

# U.S. Regulators Continue Scrutiny of Virtual Currencies and ICOs

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This past week, we received further evidence that U.S. federal regulators will continue to scrutinize potential compliance issues in virtual currency trading and initial coin offerings (“ICOs”) under existing law. However, the key takeaway is that the U.S. regulators, so far, are doing so under established interpretations of their existing authority. None of these events should be construed either as establishing a new regulatory framework or as a significant expansion of prior regulatory authority.

- On March 6, a federal court granted the Commodity Futures Trading Commission’s (“CFTC”) request for a preliminary injunction to halt allegedly fraudulent trading of virtual currencies. In doing so, the court adopted the CFTC’s 2015 interpretation that virtual currencies, like Bitcoin, are “commodities.” As a result, spot transactions in virtual currencies are subject to the CFTC’s anti-fraud and manipulation enforcement authority in the Commodity Exchange Act (“CEA”). While it does not subject spot transactions to full CFTC regulation, it demonstrates the CFTC’s authority to take action against fraudulent or manipulative conduct even in purely unleveraged and unmarginated spot transactions.
- Also on March 6, the Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”) published a letter written to Senator Ron Wyden (D-OR) in February in which it confirmed that ICO token issuers and exchanges that sell convertible virtual currency for “another type of value” qualify as a money services business (“MSB”), subject to the anti-money laundering (“AML”) and other requirements under the Bank Secrecy Act (“BSA”).
- Finally, on March 7, the Securities and Exchange Commission’s (“SEC”) divisions of Enforcement and Trading and Markets issued a joint public statement calling for market participants that offer a platform for trading those ICO tokens and other digital assets that qualify as a “security” to adhere to existing requirements that they formally register with the SEC.

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While these actions simply confirm the existing authority of these regulators under current law, they demonstrate the clear willingness of the federal regulators to take action to prevent violations of that law in this new and rapidly developing environment. Certainly virtual currency and ICO-related businesses should ensure they are cognizant of the reach of these regulators and existing law, and ensure that their businesses conform to those strictures. It also remains critically important that such businesses continue to monitor regulatory developments in this fast-evolving market.

### **Court Affirms the CFTC’s Position That Virtual Currency Is A “Commodity,” And That Spot Transactions Are Subject To CFTC Anti-Fraud Rules**

On March 6, Judge Jack Weinstein of the United States District Court for the Eastern District of New York granted the CFTC a preliminary injunction against CabbageTech, Corp. for its alleged fraudulent offer of trading and investment services related to virtual currency. This is the first case to accept the CFTC’s position that virtual currency meets the definition of a “commodity” under the CEA. While the CFTC has formally treated virtual currencies such as Bitcoin as “commodities”<sup>1</sup> since 2015,<sup>2</sup> this is the first federal court decision to evaluate the issue. By affirming the Commission’s position, the court’s holding thus provides further support for the CFTC’s regulatory authority over virtual currency derivatives, and its power to bring enforcement actions for violations of the CEA’s anti-fraud and anti-manipulation provisions in purely unleveraged and unmargined virtual currency spot transactions. However, this decision should be seen to only affirm existing CFTC policy, and does not go beyond that to provide support for any expansion of the CFTC’s jurisdiction.

The case, CFTC v. McDonnell et al.,<sup>3</sup> is a civil enforcement action by the CFTC against Patrick McDonnell and his company, CabbageTech Corporation (doing business as Coin Drop Markets), alleging the operation of a deceptive and fraudulent virtual currency scheme in violation of the anti-fraud provisions of the CEA. The CFTC alleged that Mr. McDonnell and his company fraudulently induced “investors” to deposit various virtual currency tokens, on promises of significant returns as a result of “day trading.” The CFTC alleged that after receiving these investments, the defendants deleted their online presence and absconded with the investors’ money. In its enforcement action, the CFTC sought an injunction and monetary damages.

Mr. McDonnell had argued in response that the CFTC lacked jurisdiction to obtain an injunction pursuant to the CEA; first, because virtual currencies were not “commodities,” and second, because the CFTC did not allege that Mr. McDonnell had transacted in any derivatives contract. In a 79-page opinion, Judge Weinstein disagreed, holding both that “a ‘commodity’ encompasses virtual currency both in economic function and in the language of the statute,” and that the Dodd-Frank Act’s amendments to the CEA permit the CFTC to exercise its enforcement authority over fraud and manipulation that does not directly involve the sale of derivatives contracts.

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<sup>1</sup> See Commodity Exchange Act Section 1a(9), defining a “commodity” in relevant part as, “all...goods and articles,...and all services, rights, and interests ...in which contracts for future delivery are presently or in the future dealt in.”

<sup>2</sup> See In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29 (September 17, 2015) (In this action, the CFTC accepted a settlement with the operator of a Bitcoin options and futures risk management platform that was alleged to have operated as an unlicensed swap execution facility. In its Order resolving the matter, the CFTC asserted that “[t]he definition of ‘commodity’ is broad,” and that “Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.”).

<sup>3</sup> No. 18-CV-361, 2018 WL 1175156, at \*12 (E.D.N.Y. Mar. 6, 2018).

While Judge Weinstein’s analysis canvassed various arguments for and against regulation of virtual currencies by various regulatory authorities, his analysis of the central question regarding whether they are commodities was concise:

Virtual currencies can be regulated by CFTC as a commodity. Virtual currencies are “goods” exchanged in a market for a uniform quality and value. Mitchell Prentis, *Digital Metal: Regulating Bitcoin As A Commodity*, 66 Case W. Res. L. Rev. 609, 626 (2015). They fall well-within the common definition of “commodity” as well as the CEA’s definition of “commodities” as “all other goods and articles . . . in which contracts for future delivery are presently or in the future dealt in.” Title 7 U.S.C. § 1(a)(9).

After holding that virtual currency meets the CEA’s definition of a “commodity,” the Court turned to the matter of the CFTC’s jurisdictional authority to regulate and police virtual currency derivative and spot transactions. The Court quickly acknowledged that the CFTC possesses exclusive regulatory jurisdiction over futures contracts (and certain swaps) based on virtual currencies.<sup>4</sup> The McDonnell Court also acknowledged the broad statutory authority, and subsequent CFTC rulemaking, granting the CFTC authority to bring enforcement actions against persons committing fraud or manipulation in spot commodity markets.<sup>5</sup>

However, the Court also noted that the CFTC “does not have regulatory authority over simple quick cash or spot transactions that do not involve fraud or manipulation.”<sup>6</sup> The Court also held that the CFTC shares “concurrent or overlapping jurisdiction” with other regulatory agencies over spot commodity transactions.<sup>7</sup> In the context of virtual currency spot transactions, other regulatory agencies – such as FinCEN and the SEC –also have the authority to act where the activities of virtual currency spot market participants also fall within their jurisdictional mandate.<sup>8</sup>

The Court’s decision in McDonnell is thus notable for a couple of reasons. On one hand, it affirms the CFTC’s position regarding its authority to regulate virtual currency derivatives transactions and to bring enforcement actions against fraud and manipulation in virtual currency spot markets. The McDonnell Court’s decision has already been relied upon by the CFTC in another pending federal district court case,<sup>9</sup> and should this approach be broadly adopted by federal courts, the position would mean, among other outcomes:

- That the CFTC will be confirmed in its authority to adopt regulations and require registration of companies transacting in virtual currency derivatives,
- That the CFTC can bring civil enforcement actions or refer for criminal prosecution cases involving fraud or manipulation in connection with virtual currency spot transactions,

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<sup>4</sup> Under CEA Section 2, the CFTC has exclusive jurisdiction over, “accounts, agreements . . . and transactions involving swaps or contracts of sale of a commodity for future delivery.”

<sup>5</sup> See CEA Section 9(1) prohibiting the use of “any manipulative or deceptive device or contrivance . . . in connection with . . . a contract of sale of any commodity in interstate commerce.” See also the CFTC’s Rule 180.1, which adopts a prohibition on fraud in connection with the sale of commodities that mirrors the liability for securities fraud under SEC Rule 10b-5.

<sup>6</sup> 2018 WL 1175156 at \*11.

<sup>7</sup> *Id.*

<sup>8</sup> For example, where persons operate as MSBs in the case of FinCEN, or offer or sell “securities,” as the SEC has frequently found in the case of ICO token offerings.

<sup>9</sup> Plaintiff’s Notice of Supplemental Authority at 1, Commodity Futures Trading Commission v. My Big Coin Pay, Inc. et al., No. 1:18-cv-10077 (D. Mass. Mar. 8, 2018) (In its notice, the CFTC points to the McDonnell Court’s decision to support the claim that virtual currencies are “commodities” under the CEA, and thus that the Commission “has standing to exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce.”)

- Private parties can assert private civil claims under the CEA’s private right of action with respect to fraud or manipulation in connection with various types of virtual currency transactions, including futures (but generally not including spot transactions), and
- Virtual currency market participants would be provided with further legal certainty in conducting activities in both the derivatives and spot markets.

However, the Court’s acknowledgement of the potential for concurrent jurisdiction also maintains the status quo, whereby no one agency is granted full regulatory authority over virtual currency spot market transactions. Thus, the decision should not be viewed as increasing the CFTC’s authority or the beginning of more aggressive Commission enforcement, but merely as an affirmation of the same contours to the CFTC’s jurisdiction that it has previously asserted its authority over.

### **FinCEN Confirms That ICO Issuers And Exchange Platforms Are Subject To The Bank Secrecy Act**

In a letter sent to Senator Ron Wyden on February 13, 2018, but made public only on March 6, FinCEN advised that ICO token issuers and exchanges that sell convertible virtual currency are “money transmitters” subject to registration with FinCEN as an MSB. This position is consistent with FinCEN’s March 2013 guidance,<sup>10</sup> and aligns with the agency’s policy, beginning in 2011, of subjecting virtual currency exchangers and administrators to BSA requirements. This explicit acknowledgment that ICO token sales may constitute “money transmission” thus provides further certainty that ICO token issuers and exchange platforms are subject to some form of federal AML requirements. While the letter outlines a potential exception in the case of ICOs that are structured as the offering of securities or derivatives, this is only an exception from FinCEN’s regulation, as the ICO would still be subject to the regulations and AML requirements imposed under the SEC or CFTC’s respective rules (e.g., an issuer selling ICO tokens that are securities might use a broker-dealer, which is subject to AML requirements).

In FinCEN’s March 2013 guidance, the agency outlined the circumstances under which persons who use, administer or exchange virtual currencies are required to register as MSBs. The guidance made clear that “a user of virtual currency is *not* an MSB under FinCEN’s regulations,” but that “an administrator or exchanger is.” That guidance further explained that:

- An “exchanger” is a “person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency,” and
- An “administrator” is “a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.”

While Assistant Secretary for Legislative Affairs Drew Malone acknowledged in his letter to Senator Wyden that virtual currency exchangers and administrators have long been subject to the money transmitter requirements under the BSA, this is the first time that FinCEN has expressly stated that ICO token issuers and their exchange platforms may be subject to the same regulatory requirements.

Under the BSA and its implementing regulations, persons operating as MSBs must register as such with FinCEN. All persons who are required to register as an MSB are subsequently subject to a series AML and other

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<sup>10</sup> FinCEN, *Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FIN-2013-6001 (March 18, 2013).

requirements under the BSA. Thus, it is potentially a criminal offense<sup>11</sup> to operate without either being registered or without satisfying the following requirements:

- Preparation of a written AML compliance program designed to mitigate risks specific to its business, including AML risk,
- Administering an effective KYC program and collecting sufficient customer identification information to comply with its AML compliance program,
- Filing various reports, including suspicious activity reports as required under the BSA, and
- Maintaining various records of transactions that exceed certain thresholds.

FinCEN's February letter explicitly indicates that ICO token issuers and exchanges that sell ICO coins or tokens, or exchange them for other virtual currencies, are subject to BSA regulation as MSBs.

The guidance in this letter should not be viewed as an announcement of new policy, but instead as a statement of existing law. Thus, while this letter is not an extension of FinCEN's authority, or an announcement of a more aggressive crackdown, its publication should provide a warning that ICO developers and exchanges would be wise to heed.

## **SEC Encourages ICO Token Exchange Platforms To Register As Alternative Trading Systems**

Finally, on March 7, the SEC's divisions of Enforcement and Trading and Markets issued a public statement ("SEC Public Statement") to alert ICO token market participants, and those selling other "digital assets" that qualify as a "security,"<sup>12</sup> of their obligations under the U.S. securities laws when operating as a platform to trade securities.<sup>13</sup> Where such a platform operates as an "exchange,"<sup>14</sup> it is required to either register with the SEC as a national securities exchange or operate pursuant to an exemption from registration.<sup>15</sup> In particular, the SEC's Public Statement pointed to the exemption provided by Regulation ATS, whereby a person meeting the definition of an "exchange" registers as an alternative trading system ("ATS") and consequently as a broker-dealer, and additionally becomes a member of a self-regulatory organization ("SRO").

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<sup>11</sup> 18 U.S.C. § 1960.

<sup>12</sup> While Chairman Clayton and the SEC have frequently asserted that many ICOs meet the definition of a "security," the SEC has yet to make such statements as to the status of virtual currencies, such as Bitcoin or Ethereum.

<sup>13</sup> U.S. Securities and Exchange Commission, *Public Statement: Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* (Mar. 7, 2018), available at <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

<sup>14</sup> See Securities and Exchange Act Section 3(a)(1), defining an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange."

<sup>15</sup> As the SEC's Public Statement indicates, SEC-registered national securities exchanges, "must, among other things, have rules designed to prevent fraudulent and manipulative acts and practices. Additionally, as a self-regulatory organization, an SEC-registered national securities exchange must have rules and procedures governing the discipline of its members and persons associated with its members, and enforce compliance by its members and persons associated with its members with the federal securities laws and the rules of the exchange."

The SEC's Public Statement is not really an extension of the SEC's authority. Instead, it should be read as an indication to ICO market participants that where ICO tokens qualify as "securities," the U.S. securities laws already provide requirements for persons operating as a trading platform for such tokens. With this in mind, the SEC's Public Statement was likely issued to encourage such market participants to begin operating under some form of regulatory oversight. Whether that oversight is provided by the SEC itself or the SEC in conjunction with SROs to work to regulate and surveil such market activities, the Commission appears intent on bringing further oversight to the nascent industry where it can under its authority.

The SEC under Chairman Jay Clayton has frequently expressed concern toward the unregulated nature of an ICO industry that has appeared rife for fraud and manipulation. In recommending that platforms register as an ATS and a broker-dealer, the SEC's Public Statement pointed out that this would subject the platforms facilitating offers and sales of ICOs and digital assets that are securities to requirements for policies and procedures to prevent any misuse of material non-public information, recordkeeping requirements, and financial responsibility rules designed to protect client funds and securities, along with subsequent requirements imposed by an SRO.

The SEC's Public Statement goes on to note that some trading platforms that do not meet the definition of an "exchange" under the federal securities laws, but that directly or indirectly offer trading or other services related to digital assets that are securities (for example, digital wallet services that hold digital assets that are securities) may be subject to other registration requirements applicable to broker-dealers, transfer agents, or clearing agencies, among other things.

Like FinCEN's guidance discussed earlier, the SEC's guidance strongly suggests that companies engaged in ICO-related businesses should carefully review any potential registration requirements. In both cases, the regulators are asserting their existing authority and making clear the necessity of compliance. ICO market participants should view this as a cautionary reminder of their existing obligations under the U.S. securities laws.

## Conclusion

While neither the holding of the Eastern District of New York, nor the statements of FinCEN or the SEC serve to announce new policy or more aggressive enforcement, persons engaged in virtual currency and ICO businesses would be well served to heed the warnings of regulators and conduct a thorough examination of both their initial and continuing requirements under the law.

For further information on this topic, and ongoing updates, please refer to the [Cleary FinTech Update](#).

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