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Crypto Developments Are Noteworthy, But Not Alarming

By **Sarah Auchterlonie and Emily Garnett** (March 29, 2018, 1:01 PM EDT)

While a **recent article series** by John Reed Stark and David Fontaine cautions cryptocurrency exchanges to be "prepared for relentless U.S. regulatory oversight," the specter of financial regulation should not be as frightening as the articles suggest. Stark and Fontaine astutely highlight recent developments involving the Financial Crimes Enforcement Network, the U.S. Commodity Futures Trading Commission, and the U.S. Securities and Exchange Commission. They predict the "perfect storm" of "regulatory headwinds" on the horizon for cryptocurrency. We proffer, instead, that U.S.-based cryptocurrency offerors and exchanges are at no greater risk today than they have been in the last few years. Indeed, in some respects, the risk of increased federal regulation is reducing, specifically:

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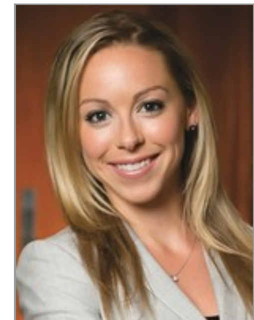
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- Cryptocurrency exchanges' principal regulatory concerns remain state licensing requirements, where state-by-state analyses determine whether a firm's conduct requires a state money transmitter license. FinCEN registration is vital, yet simple. The challenge for cryptocurrencies is the same as for other financial firms: implementing meaningful protections against fraud and misuse of their systems and information.

- Second, the recent CFTC enforcement action, CFTC v. Coin Drop Markets, provides welcome clarity to virtual currency exchanges. The Coin Drop Markets court explains that CFTC oversight is limited to futures and derivatives and cases of misrepresentation or fraud. "Spot" trades that are nearly instantaneous typically avoid direct CFTC oversight.

- Third, the operative test for being a security remains the four-factor Howey test, enunciated back in 1946. Despite exuberant SEC enforcement activities, like recently issuing a wave of subpoenas, cryptocurrency sellers can control their risk by carefully structuring their product and practicing good marketing hygiene to avoid being perceived as an investment.

Below we cover developments at the three federal agencies on the cryptocurrency beat: FinCEN, CFTC and SEC, and why their activities are noteworthy, but not alarming.

State money transmitter licensing regimes continue to overshadow FinCEN's enforcement authority.

A recent letter exchange between FinCEN and a U.S. senator about FinCEN's authority over

cryptocurrency is a rehash of old news rather than a harbinger of things to come. On March 6, 2018, FinCEN published a letter addressed to Sen. Ron Wyden, D-Ore., asserting that cryptocurrency exchanges are typically money transmitters and must register with FinCEN and comply with the Bank Secrecy Act's know-your-customer and anti-money laundering

requirements.[1] FinCEN is a division of the U.S. Treasury Department that oversees laws designed to combat money laundering and terrorist financing, which includes oversight over all "money services businesses." Stark and Fontaine characterize the letter as an indication that cryptocurrencies are "squarely in the sights of federal regulators."[2] Although FinCEN has exercised enforcement authority over cryptocurrency businesses for failing to register, we do not believe the letter indicates a sea change in FinCEN's approach.

FinCEN has said since 2013 that it has jurisdiction over cryptocurrency businesses as money transmitters.[3] FinCEN's 2013 position was followed with enforcement actions brought concurrently with the U.S. Department of Justice against cryptocurrency businesses for failing to register with FinCEN and the applicable state money transmitter regulatory regimes.[4] FinCEN's March 6 letter was not meant as a pronouncement of enforcement fervor. Rather, it was a response from a Democratic senator who sits on the Intelligence Committee — not Banking or any other committee that has direct oversight over cryptocurrencies. Although Wyden's original letter has not been made public, one would imagine his focus was on AML practices related to terrorism financing, not on the more mundane registration requirements for legitimate, domestic cryptocurrency businesses. FinCEN was merely reporting that when it comes to virtual currency, it is doing its BSA/AML job.

Fear of FinCEN is misplaced. The FinCEN registration process can be completed in about an hour. The major obstacle for cryptocurrency exchanges is the state money transmitter licensing process and, of course, actually implementing a BSA/AML compliance program. State licensing regimes generally seek to prevent underfunded criminals from handling other peoples' money. In addition to submitting detailed information regarding the company's business plans, financial statements, and compliance and cybersecurity requirements, most states require the entity to be bonded, sometimes in an amount exceeding a million dollars, to insure customers' funds from potential losses. Likewise, executives must submit to a comprehensive background check and sign up for regular auditing from the licensing entity.

Although clunky to navigate, the multistate licensing regime continues to serve a key oversight function for the budding cryptocurrency industry. On behalf of our cryptocurrency clients, we have discussed money transmitter licensing requirements with nearly every state regulatory authority. They vary widely. New York has its BitLicensing license, which by one account costs $100,000 alone.[5] In addition to New York, states such as California and Washington are creating bit-specific licensing regimes. Other states like Delaware and Wyoming are carving out exemptions for cryptocurrency businesses. The old adage that states are the "laboratories of democracy"[6] plays true: state regulators are largely informed, responsive and, along with state legislatures, sensitive to striking the appropriate balance between regulation and supporting an emerging industry. Our sense from the states is that while the licensing process is onerous, there is not an unusual fervor for enforcement directed toward virtual currencies.

The CFTC's oversight remains restricted to futures and cases of misrepresentation and fraud.

With regard to commodities regulation, instead of being evidence of a "crypto crackdown,"[7] a March 6 court order out of the Eastern District of New York signals that the judiciary will appropriately restrain federal enforcement exuberance about cryptocurrencies. In CFTC v. Patrick K. McDonnell, and CabbageTech Corp. d/b/a Coin Drop Markets,[8] the court found that since the CFTC alleged the defendants defrauded their customers and failed to implement BSA/AML procedures, the CFTC had enforcement authority under the Currency Exchange Act and BSA. As noted above, crypto firms can't skimp on BSA/AML compliance. But buried in the order is a statement that the CFTC's jurisdiction is limited to products over which the CFTC has direct enforcement (e.g., futures, options, derivatives) and misrepresentation and fraud about commodities. Implied is the finding that the CFTC does not have authority over "spot" or daily crypto transactions in the absence of fraud or misrepresentation. This is reinforced by the CFTC's own guidance:

> The CFTC's jurisdiction is implicated when a virtual currency is used in a derivative contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce. Beyond instances of fraud or manipulation, the CFTC generally does not oversee 'spot' or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing.[9]

One of the virtues of virtual currency is that transactions are fast, and almost always meet the two-days-to-trade requirement. So long as cryptocurrency businesses avoid misrepresentation or fraud — a decidedly low bar for most of the major players in the industry — and do not otherwise market, exchange or administer other CFTC-regulated products (futures, options, derivatives), then the CFTC does not have direct enforcement authority over the business.

Although the SEC continues to be the dominant player in federal oversight over cryptocurrency exchanges, its enforcement priorities are constrained by limited resources and ex-post, rather than ex-ante, supervisory authority.

Of the three federal agencies claiming their space in crypto, the SEC is potentially the most irksome in that dire consequences attach to a judge-made balancing test that lacks clear lines. The remedy for an unregistered securities offering is unwinding the transaction. But the statement from SEC leadership that "every ICO I've ever seen is a security"[10] is bold given the paucity of case law about cryptocurrencies, the great variety in cryptocurrency products, and that the SEC remains confined in its analyses to the nearly 70-year-old Howey test, from SEC v. W. J. Howey Co., 328 U.S. 293 (1946). Stark and Fontaine cite a recent wave of administrative subpoenas to firms that issued ICOs as more evidence that the SEC seeks to expand its authority.

For some time, the SEC has focused on cryptocurrencies as a potential area of enforcement. In 2013 and 2014, the SEC released separate "investor alerts" cautioning investors to exercise discretion when investing in cryptocurrencies.[11] Within such alerts, the SEC asserted its jurisdiction over cryptocurrencies that operate as securities.

The SEC's jurisdiction is murky, however, when companies offer for sale digital coins or tokens to buy particular products or access to a digital venue. In one sense, a digital token can be viewed like a store gift card — buyers trade money for a digital record of currency that is used to buy the offeror's products. At an even simpler level, a digital token can be viewed like a concert ticket, which promises access to a venue. While ticket-scalping laws may apply, facilitating the exchange of gift cards or concert tickets is not under SEC jurisdiction.

SEC concerns arise when the digital tokens become more (or less) valuable than their initial purchase price because buyers treat them like investments rather than a gift card or admission ticket. In July 2017, the SEC took the position in the "DAO Report" that DAO, a decentralized autonomous organization marketing cryptocurrencies, sold tokens that were securities.[12] In the report, the SEC made clear that the "hallmark of a security is an investment of money or value in a business or operation where the investor has a reasonable expectation of profits based on the efforts of others" and any cryptocurrency that marketed itself as an investment was likely a security. In support, the SEC cited the nearly 70-year-old Howey test. Soon after, in September 2017, the SEC established a new cyber unit, focused on misconduct involving distributed ledger technology and the unfortunately named practice of initial coin offerings.[13]

Since then, the SEC has continually reinforced its position that a token marketed for investment purposes is likely a security and should be licensed with the SEC. Likewise, an entity that trades tokens that are securities will meet the definition of exchange and must comply with applicable federal and state licensing regimes. In its latest iteration of this position, the SEC released on March 7, 2016, a "statement on potentially unlawful online platforms for trading digital assets" (March 7, 2018). Stark and Fontaine cite the SEC's latest statement as an indication that the SEC is "expanding its focus to include platforms that offer trading of digital assets."[14]

We disagree. In the statement, the SEC is reinforcing, rather than "expanding," its focus on cryptocurrency platforms and exchanges. Indeed, dating back to the earliest pronouncements and subsequent enforcement actions, the SEC has cited cryptocurrency businesses for failing to register as an exchange and failing to license their tokens as securities. See, e.g., "DAO Report," which states, "any entity or person engaging in the activities of an exchange must register as a national securities exchange or operation pursuant to an exemption from such registration";[15] see also Chairman Jay Clayton's testimony, where he asserts, "Merely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security.")[16]

Nevertheless, the SEC's long-standing view that most tokens are securities faces a practical

Nevertheless, the SEC's long-standing view that most tokens are securities faces a practical challenge: all tokens are not securities. Some tokens truly act as purchase cards or concert tickets. The offerors provide products — or access to a venue — which have value because the product is desirable.

The recent wave of SEC subpoenas doesn't establish SEC authority over all cryptocurrency. An administrative agency's subpoena power extends to "mere suspicion" of a violation within the agency's statutory authority, and most courts will uphold an agency's limited investigation to determine whether conduct is, indeed, covered by an agency's implementing statute. Industry participants should not presume that all issued subpoenas will lead to enforcement actions.

The SEC is unlikely to bring a test case against a utility token that has a strong argument it is not a security at the risk of establishing bad law. More likely, the SEC will continue to prioritize enforcement actions against: (1) cryptocurrencies that provide a clear example of security-like characteristics, e.g., those that market themselves as investments to third parties; and (2) clear cases of fraud, misrepresentation, market abuse and other aggravating factors that play nicely into establishing jurisdictional enforcement authority.

Finally, without additional funding for the SEC budget (a potential development[17]) and clarified SEC authority over all tokens, the SEC will likely continue to focus on enforcement actions against more nefarious cryptocurrency businesses.

Conclusion

None of our analysis should be construed to give free reign to current and new crypto players to operate without complying with applicable state and federal regulatory requirements. Indeed, as we discuss above, the industry faces significant requirements on both the state and federal levels, including money transmitter requirements, federal AML, KYC and cybersecurity considerations, and an appropriate analysis of whether the token, ICO or exchange should be registered with federal and state authorities. A risk-focused regulatory compliance plan with strong controls to prevent activities from eking into an unpermitted area should continue to be firms' paramount concern. But fundamentally, while technology evolves quickly, laws generally don't. And for those in the cryptocurrency frontier, that's a good thing.

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[1] CoinDesk, "FinCEN Raises Major Licensing Problems for ICOs In New Letter To Congress," (March 6, 2018) (last viewed March 18, 2018).

[2] John Reed Stark and David Fontaine, "3 Critical Events for Cryptocurrency Exchanges: Parts 1 and 2" Law360, (March 12-13, 2018).

[3] See "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," (March 18, 2013). Specifically, FinCEN took the position that the Bank Secrecy Act applies to administrators or exchangers of virtual currency and must in turn register as a money service business, or MSB) (last viewed 3/16/2018).

[4] See, e.g., United States v. Murgio et al., Case 15-cr-00769 (S.D.N.Y. 2016); United States v. Lord and Lord, Case No. 15-cr-00240 (W. LA. 4/20/2017).

[5] Yessi Bello Perez, "The Real Cost of Applying for a New York BitLicense," CoinDesk (Oct. 23, 2015) (last viewed 3/16/2018).

[6] U.S. Supreme Court Justice Louis Brandeis, New State Ice Co. v. Liebmann, 285 U.S. 262 (1932))(A "state may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country.")

[7] John Reed Stark and David Fontaine, "3 Critical Events for Cryptocurrency Exchanges: Part 2" Law360, (March 13, 2018).

[8] 18cv361 (E.D.N.Y. March 6, 2018), at *22.

[9] LabCFTC, "A CFTC Primer on Virtual Currencies," (10/17/2017) (last viewed 3/16/2018); See also 7 U.S.C. §2(c)(2)(C)(i)(II)(bb)(AA) providing that the CFTC shall not have jurisdiction over a contract of sale that results in actual delivery within two days.

[10] Clayton, J., Testimony, Sen. Banking, Housing and Urban Affairs Committee (Feb. 6, 2018).

[11] Investor Alert: Ponzi Schemes Using Virtual Currencies (7/23/2013), (last viewed 3/16/2018) and Investor Alert: Bitcoin and Other Virtual Currency-Related Investments (5/7/ 2014) (last viewed 3/16/2018)

[12] Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO (7/25/2017) (last viewed 3/16/2018).

[13] See SEC Chairman Jay Clayton, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, (2/6/2018).

[14] John Reed Stark and David Fontaine, "3 Critical Events for Cryptocurrency Exchanges: Part 1" Law360, (March 12, 2018).

[15] SEC "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017) (hereinafter "DAO Report.") at 2.

[16] SEC Chairman Jay Clayton, "Statement on Cryptocurrencies and Initial Coin Offerings," (12/11/2017) (last viewed 3/19/2018).

[17] "SEC Chairman Plans To Ask For Budget Increase in 2019 Following Security Breach," TheStreet (9/26/2017) (last viewed 3/18/2018).

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