exchange self-certified a new contract for Bitcoin binary options. The product self-certification process was designed by Congress to "give the initiative to DCMs [Designated Contract Markets] to certify new products . . . [which] is consistent with a DCM's role as a self-regulatory organization . . ." according to the CFTC Backgrounder to Virtual Currency Markets. [9] The process does not allow for public comment. The CFTC has only limited input.

Nevertheless, the CFTC has taken an active role centered on investor protections. Within the limits of the self-certification process, the CFTC staff has engaged in what the Backgrounder calls "heightened review for virtual currency." That process, centers largely on strengthening oversight and monitoring, including: derivatives clearing organizations setting substantially high initial and maintenance margin for cash-settled Bitcoin futures; setting large trader reporting thresholds at five bitcoins or less; entering into information sharing agreements with spot market platforms; monitoring data from cash markets; and other, similar steps. The CFTC "expects that any registered entity seeking to list a virtual currency derivative product would follow the same process, terms and conditions" the Backgrounder notes. Accordingly, while there is currently trading involving virtual currencies in these markets, it is being carefully monitored by the CFTC which continues to focus on its investor protection rule.

III. The Future

The SEC, CFTC, FinCEN, DOJ and the banking regulators continue to monitor the cryptocurrency markets and take action within their limited spheres. The SEC and the CFTC have been particularly aggressive. The SEC, for example, has issued guidance in The DAO Report on what constitutes a securities – the predicate to its jurisdiction – and is litigating the question in *Munchee*. The agency has also engaged in a dialogue with market participants about investment by funds and ETFs in virtual currencies and authorizing trading. Those discussions are continuing as the SEC tries to ensure that securities law type protections are available to investors in the virtual currency market. At the same time the Enforcement Division has not only brought a number of fraud cases, it is currently conducting a significant non-public investigation into cryptocurrencies which appears to be a sweep, gathering additional information to inform the processes of the agency and perhaps as the predicate for more enforcement actions.

The CFTC has taken a similar approach. The jurisdiction of the agency – predicated on determining that a virtual currency is a commodity – has been upheld by the first court to consider the question. The agency has also brought a series of fraud actions and is using its limited authority over the trading that has been initiated to bolster investor protections.

As the regulators debate various issues and investigate the market is moving forward. Praetorian Group, for example, announced an anticipated $75 million initial coin offering and filed a registration statement with the SEC which appears to be a first. The firm invests in residential and commercial real estate. Coin investors would have a right to profits but not an interest in the actual real estate under the terms of the offering.[10]

Cameron and Tyler Winklevoss, who were not able to secure approval for a trading platform from the SEC, have returned with a request that a self-regulatory organization be created to monitor virtual currencies.[11] The proposal follows remarks from a CFTC Commissioner who initially suggested that such an organization be created.[12] This may signal an effort to circumvent the limitations the two brothers encountered when trying to deal with the SEC.

In the end, the final word on virtual currencies may ultimately evolve from the markets and the investors who have fostered growth in the virtual markets to date. Recently Facebook banned advertisements for cryptocurrencies.[13] If social media continues on this path it could have a more significant impact on virtual currencies than all of the regulators.

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[1] *See also* FinCEN Fines BTC-e Virtual Currency Exchange $110 Million for Facilitating Ransomeware, Dark Net Drug Sales (July 27, 2017), available at www.fincen.gov/news/news-releases/fincen-fines-btc-e-virtual-currency-exchange-110 -million-facilitating-ransomeware; Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (March 18, 2013), available at www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering. The

DOJ has criminal authority here also. *See, e.g., U.S. v. Zaslavskiy*, No. 17-MJ-934 (E.D.N.Y. Filed Nov. 1, 2017)(Indictment in connection with initial coin offering supposedly backed by real estate or diamonds; based on fraudulent sale of unregistered securities).

[2] *See also In the Matter of Bitcoin Investment Trust*, Adm. Proc. File No. 3-17335 (July 11, 2016)(settled action against bitcoin related stock exchange charging registration violations); *SEC v. Gara*, Civil Action No. 3:15-cv-01760 (D. Conn. Filed Dec. 1, 2015) (scheme offering opportunity to mine virtual currency attracted 10,000 investors and raised about $19 million in four months; it was a Ponzi scheme); *In the Matter of BTC Trading, Corp.*, Adm. Proc. File No. 3-16307 (Dec. 8 2014)(settled action against virtual currency trading operation charging sale of unregistered securities and unregistered brokers).

[3] Letter from Dalia Bass, Director, Division of Investment Management to Paul Schott Stevens and Timothy W. Cameron, dated January 18, 2018, available at www.sec.govdivisions/investment/noaction/2018/cryptocurrency-011818.htm.

[4] *See also* NERA, A Look at Initial Coin Offerings (Dec. 12, 2017) (discussing questions of liquidity and valuation for ICOs), available at: http://www.nera.com/content/dam/nera/publications/2017/PUB_A_Look_at_ICOs_1217.pdf.

[5] Divisions of Enforcement and Trading and Markets, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (March 7, 2018), available at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

[6] *See, e.g.*, SEC Chairman Jay Clayton, Testimony on Virtual Currencies: The Oversight Role of the U.S. SEC and U.S. CFTC, Senate Committee on Banking (Feb. 6, 2018), available at https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission; Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions (Jan. 19, 2018), available at https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors).

[7] Chairman Jay Clayton, Opening Remarks at the Securities Regulation Institute, Washington, D.C. (Jan. 22, 2018), available at https://www.sec.gov/news/speech/clayton-opening-remarks-sec-speaks.

[8] The Division evolve its access theory in early cases such as *SEC v. National Student Marketing*, 430 F. Supp. 639 (D.D.C. 1977); *but see SEC v. Arthur Young*, 584 F. 2d 1018 (9th Cir. 1978) (refusing to apply access theory to outside auditors absent statutory authority).

[9] CFTC Backgrounder to Virtual Currency Future Markets (January 4, 2018)("Backgrounder"), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

[10] Law 360 (March 7, 2018), www.law360.com/articles/1019491/print?section=securities.

[11] Law 360 article available at www.law360.com/articles/1021500/print?section =securities (March 14, 2018).

[12] CFTC Commissioner Brian Quintenz, Key Note Address before DC Blockchain Summit (March 7, 2018)(discussing possible SRO for virtual currency), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz8; *see also*, Statement of Commissioner Quintenz on Proposal vy Cameron and Tyler Winklevoss (March 13, 2018(welcoming proposal), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement031318.

[13] Sheera Frenkel, *The New York Times* (Jan. 30, 3018), https://www.nytimes.com/2018.01/30/technology/facebook-cryptocurrency-adds.html.