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3 Critical Events For Cryptocurrency Exchanges: Part 1

By **John Reed Stark and David Fontaine** (March 12, 2018, 3:36 PM EDT)

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Notice to all cryptocurrency exchanges: Be prepared for a relentless U.S. regulatory onslaught.

That seems to be the clear warning embodied in three events last week involving the U.S. Securities and Exchange Commission, the Financial Crimes Enforcement Network at the U.S. Department of the Treasury, and the U.S. Commodity Futures Trading Commission:

1. The SEC's "Statement on Potentially Unlawful Online Platforms for Trading Digital Asset," jointly issued by the SEC's enforcement division and its trading and markets division, on March 7, 2018;

2. FinCEN's response to a congressional request by Democratic Sen. Ron Wyden, ranking member on the U.S. Senate Committee on Finance, sent on Feb. 13, 2018, and made public on March 6, 2018; and

3. The CFTC's March 6, 2018, litigation victory in U.S. federal district court against defendants Patrick K. McDonnell and CabbageTech Corp., d/b/a Coin Drop Markets, or CDM, which confirmed that virtual currencies are goods exchanged in a market for a uniform quality and value and fall well within the common definition of "commodity."

The confluence of these events, which all occurred during the same 24-hour time window, is more than a mere harbinger. These three powerful, essential and historically respected U.S. federal enforcement agencies are no longer content with generating regulatory headwinds or publicizing menacing saber rattling. Instead, the SEC, FinCEN and the CFTC have now unleashed the perfect storm — and cryptocurrency exchanges, trading platforms and the like currently reside right smack in the eye of it.

The Backdrop

Online trading platforms have become a popular destination for investors who want to buy and sell digital assets, including coins and tokens offered and sold in so-called initial coin offerings, the trending method of capital formation by which startups or other parties can issue cryptographic tokens in an effort to fund or bootstrap a new blockchain network.

But the hype about cryptocurrencies has reached a level beyond anyone's expectations and is now part of the lexicon and discourse of our society, discussed with excitement and enthusiasm everywhere from hedge fund boardrooms to neighborhood coffee shops.

Cryptocurrency opportunities have become ubiquitous. The mayor of Berkeley, California, has even gone so far as to propose using local tax and bond proceeds to finance a cryptocurrency token. There are even crypto-IRA shops, where investors can shift digital currencies into their individual retirement accounts and 401(K) retirement plans. Meanwhile, cryptocurrency exchanges and similar platforms reside prominently at the center of all of this hype, facilitating transactions, generating buzz and creating the allure of an easy path to riches.

It is, therefore, not surprising that while the SEC, FinCEN and the CFTC each approach cryptocurrency exchange jurisdiction from distinct regulatory perspectives, all three federal agencies have expressed similar stridency and concerns about the regulatory failures of, and dangers posed by, these exchanges.

- Per the SEC and the CFTC, cryptocurrency exchanges pose a threat to investors, especially retail investors, because these exchanges currently operate unfettered, unmonitored and essentially free from regulatory oversight. As a result, these agencies are concerned about the potential for market manipulation and volatile swings or flash crashes that could devastate unsophisticated investors. Moreover, given the international, virtual and shadowy nature of cryptocurrency exchanges, the risks of trading virtual currencies can be amplified, while the SEC's ability to pursue off-shore cryptocurrency fraudsters and recover funds remains startlingly limited; and

- Per FinCEN, the potential use of these exchanges to facilitate money laundering by criminal enterprises ranging from ransomware purveyors to drug dealers to terrorist organizations poses a threat to the well-being and safety of U.S. citizens.

What all of these regulatory activities and recent public comments signal is a coming sea change in the cryptocurrency arena. This syncopated and opportune federal regulatory alignment relating to cryptocurrency exchanges is arguably unprecedented in the global financial marketplace — and thus warrants careful and thoughtful analysis.

In this two-part series, we unpack the SEC statement, the Wyden response and the CDM order, extrapolating key takeaways from each, scrutinizing their underlying legal theories, and forecasting their ultimate impact. Part one of our series addresses the SEC statement.

Cryptocurrency Exchanges and the SEC

The SEC statement is not the first SEC regulatory pronouncement addressing cryptocurrency issues, nor will it likely be the last. SEC Chairman Jay Clayton formally launched his cryptocurrency regulatory efforts with a July 25, 2017, investor bulletin warning investors about ICOs and, issued that same day, a report of investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934, explaining how ICOs are unlawful.

During the ensuing months, Clayton went on a crypto-tour (highlighted below), asserting over and over again that cryptocurrency tokens in many cases looked like securities and were susceptible to fraud and chicanery by insiders, management, and better-informed traders and market participants.

- On Nov. 9, 2017, speaking at an SEC conference ("I have yet to see an ICO that doesn't have a sufficient number of hallmarks of a security ... there is also a distinct lack of information about many online platforms that list and trade virtual coins or tokens offered and sold in ICOs.");
- On Dec. 11, 2017, issuing an official SEC "Statement on Cryptocurrencies and Initial Coin Offerings" ("By and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws."); and
- On Feb. 6, 2018, testifying before the Senate Banking, Housing and Urban Affairs Committee ("I believe every ICO I have ever seen is a security ... ICOs should be regulated like securities offerings. End of Story").

The SEC even went so far as to turn the spotlight on social media ICO promotions and endorsements by celebrities that failed to disclose properly the celebrity's financial relationship to the ICOs. The SEC warning admonished celebrities and other influencers that they may run afoul of securities laws when advertising cryptocurrencies and other investments, including ICOs.

Despite the SEC's warnings, however, ICO growth has continued at an astonishing pace. Before 2017, ICOs had reportedly raised a total of about $300 million going back to 2014. Fast forward to 2017, when according to Coindesk, the ICO market raised over $3.7 billion in 235 ICOs, including over $800 million in ICOs during the month of September 2017 alone. And there is no sign of a slowdown — one recent report claims around 68 successfully conducted ICOs raising roughly $1.3 billion in January 2018, showing only a slight decline from its all-time-high in December 2017 (74 ICOs, with $1.6 billion raised).

Thus, not surprisingly, the SEC's enforcement division has stopped issuing warnings and started issuing subpoenas — initiating a barrage of ICO-related enforcement actions (some of which are listed for reference at the end of the SEC statement). The SEC enforcement division also launched a massive crypto-sweep, issuing a reported 50 to 100 information requests and subpoenas to companies and advisers involved in the cryptocurrency market.

Now it appears the SEC staff is going one step further. Specifically, the SEC is expanding its focus to include platforms that offer trading of digital assets, many of which the SEC clearly considers in violation of U.S. securities laws. In other words, with its issuance of the statement last week, in contrast to previous activities that focused on digital coins and their developers, the SEC is now poised to take on their secondary market.

The SEC Statement

The SEC statement offers a laundry list of concerns regarding cryptocurrency exchanges but, most importantly, reflects a focused concern on how cryptocurrency exchange platforms appear to investors as SEC-registered and regulated marketplaces when they, in fact, are not, explaining:

> Many platforms refer to themselves as "exchanges," which can give the misimpression to investors that they are regulated or meet the regulatory standards of national securities exchanges ... many of these platforms give the impression that they perform exchange-like functions by offering order books with updated bid and ask pricing and data about executions on the system.

The SEC statement emphasizes that if a platform offers trading of digital assets that are securities and it operates as an "exchange" — as defined by federal securities laws — then the platform must register with the SEC or obtain a valid exemption. The SEC statement declares:

> A number of these platforms provide a mechanism for trading assets that meet the definition of a "security" under the federal securities laws. If a platform offers trading of digital assets that are securities and operates as an "exchange," as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration. The federal regulatory framework governing registered national

> securities exchanges and exempt markets is designed to protect investors and prevent against fraudulent and manipulative trading practices.

The SEC statement warned investors to remain cautious about cryptocurrency exchanges, urging the importance of careful due diligence before conducting business with any cryptocurrency exchange, going so far as to list the kinds of questions investors should consider asking. These questions range from probing the nature of trading protocols, to how prices are set, to whether the U.S. brokerage regulator, the Financial Industry Regulatory Authority, has information about entities operating the platform. The SEC also recommends that investors ask whether the tokens offered should be regulated as securities and whether the platforms prioritize certain traders over others.

Now that the SEC statement is official, the SEC enforcement division will probably begin to send subpoenas to exchanges (some of which may have already been issued). That alone could prompt some voluntary delisting of tokens that clearly run afoul of securities laws, or even the halting of trading on, or the shutting down of, certain cryptocurrency exchange platforms.

While the SEC statement does not provide a detailed legal breakdown of its approach, the legal analysis is not necessarily complex, but rather a straightforward application of the same principles the SEC has promulgated and enforced throughout its 85-year history. In essence, what the SEC is saying is that the rules have not changed, and cryptocurrency exchanges are not supposed to be conducting exchange-related activities until becoming SEC-registered.

Crypto Platforms as Unregistered Exchanges

After having previously declined to approve proposed rule changes to facilitate the listing and trading of shares of the Winklevoss Bitcoin Trust, the SEC on July 24, 2017, affirmed its role in regulating platforms like those on which blockchain-based instruments are traded. Thus, to the extent that ICO tokens traded on a digital asset trading platform are securities, the platform may be required to register as a national securities exchange under Section 3(a)(1) of the Exchange Act.

Given the nature of the platforms that trade cryptocurrency tokens and provide users with an electronic system that matches orders from multiple parties to buy and sell tokens for execution based on nondiscretionary methods, cryptocurrency platforms would appear to fall squarely within the definition of a securities exchange.

Put simply, a securities exchange is a company that creates the opportunity for potential buyers and sellers of a security to come together for trading — and per the SEC, FinCEN and the CFTC, cryptocurrency tokens are securities. Hence, the registration requirement.

This means that cryptocurrency exchanges could require registration as a national securities exchange pursuant to Sections 5 and 6 of the Exchange Act or could be required to operate pursuant to an appropriate exemption (such as an alternative trading system that complies with Regulation ATS, which requires, among other things, registration as a broker-dealer and filing of a Form ATS with the SEC).

As with traditional exchanges, cryptocurrency exchanges will have to (1) mandate that investor funds and securities be handled appropriately; (2) ensure that investors understand the risks involved in purchasing the often illiquid and speculative securities that are traded on a cryptocurrency exchange; (3) make buyers aware of the last prices on securities traded over a cryptocurrency exchange; and (4) provide adequate disclosures regarding their trading policies, practices and procedures. Overall, entities providing exchange-like services must carefully handle access to, and control of, investor funds, and provide all users with adequate protection and fortification.

It is important to note that Exchange Act registration is onerous, expensive and creates an ongoing regulatory responsibility. This requires not only large amounts of capital but also creates an entity subjected to constant SEC scrutiny, which, in turn, requires a rigorous and robust compliance program.

In other words, registration is far from easy and continuing a successful and fully compliant exchange operation is even tougher. Perhaps that is why there are so few actual SEC-registered exchanges (**here** is a list of all SEC registered exchanges).

Cryptocurrency Platforms as Unregistered Broker-Dealers

One of the more critical federal and state regulatory registration requirements that may emerge when participating in the operation of a cryptocurrency exchange is that of broker-dealer activity. If tokens are deemed securities, intermediaries such as token exchanges and promoters would likely need to comply with broker-dealer registration requirements.

Along those lines, the SEC statement last week also warned that trading platforms offering "digital wallet" and other services, which are used to safekeep, track and manage digital assets, could run afoul of laws that apply to brokerage firms and other regulated entities that must keep track of the owners of securities:

> These and other services offered by platforms may trigger other registration requirements under the federal securities laws, including broker-dealer, transfer agent, or clearing agency registration, among other things.

Specifically, Section 15(a)(1) of the Securities Exchange Act of 1934 makes it unlawful for a person to "effect a transaction in securities" or "attempt to induce the purchase or sale of, any security" unless they are registered as a broker or dealer under the rules and regulations of FINRA, the regulatory organization designated by the SEC to license and regulate broker-dealers.

The ramifications for failure to register as a broker-dealer are severe, even criminal. Section 29(b) of the Exchange Act provides that every contract made in violation of any provision of the broker-dealer registration requirements "shall be void" as to rights of persons who made or engaged in the performance of such contract. It results in the underlying purchase of securities becoming a voidable transaction that gives the investor a right of rescission, so for purchasers losing money on the investment, there is an instantaneous and simple claim to get a refund of their investment.

Moreover, Section 20(e) of the Exchange Act, under which the SEC may impose aiding-and-abetting liability on any person that knowingly or recklessly provides substantial assistance in a violation of the Exchange Act, creates additional potential liability. Finally, merely retaining and permitting an unlicensed intermediary to help facilitate or effect a securities transaction (such as a cryptocurrency exchange) may be a violation of federal and many state laws and may subject the issuer to possible civil and criminal penalties.

In accordance with these fairly stringent requirements, when a company is at all engaged in facilitating or helping conduct cryptocurrency trading, the company may be required to register as a broker-dealer with the SEC. For instance, many cryptocurrency promoters and affiliates negotiate payment of fees based on various digital wallet or other service-oriented operations, which may hinge on some iteration of transaction-based compensation. Even if the arrangement masquerades the true intent of the relationship, payment of transaction-based compensation is treated by the SEC as a nearly conclusive indication triggering broker-dealer required registration.

Thus, when an unregistered person or entity is involved as a broker, finder, etc. when operating a cryptocurrency exchange, such as by affording an investor safekeeping of their digital assets, the cryptocurrency could become immediately and irrevocably tainted. Broker-dealers are supposed to serve as a gatekeeper to protect investors in the marketplace and are required to "observe high standards of commercial honor and just and equitable principles of trade" in the conduct of its business, including determining if an investment is "suitable" for its customer and maintain meticulous records of communications, representations, transactions and other important information. Broker-dealers also are subject to SEC and FINRA examination together with a broad range of regulations and rules of conduct.

One final note: The SEC considers the principle of gatekeeper registration sacrosanct, broadly construing the broker-dealer laws while narrowly construing the few permitted exceptions.

Please stay tuned for part two of this series, which will address the Wyden response and the CDM order, and also provide some final thoughts looking ahead.

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