



# Regulatory Alert

## Financial Services Regulatory Insight Center



February 2018

## Regulating Virtual Currencies

### Key points

- Recent price swings in digital currencies as well as expanding numbers of initial coin offerings (ICOs) have attracted both increased investor interest and heightened concern from regulators.
- The CFTC and SEC have taken the lead at the federal level issuing guidance, orders, and findings to address the growing volume of trade in digital currency derivatives and the risk of fraud from related investment products.
- The U.S. Treasury Department has indicated concerns over virtual currencies being used for money laundering activities, and several states have regulated virtual currency through their money transmission laws.
- Governments around the world have taken different approaches to digital currencies, and international cooperation will likely become a key issue.

### Summary

U.S. Treasury Secretary Mnuchin has expressed concerns about the use of cryptocurrencies for illicit activity and is urging the G20 nations to join the U.S. in regulating this market, according to news reports.<sup>1</sup> His remarks follow a recently issued [joint statement](#) by the Directors of Enforcement at the CFTC and SEC emphasizing their intent to combat fraud carried out "under the guise of offering digital instruments" by examining not merely the form of a transaction but the substance of the underlying activity to identify

violations of U.S. securities and commodities laws. Over the past year, price swings in digital currencies have attracted both increased investor interest and heightened regulatory concern, bringing to light issues around trading and market abuse, fraud and consumer/investor protection, and the use of virtual currency in money laundering.

This Regulatory Alert highlights some of the recent developments in the regulatory oversight of digital currencies.

<sup>1</sup> Saleha Mohsin, Mnuchin Warns Against Bitcoin Becoming the Next 'Swiss Bank Account', Bloomberg, January 12, 2018.



## Markets and investor protection

The CFTC and SEC have taken the lead to regulate digital currencies at the federal level with notable steps toward regulating the trading of digital currency derivatives and educating and protecting investors. Importantly, these agencies can only regulate digital currencies indirectly and do not regulate the operations of the exchanges or the trading of the actual currencies.

### CFTC

The CFTC has extended supervisory authority over the trading of digital currency derivatives and has supported self-certification of new digital currency derivatives contracts. In particular, it has:

- Defined virtual currencies as “commodities”: In 2015, the CFTC issued an Order that found “virtual currencies” to be commodities under the Commodity Exchange Act (CEA),<sup>2</sup> which subjects the trading of related derivatives to CFTC jurisdiction and requires a trading platform to register as a Swap Execution Facility or Designated Contract Market.
- Defined “actual delivery” for virtual currency: The CFTC found in 2016 that a virtual currency transaction did not qualify for the CFTC’s 28-day “actual delivery” exception, thereby subjecting the transaction to the agency’s direct oversight authority over “retail commodity transactions” as if it were a commodity future.<sup>3</sup> More recently, the CFTC published a [proposed interpretation](#) of its authority over retail commodity transactions involving virtual currency.
- Permitted self-certification of new contracts: In December 2017, the CFTC allowed two exchanges to [self-certify](#) new contracts for Bitcoin futures products, and a third exchange self-certified a new contract for bitcoin binary options. The CFTC also approved LedgerX as the first federally regulated virtual currency derivatives exchange and clearinghouse.

### SEC

The SEC’s actions related to virtual currencies have focused on anti-fraud and securities registration issues. More recently, it has taken

specific steps in the regulation of ICOs. The SEC has:

- Taken fraud enforcement actions: In 2013, the SEC charged a company with defrauding investors in a Ponzi scheme involving virtual currencies.<sup>4</sup> The agency also issued an investor alert in July 2013 on [Ponzi schemes Using virtual Currencies](#). In 2015, the SEC charged two Bitcoin mining companies with conducting a Ponzi scheme to defraud investors.<sup>5</sup>
- Found ICOs to be securities: On July 25, 2017, the SEC issued a [report](#) on ICOs and “token sales” used to raise capital for investments in projects and stated the conditions for when tokens offered in these ICOs were securities and therefore subject to the federal securities laws. The SEC noted that not all tokens are securities and applied its three-part *Howey* test to define an investment contract. The SEC’s Office of Investor Education and Advocacy issued an [Investor Bulletin](#) and an [Investor Alert](#) to make investors aware of potential risks related to participating in ICOs.
- Initiated enforcement actions involving ICOs: The SEC has recently taken several enforcement actions involving fraudulent ICOs.<sup>6</sup> The SEC issued statements warning investors about [unlawful ICO promotion](#), and SEC Chairman Jay Clayton issued a [Statement on Cryptocurrencies and Initial Coin Offerings](#). In December 2017, a company halted an ICO after failing to register with the SEC, as the tokens offered during the ICOs were securities under the *Howey* test.<sup>7</sup>
- Limited exchange-traded funds: The SEC stated in a [staff letter](#) that it opposes registering cryptocurrency ETFs until regulators and industry participants address how the ETFs address the investor protection in the Investment Company Act of 1940. The SEC’s questions concern valuation, liquidity,

<sup>2</sup> In re Coinflip, Inc., d/b/a Derivabit et al., CFTC Docket No. 15-29.

<sup>3</sup> In re BFXNA INC. d/b/a BITFINEX, CFTC Docket No. 16–19 (June 2, 2016) (consent order).

<sup>4</sup> SEC v. Shavers and Bitcoin Savings and Trust, Case No. 4:13-CV-416 (E.D.Tex.) (Aug. 6, 2013); SEC v. Trendon T.

Shavers and Bitcoin Savings and Trust, Civil Action No. Civil Action No. 4:13-CV-416.

<sup>5</sup> SEC v. Homero Garza, Gaw Miners, December 1, 2015.

<sup>6</sup> SEC v. Recoin Group Foundation, LLC, September 2017.; SEC v. PlexCorps, December 4, 2017.

<sup>7</sup> In re Munchee, SEC File No. 3-18304, December 11, 2017.

custody, arbitrage, and potential market manipulation.

### Financial crimes

As noted by Secretary Mnuchin, the U.S. Treasury Department continues to be concerned about virtual currencies being used in money laundering activities.

- **FinCEN:** In March 2013, FinCEN issued [guidance](#) that stated that a virtual currency administrator or exchanger is a money transmitter and subject to money services business (MSB) registration, reporting, and recordkeeping regulations.
- **FSOC:** Secretary Mnuchin reported in January 2018 that the FSOC had created a working group to examine the potential use of virtual currencies in money laundering.

### Other jurisdictions

There is a great deal of uncertainty in the regulatory landscape for digital currencies and presently the market is largely unregulated. However, multiple jurisdictions and regulatory authorities are beginning to seek more defined regulatory parameters. The steps they are taking are varied and, in addition to those noted above, include the following:

- Several states have regulated virtual currency through their money transmission laws, with

New York having implemented specific licensing requirements for virtual currency businesses.

- France and Germany will reportedly make joint proposals to regulate Bitcoin at the March 2018 G20 summit, and an IMF spokesperson has emphasized the need for global coordination of Bitcoin regulation.<sup>8</sup> Secretary Mnuchin has indicated support for these efforts.
- Some countries, such as South Korea and China, have taken actions to limit access to cryptocurrencies, including placing bans on anonymous bank accounts for cryptocurrency trading, limiting access to trading through cryptocurrency accounts, and banning ICOs.

Federal agencies are limited in their authority to regulate a variety of digital assets that can also be characterized as mediums of exchange or registered as payment services outside of CFTC and SEC regulation. If investor interest in digital currencies outlasts the recent volatility and continues to grow, these regulatory issues will likely lead to calls for a specific digital currency regulatory framework. Additionally, given the ease in which digital assets can move globally, international cooperation will likely become a key issue.

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<sup>8</sup> France, Germany to make joint bitcoin regulation proposal at G20 summit, Reuters, January 18, 2018; IMF Calls for Global Talks on Cryptocurrencies, Bloomberg, January 18, 2018;

Mnuchin Warns Against Bitcoin Becoming the Next 'Swiss Bank Account', Bloomberg, January 12, 2018.