

CRYPTOCURRENCIES AND TOKENS: WHAT ARE THEY AND WHO REGULATES THEM?

*“Now this is not the end. It is not even the beginning of the end.
But it is, perhaps, the end of the beginning...”
Great Britain Prime Minister, Sir Winston Churchill, 1942*

Celiza P. Bragança, Esq.,¹ and Louis L. Straney²

Consider the following characteristics of an investment:

- a start-up, less than a decade in existence, with no operating history;
- subject to limited government oversight and regulation;
- documented incidents of outright theft of assets and system hacking;
- often associated with terrorism financing, money laundering and drug-related enterprises;³
- trading on unregulated and generally unaudited global exchanges;⁴

1. Celiza Bragança represents participants in the cryptocurrency/token space as well as investors in recovering losses. Lisa has been a Branch Chief for the U.S. Securities & Exchange Commission Division of Enforcement, a BigLaw litigator, and legal director of a disability rights organization. She has an M.B.A. and J.D. from The University of Chicago.

2. Louis Straney is a financial market historian, securities litigation consultant and expert witness. After his twenty-four year career as a Wall Street supervisor, he has authored several articles and books on financial crimes and is a frequent instructor for Canadian and U. S. market regulators, law enforcement and bar associations.

3. It was reported by CNN Tech/money.com quoting Lee Dongeun, in an article related to the South Korean Internet and Security Agency, “[w]e don’t know how much (Bitcoin) has stolen so far, but we do know that the police have confirmed the regime’s hacking attempts.” Sherisse Pham, *North Korea May be Making a Fortune From Bitcoin Mania*, CNN (Dec. 13, 2017), <http://money.cnn.com/2017/12/12/technology/north-korea-bitcoin-hoard/index.html>. On December 26, 2017, Pavel Lerner, the chief executive of a UK-based Bitcoin Exchange, EXMO, was kidnapped in the Ukraine. See Oscar Williams-Grut, *The CEO of a UK-registered bitcoin exchange has been kidnapped in Ukraine*, BUSINESS INSIDER (Dec. 29, 2017), <http://www.businessinsider.com/exmo-bitcoin-ceo-pavel-lerner-kidnapped-in-ukraine-2017-12>.

4. The Chicago Board Options Exchange (CBOE) initiated futures on bitcoin on 12/10/2017, which was followed by regulated trading on the CME and NASDAQ

- often promoted through unproven and exaggerated representations;
- not widely recognized as legal tender; and
- controlled by a small number of investors.⁵

The investment is bitcoin, one of the best performing investments of 2017.⁶ Bitcoin is the most used and well-known of the more than 1,300 virtual coins or tokens circulating today. Some refer to all of these virtual coins as cryptocurrencies.

Cryptocurrencies⁷ like bitcoin are front page news. Tokens like bitcoin are just some computer code created and maintained on a blockchain. For our purposes, a cryptocurrency is a particular kind of coin or token that some people use in lieu of government-issued currency. As of March 2018, there are disputes over whether most virtual coins or tokens are cryptocurrencies, commodities, or securities. The determination of whether a virtual coin is a security, commodity, or currency is critical to determining the applicable regulatory scheme.

exchanges. See Jesse Damiani, *CBOE Launches Bitcoin Futures Trading Dec. 10*, FORBES (Dec. 4, 2017), <https://www.forbes.com/sites/jessedamiani/2017/12/04/cboe-launches-bitcoin-futures-trading-dec-10/#14c87ee34d28>.

5. The Atlantic magazine reports that approximately 1,000 people or groups own 40% of all bitcoins in circulation. Derek Thompson, *Is Bitcoin the Most Obvious Bubble Ever?*, THE ATLANTIC (Dec. 9, 2017) <https://www.theatlantic.com/business/archive/2017/12/bitcoin-bubble/547952/>. A recent study by Cambridge University concluded that there were between 2.9 and 5.8 million cryptocurrency participants who own cryptocurrency “wallets.” GARRICK HILEMAN & MICHEL RAUCHS, GLOBAL CRYPTOCURRENCY BENCHMARKING STUDY 27 (2017), available at https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2017-global-cryptocurrency-benchmarking-study.pdf. A wallet, however, does not necessarily indicate asset ownership.

6. Assuming an efficient market and liquidity, bitcoin advanced 1,300% during 2017. See Charles Bovaird, *What Does Bitcoin’s Meteoric Rise Mean for Investors?*, FORBES (Dec. 7, 2017), <https://www.forbes.com/sites/cbovaird/2017/12/07/what-does-bitcoins-meteoric-rise-mean-for-investors/#6fa2ee143dd4>.

7. While bitcoin (BTC) is the most recognized example of a cryptocurrency, at the time of this article, there are more than 1,300 “coins” or “tokens” trading on various exchanges. Ethereum and Litecoin are also popular cryptocurrencies.

During 2017, the price of bitcoin defied gravity, rising from just under \$1,000 to over \$20,000.⁸ As of March 2018, bitcoin is trading below \$10,000. To some, this phenomenon is a reprise of the Beanie Baby craze of the 1990's.⁹ But to others, cryptocurrencies are simply the next generation of payment systems that started with PayPal, Apple Pay, and the electronic payment of your *grande Americano* through a Starbucks app. Without question, much of the bitcoin interest is driven by the long-recognized motivator -- the fear of missing out ("FOMO").

The sage of the futures markets, Chairman Emeritus of the CME Group Leo Melamed, has referred to cryptocurrencies as "an asset class" that can be controlled,¹⁰ while Jamie Dimon, JPMorgan Chase CEO, opined that bitcoin is a "fraud...stupid...and worse than tulip bulbs...it will blow up".¹¹ In the view of the authors, both Melamed and Dimon are correct. Virtual coins could revolutionize the way some financial services are delivered. At the same time, there will be many who use virtual coins to engage in fraud.

What is Bitcoin?

Bitcoin, the first virtual coin, was created in 2009 as open-source software by a person or group using the alias Satoshi Nakamoto.¹² The White Paper

8. Stan Higgins, *From \$900 to \$20,000: bitcoin's Historic 2017 Price Run Revisited*, COINDESK (Dec 29, 2017), <https://www.coindesk.com/900-20000-bitcoins-historic-2017-price-run-revisited>.

9. One optimistic seller currently has the Purple Princess Bear Beanie Baby listed on eBay for a solid \$350,000. *See Princess Bear/ Princess the Bear, a purple bear with a white rose on it chest*, EBAY, <https://www.ebay.com/itm/Princess-Bear-Princess-the-Bear-a-purple-bear-with-a-white-rose-on-it-chest/201958859916?hash=item2f05afa48c:g:s8sAAOSwMvtZRxko> (last visited May 25, 2018).

10. Reuters, Tomo Uetake & Hideyuki Sano, *CME's Melamed sees bitcoin becoming new asset class*, REUTERS (Nov. 7, 2017) <https://www.reuters.com/article/us-cme-group-bitcoin/cmcs-melamed-sees-bitcoin-becoming-new-asset-class-idUSKBN1D712M>.

11. Thomas Heath, *Is bitcoin another tulip craze or a legitimate investment?*, WASHINGTON POST (Sept. 14, 2017), https://www.washingtonpost.com/news/get-there/wp/2017/09/14/is-bitcoin-another-tulip-craze-or-a-legitimate-investment/?noredirect=on&utm_term=.25bddae81837.

12. Sophie Bearman, *Bitcoin's creator may be worth \$6 billion — but people still don't know who it is*, CNBC (Oct. 27, 2017). Bitcoin was created with a possible issuance of 21 million coins. Currently, approximately 17 million coins have been

credited to Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, proposed a system that would skirt traditional regulatory and business channels and permits, allowing “two willing parties to transact directly with each other without the need for a trusted third party.”¹³ According to the White Paper, the initial objective of this cryptocurrency was to develop a peer-to-peer system that avoids the oversight of and transactional expenses imposed by non-stakeholder third parties.

To add to the mystery of bitcoin’s family tree, there is a body of unverified speculation that Jed McCaleb, who founded the now defunct cryptocurrency exchange, Mt. Gox, is Nakamoto. Mt. Gox was a major cryptocurrency/token broker until it shut down after being hacked multiple times.¹⁴ With Nakamoto, McCaleb, and others, the key modifier is “unverified.” On the world wide web, an alias or opaque user name is common.

Cryptocurrencies/tokens are based on blockchain technology. Unlike currency issued and backed by a sovereign nation (called “fiat” currency), the bitcoin you “hold” in your “wallet” (account) is just an entry on an electronic ledger (blockchain) that looks like this:

000000000000000000000000052138b6fe93e686b520bd1e99329890f6ec8cccf93da

While many representations of bitcoin depict a physical coin, that is misleading. Cryptocurrencies exist only in the electronic world – on distributed electronic ledgers.

Unlike a bank account that maintains *the* definitive record of your account, your bitcoin exists in thousands of separate identical ledgers around the world. The transaction entry listed above might reflect the transfer of one bitcoin from Lou to Mary. If you examined the transaction online – as anyone who knows the transaction number can do – you would see a number identifying Lou’s wallet as the transferor, a number identifying Mary’s wallet as the transferee,

issued with an estimate that issuance will cease in 2140. However, the coins can be subdivided, much like stock splits, making the potential ultimate float well above 21 million coins.

13. SATOSHI NAKAMOTO, *BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM* (2008).

14. Andy Greenberg, *Bitcoin's Price Plummets As Mt. Gox Goes Dark, With Massive Hack Rumored*, FORBES (Feb. 25 2014), [HTTPS://WWW.FORBES.COM/SITES/ANDY-GREENBERG/2014/02/25/BITCOINS-PRICE-PLUMMETS-AS-MT-GOX-GOES-DARK-WITH-MASSIVE-HACK-RUMORED/#72C56DEECE1F](https://www.forbes.com/sites/andy-greenberg/2014/02/25/bitcoins-price-plummets-as-mt-gox-goes-dark-with-massive-hack-rumored/#72c56deec1f).

and the amount of bitcoin that was transferred. This exact same information would be recorded on a blockchain maintained on all ledgers.

There is a significant incentive for folks to maintain the distributed electronic ledgers – awards of bitcoin! If you are the first person to solve a complex problem, you are not only entitled to append the current bitcoin transaction to the blockchain, but you receive an award of bitcoin. To “earn” bitcoin, people get faster and faster computers that race to solve the problem first. Each time another bitcoin transaction needs to be recorded, the computers again race to solve the problem.

The people who maintain blockchain ledgers and earn bitcoin are called “miners.” Bitcoin mining has evolved from being something done by college kids in dorms to a process that requires highly specialized computer hardware, dedicated block-chain software¹⁵, and a huge amount of electrical power.¹⁶

The value of bitcoin in circulation is more than \$200 billion. As a currency, the value of bitcoin is currently exceeded only by the sovereign currencies of the United States, the European Union, and Japan.¹⁷ Bitcoin and other cryptocurrencies are gaining wider acceptance. The State of Nebraska, for example, recently announced that it would permit attorneys to accept payment from clients in bitcoin, as long as the bitcoin is immediately converted to U.S. currency.¹⁸ If cryptocurrency maps are accurate, many of the bitcoin ATMs are concentrated in the U.S. Northeast and metro Chicago.¹⁹ Initially, the ATMs were deposit only, but purchase, sale and exchange machines were

15. Blockchain, in this context, refers to open source ledgers that store transactional data.

16. Servers dedicated to currency mining run 24/7, require a controlled environment and reportedly create a high level of ambient noise. Due to the low cost of electric power, Iceland is a favored base for servers associated with cryptocurrency mining. See Alex Hern, *How Iceland became the bitcoin miners' paradise*, THE GUARDIAN (Feb. 13, 2018), <https://www.theguardian.com/world/2018/feb/13/how-iceland-became-the-bitcoin-miners-paradise>.

17. STATISTICS ON PAYMENT, CLEARING AND SETTLEMENT SYSTEMS IN THE CPMI COUNTRIES, BANK FOR INTERNATIONAL SETTLEMENTS, (Dec. 2016). When a currency lacks the direct backing of a commodity (such as the pre-1971 Gold Standard in the U. S.), and is only supported by a legal decree, it is referred to as “fiat currency.”

18. Joan C. Rogers, *Lawyers Can Accept Bitcoin—But Must Exchange ASAP, Nebraska Says*, BLOOMBERG (Sept. 12, 2017) (citing Nebraska Supreme Court Ethics Committee, Op. 17-03, (Sept. 11, 2017)).

19. See *Bitcoin ATM map*, <https://coinatmradar.com/> (last visited May 25, 2018).

quickly introduced. An actual tally of cryptocurrency machines is a moving target. For example, in Albuquerque, New Mexico, a bitcoin ATM was deactivated within weeks of being installed.

Does this mean that bitcoin can supplant the traditional role of a sovereign-backed currency or money? Money is something that (1) serves as a medium of exchange -- people tend to agree to accept it in exchange for goods and services; (2) serves as a measure of value -- it is a common language used to communicate in the marketplace; and (3) serves as a store of value -- you can put it under your pillow and use it two weeks from now. There is no requirement that money be issued by a government. On the Pacific island of Yap, stones weighing tons are used as money. Until recently, cigarettes were used as money by prisoners who are not permitted to have legal tender. Because of rampant hyperinflation, Venezuelans have recently been using eggs as money.²⁰ While cryptocurrencies are easier to use as money than eggs, cattle, and giant stones, they create a fertile ground for fraud. Advertisements similar to the following are quite common:

The Cryptocurrency Boom is a One-in-a-lifetime Opportunity

Search through your coat pockets...behind the
sofa cushions...the glove compartment of your car
Because all it takes is some spare change to capitalize
on the stock opportunity of a lifetime: cryptocurrencies.
If you make the right moves, you could find yourself
jumping for joy on top of an enormous pile of cash.
Ready or not, a growing number of economies, banks, and
billionaires are backing these new forms of tender.
And once you understand how easy it is to profit
from cryptocurrencies, it's easy to see why...
The cryptocurrency market is preparing to take off.
And the only time to buy is now.
Just one tiny investment – even one under \$100 – could soon put
you in a new class of “cryptocurrency millionaires.”

20. See Jacob Goldstein & David Kestenbaum, *The Island of Stone Money*, NPR (Dec. 10, 2010), <https://www.npr.org/sections/money/2011/02/15/131934618/the-island-of-stone-money>.

So sign up for your report below and see whether jumping on this moon-bound rockets is right for you.²¹

Who Regulates These Things?

Thus far, there has been a great deal of confusion about what law is applicable to cryptocurrencies/tokens. The Commodity Futures Trading Commission (CFTC) considers cryptocurrencies like bitcoin to be commodities. SEC Chairman Jay Clayton opined that all the initial coin offerings (ICOs) that he has seen are securities. Yet it is not clear whether many offerings of tokens are cryptocurrencies, commodities (like gold), or securities, or perhaps something else altogether. The lack of detail regarding ICOs does not seem to matter to purchasers who appear to have a voracious appetite for them. Many people jump at the chance to invest in a new token (ICO) based upon little more than a White Paper describing an idea.

The United States Treasury Department is leading a consortium of federal and state agencies to coordinate their approach to cryptocurrencies/tokens.²² Investors should not expect much clarity in the near term. The legacy regulatory system for securities, currency, and commodities is not a good fit for regulating cryptocurrencies/tokens. The federal securities laws are based on statutes from 1933, 1934 and 1940 that did not contemplate the possibility of a widely-accepted currency that was not backed by a sovereign.

Regulation of cryptocurrencies/tokens is primarily taking place through enforcement actions. In early 2018, the SEC launched a wide-ranging investigation into the issuance of cryptocurrencies/tokens. There are reports of as many as 80 SEC subpoenas having been served on entities involved in token offerings. Recipients of those subpoenas include some of the biggest players in the space like tZERO (Overstock.com's token) and Michael Arrington's \$100 million cryptocurrency hedge fund, TechCrunch.²³

21. *The Cryptocurrency Boom is a Once-in-a-lifetime Opportunity*, MONEY MORNING, <https://moneymorning.com/acq/aol/the-cryptocurrency-boom-is-a-once-in-a-lifetime-opportunity/> (last visited May 29, 2018).

22. OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS, CFTC BACKGROUNDER (2018), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

23. Molly Zuckerman, *US: TechCrunch Founder's Crypto Fund Becomes Yet Another Target Of SEC Crypto Probe*, COINTELEGRAPH (Mar. 3, 2018),

A. Regulation of Tokens as Currency

To the extent that a token is solely a cryptocurrency, a purchaser has no more legal protection than a person who purchases Euros or pesos. It is up to the purchaser to determine whether holding (or “investing in”) a cryptocurrency like bitcoin is a good idea or not.

Investments in cryptocurrencies are significantly less regulated than investments in stocks and bonds. When an investment advisor or broker opens a new customer account, it is required to obtain information about the customer, including the customer’s investment objectives and her risk tolerance. When a money transmitter serves a customer it is required to collect far less information about the customer and, notably, is not required to collect any information about the customer’s investment objectives and risk tolerance.

A money transmitter selling a cryptocurrency is required to comply with federal and state laws applicable to a money transmitting business. At the federal level, the Financial Crimes Enforcement Network (FinCEN), a bureau of the Treasury Department, oversees registration and regulation of money transmitting businesses. In 2013, FinCEN issued guidance on the regulatory responsibilities of money transmitter businesses.²⁴ These regulations are primarily designed to detect and deter money laundering and other illegal activities.

A money transmitter that fails to comply with the anti-money laundering and “Know Your Customer” requirements may be subject to criminal prosecution for operation of an unlawful money transmitting business under 18 U.S.C. § 1960.²⁵ These requirements apply to transmitters of cryptocurrencies as well as sovereign-issued currencies:

Despite conflicting classifications by Federal regulators as to what Bitcoin actually is, the few Courts that have addressed this issue have held that 18 U.S.C. § 1960 covers Bitcoin because “[d]ictionaries,

<https://cointelegraph.com/news/us-techcrunch-founders-crypto-fund-becomes-yet-another-target-of-sec-crypto-probe>.

24. FinCEN, *Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FIN-2013-G001 (March 18, 2013), available at <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

25. As of May 2018, money transmitters will be required to not only know the identity of their customer and to monitor for suspicious transactions but to inquire about beneficial ownership and the nature and purpose of the account in order to develop a customer risk profile. See Customer Due Diligence Requirements for Financial Institutions, 31 C.F.R § 1010 (2016).

courts, and the statute's legislative history all point to the same conclusion: Bitcoins are funds." See *United States v. Murgio*, No. 15-cr-769, 2016 WL 5107128, at *4 (S.D.N.Y. Sep. 19, 2016); *United States v. Budovsky*, No. 15-cr-368, 2015 WL 5602853 (S.D.N.Y. Sep. 23, 2015); *United States v. Faiella*, 39 F. Supp. 3d 544 (S.D.N.Y. 2014).²⁶

These regulations are not designed to protect persons who purchase or hold currencies.

Only a few states including North Carolina and New York have enacted specific legislation addressing virtual currency money transmitters.²⁷ New York has implemented "BitLicense" regulations that apply to money transmitters doing business in New York.²⁸ New York's regulatory plan includes: (1) licensing rules and compliance provisions; (2) capital requirements; (3) custody and protection of consumer assets and other consumer protection provisions including a complaint procedure; (4) notices of material changes in business and of control and of mergers and acquisitions; (5) books and records; (6) examinations; and (7) the establishment and maintenance of anti-money laundering, cybersecurity, business continuity and disaster recovery programs. In 2017, the Uniform Law Commission issued the Uniform Regulation of Virtual Currency Act,²⁹ but to date, no state has enacted the uniform law.

State money transmitter laws generally cover cryptocurrency transactions. One notable exception is the State of Illinois. Although Illinois has invested

26. Joseph Evans, *Bitcoin, Money and Funds: the Application of the Unlicensed Money Transmitting Services Statute to Virtual Currency*, FORDHAM JOURNAL OF CORP. & FIN. LAW (Nov. 14, 2016), <https://news.law.fordham.edu/jcfl/2016/11/14/bitcoin-money-and-funds-the-application-of-the-unlicensed-money-transmitting-services-statute-to-virtual-currency/>.

27. For a current list, see the National Money Transmitters Association listing of state regulation which has links to state laws and regulations. *State-by-State Regulation*, THE NATIONAL MONEY TRANSMITTERS ASSOCIATION, <http://www.nmta.us/state-by-state-regulation> (last visited May 29, 2018).

28. 37 N.Y. Reg. 7 (2015).

29. UNIFORM REGULATION OF VIRTUAL-CURRENCY BUSINESSES ACT, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS (2017), available at http://www.uniformlaws.org/shared/docs/regulation%20of%20virtual%20currencies/URVCBA_Final_2017oct9.pdf.

in a blockchain technology incubator³⁰ and is the home of two exchanges that trade bitcoin futures contracts, it does not regulate cryptocurrency brokers as money transmitters. In fact, the Illinois Department of Financial and Professional Regulation issued guidance that digital currencies are not money under the Illinois Transmitters of Money Act.³¹

B. Regulation of Tokens as Commodities

Investors in cryptocurrencies can look to the CFTC for some protection. In 2014, the CFTC declared virtual currencies like bitcoin to be commodities. While the CFTC does not directly regulate the sale of a commodity – for example the sale of a gold coin – it does regulate derivatives that are based upon the value of commodities, like swaps, futures, and options contracts.

The CFTC brought several enforcement actions related to cryptocurrencies. In September 2015, for example, the CFTC brought two settled cease-and-desist actions concerning cryptocurrencies. One was against a platform for trading bitcoin options contracts.³² The operator of the trading platform, Coinflip, Inc., and its CEO agreed to cease and desist from operating a platform and consented to the entry of an order finding that these options contracts were swaps under the Commodity Exchange Act. Coinflip ceased operations.

The other September 2015 action was against a provisionally registered swap execution facility for executing prearranged trades (wash trades) in bitcoin options.³³ TeraExchange executed prearranged trades of bitcoin swaps that it informed the CFTC and National Futures Association were designed to “test the pipes.” The next day, TeraExchange issued a press release

30. Michael del Castillo, *New Chicago Blockchain Center Launches With Government Backing*, COINDESK (Jun. 8, 2017), <https://www.coindesk.com/new-chicago-blockchain-center-launches-with-government-backing/>.

31. ILLINOIS DEPT. OF FIN. AND PROF. REGULATION, DIGITAL CURRENCY REGULATORY GUIDANCE (2017), available at <https://www.idfpr.com/Forms/DFI/CCD/IDFPR%20-%20Digital%20Currency%20Regulatory%20Guidance.pdf>.

32. *In the Matter of Coinflip, Inc.*, CFTC Docket No. 15-29 (Sept. 17, 2015), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

33. *In the Matter of TeraExchange, LLC*, CFTC Docket No. 15-33 (Sept. 24, 2015), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf>.

announcing that trading in bitcoin swaps had taken place – improperly characterizing these prearranged test trades as true market transactions.

Thus far, the CFTC has brought only one action against an exchange for virtual currencies like bitcoin. In 2016, the CFTC brought a settled action against Bitfinex, one of the major online cryptocurrency/token trading platforms for operating, as an unregistered futures commission merchant (FCM) and for facilitating the financing of transactions in bitcoin for participants who were not eligible under Dodd-Frank.³⁴ Bitfinex, a business formed in the British Virgin Islands and purportedly based in Hong Kong, has ceased doing business with customers it knows to be in the United States.

In September 2017, the CFTC filed its first anti-fraud action concerning a bitcoin investment scheme.³⁵ The CFTC alleged that a bitcoin pool that purported to engage in high-frequency algorithmic trading was, in reality, a Ponzi scheme.³⁶ More recently, the CFTC filed another anti-fraud action, obtaining a temporary restraining order halting the offering of a virtual currency called My Big Coin (“MBC”).³⁷ It is interesting that the CFTC brought this case rather than the SEC. The facts alleged in the complaint are consistent with what the SEC typically would call a security so it is surprising that the CFTC brought this case rather than the SEC.³⁸

The Chicago Mercantile Exchange and the Chicago Board Options Exchange began trading bitcoin futures contracts in late 2017.³⁹ These

34. *In the Matter of BFXNA Inc.*, CFTC Docket No. 16-19 (June 2, 2016), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf>.

35. Press Release, *CFTC v. Gelfman Blueprint, Inc. et al* (Sept. 21, 2017), available at <http://www.cftc.gov/PressRoom/PressReleases/pr7614-17>.

36. Complaint, *CFTC v. Gelfman Blueprint, Inc.*, No. 17-7181 (S.D.N.Y. Sept. 21, 2017), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfgelfmancomplaint09212017.pdf>.

37. Order, *CFTC v. My Big Coin Pay, Inc. et al.*, No. 18-00077 (D. Mass. Jan. 16, 2018), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfmybigcoinpayorder011618.pdf>.

38. Complaint *CFTC v. My Big Coin Pay, Inc. et al.*, No. 18-00077 (D. Mass. Jan. 16, 2018), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfmybigcoinpaycomplt011618.pdf>.

39. CFTC, CFTC BACKGROUNDER ON OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS (Jan. 4, 2018), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

exchanges operate under the supervision of the CFTC. While the exchanges used the self-certification process to approve and begin trading these contracts, the CFTC did not object to the trading of bitcoin futures contracts.⁴⁰

In 2017, the CFTC launched LabCFTC, an initiative designed to promote responsible Fin Tech innovation.⁴¹ The CFTC has provided significant guidance for investors, issuers, and brokers including through its “Backgrounder” and its “Primer on Virtual Currencies.”⁴²

C. Regulation of Tokens as Securities

The SEC has not proposed specific regulations for virtual coins. The SEC’s position is that existing law provides adequate guidance. The longstanding definition of a security is an investment of money in a “common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”⁴³ But the devil is in the details – the question remains how is that definition to be applied to tokens created using blockchain technology.

In a December 11, 2017 statement, Chairman Clayton acknowledged that there are cryptocurrencies that are not securities. He offered some guidance as to his view of when a token might be classified as a security:

For example, a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well

40. Contrast this with the position of the SEC Division of Investment Management on mutual funds holding cryptocurrencies. SEC, STAFF LETTER: ENGAGING ON FUND INNOVATION AND CRYPTOCURRENCY-RELATED HOLDINGS (Jan 18, 2018), *available at* <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>.

41. CFTC Launches LabCFTC as Major FinTech Initiative, CFTC Release No. 7558-17 (May 17, 2017), *available at* <http://www.cftc.gov/PressRoom/PressReleases/pr7558-17>.

42. CFTC, CFTC BACKGROUNDER ON OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS (Jan. 4, 2018), *available at* http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf; CFTC, CFTC PRIMER ON VIRTUAL CURRENCIES (Oct. 17, 2017), *available at* http://www.cftc.gov/idc/groups/public/documents/file/labcfrc_primercurrencies100417.pdf.

43. *See* Jay Clayton, Chairman, SEC, Public Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017).

be an efficient way for the club's operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value –with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.⁴⁴

While the CFTC has acknowledged the challenges that cryptocurrencies and blockchain technology present to the existing regulatory scheme, the SEC appears committed to regulating the new technology through enforcement actions under existing law. It is unclear whether proposals like SAFT (Simple Agreement for Future Tokens) – a protocol developed by lawyers for lawfully issuing tokens as non-securities – will be widely adopted.⁴⁵ As time goes on, they look less promising.

Fraudulent offerings

Enforcement actions under existing law have worked well in protecting investors from fraudulent offerings. One of the earliest SEC actions was a 2013 federal court action against Trenton Shavers and Bitcoin Savings and Trust.⁴⁶ BTCST claimed that it was raising funds to engage in market arbitrage activity – including selling bitcoin to people who wanted to buy bitcoin “off the radar”. BTCST promised up to 7% interest per week. At least some BTCST investors may have known that the Internet name of the Shavers was “pirateat40” and BTCST was previously known as “First Pirate Savings & Trust.”

44. *Id.*

45. JUAN BATIZ-BENET, MARCO SANTORI, & JESSE CLAYBURGH, THE SAFT PROJECT: TOWARD A COMPLIANT TOKEN SALE FRAMEWORK (Oct. 2, 2017), available at <https://www.cooley.com/news/insight/2017/2017-10-24-saft-project-whitepaper>.

46. Complaint, *SEC v. Trenton Shavers, et al*, No. 4:13-cv-416 (E.D.Tex. July 23, 2013), available at <https://www.sec.gov/litigation/complaints/2013/comp-pr2013-132.pdf>.

Nevertheless, Shavers and BTCST raised 700,000 bitcoin – approximately \$4.5 million. In the end, they were ordered to pay \$40 million in disgorgement and \$150,000 in civil penalties.⁴⁷

In 2015, the SEC filed *SEC v. Homero Joshua Garza*, a federal court action halting the offering of interests in a bitcoin mining operation. Garza sold \$20 million of shares in a digital mining contract he called a “Hashlet.” Investors were told that they owned a share of computing power by investing in the Hashlet. Garza sold far more interests in the Hashlet than existed – promising to pay a return that far exceeded the actual return on the mining operations.⁴⁸ Garza used funds from new investors to make payments to earlier investors. He was charged in a parallel criminal case and ultimately pled guilty to one count of wire fraud.⁴⁹

In June 2017, the SEC obtained emergency relief halting a fraudulent scheme that raised over \$37 million.⁵⁰ Recidivist securities law violator and UK resident Renwick Haddow created an unregistered broker-dealer to sell securities in two companies that he created, Bitcoin Store (a purported cryptocurrency trading platform) and Bar Works (a purported chain of co-working spaces). Haddow is also facing criminal charges for his fraudulent activities.

In September 2017, the SEC obtained emergency relief halting another fraudulent scheme involving cryptocurrency.⁵¹ According to the SEC complaint, the offerors claimed that the REcoin token was backed by real estate and that they had hired a team of lawyers, professionals, brokers, and

47. Press Release, SEC, Final Judgment Entered Against Trendon T. Shavers, A/K/A/ "Pirateat40" - Operator of Bitcoin Ponzi Scheme Ordered to Pay More Than \$40 Million in Disgorgement and Penalties (Sept. 22, 2014).

48. Press Release, SEC, SEC Charges Bitcoin Mining Companies (Dec. 1, 2015), available at <https://www.sec.gov/litigation/litreleases/2015/lr23415.htm>.

49. Press Release, SEC, SEC Obtains Final Judgment Against Founder of Bitcoin Mining Companies Used to Defraud Investors (Oct. 4, 2017), available at <https://www.sec.gov/litigation/litreleases/2017/lr23960.htm>.

50. Press Release, SEC, SEC Files Fraud Charges in Bitcoin and Office Space Investment Schemes (June 30, 2017), available at <https://www.sec.gov/litigation/litreleases/2017/lr23870.htm>.

51. Press Release, SEC, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017), available at <https://www.sec.gov/news/press-release/2017-185-0>.

accountants who would invest the proceeds of the offerings in real estate.⁵² There is a parallel criminal action pending.

In December 2017, the SEC obtained emergency relief to halt the offering of the PlexCoin token by a repeat securities law violator as a fraudulent offering.⁵³ In January 2018, the SEC obtained a court order halting the AriseCoin offering, an offering to create the purported first-of-its-kind decentralized bank. The issuer, AriseBank, allegedly made false statements that it was able to offer FDIC-insured accounts and an AriseBank-branded VISA card to spend 700-plus cryptocurrencies. The SEC sought an emergency asset freeze and the appointment of a receiver to unwind what the SEC alleges is an “outright scam.” AriseBank is contesting the SEC’s allegations.

Unregistered securities offerings

The SEC brought its first action against an issuer for failing to register a token as a security in 2014.⁵⁴ As of March 2018, only one token has been registered with the SEC as a securities offering.⁵⁵ Others that do not register base that decision upon exemptions under the securities law such as crowdfunding and Reg D.

The first significant guidance from the SEC on how to determine whether a token is a security was issued in July 2017. At that time, the SEC issued a Section 21(a) report analyzing whether the sale of DAO (decentralized autonomous organization) tokens are securities, without bringing charges against DAO.⁵⁶ In the DAO Report, the SEC set out how, applying the *Howey*

52. Complaint, *SEC v. REcoin Group Foundation, LLC et al.*, 17 Civ. 5725 (E.D.N.Y. Sep. 29, 2017), available at <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-185.pdf>.

53. Press Release, SEC, SEC Emergency Action Halts ICO Scam (Dec. 4, 2017), available at <https://www.sec.gov/news/press-release/2017-219>.

54. *In re Erik Vorhees*, Exchange Act Release No. 9592 (June 3, 2014), available at <https://www.sec.gov/litigation/admin/2014/33-9592.pdf>. Vorhees failed to register securities offerings apparently because he was only accepting payments in bitcoin.

55. Praetorian Group, Registration Statement (Form S-1), available at https://www.sec.gov/Archives/edgar/data/1721980/000137647418000045/pr_s1.htm.

56. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Rel. No. 81207 (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf> (hereinafter the “DAO Report”).

test, it concluded that the DAO token was an “investment contract.” Although the DAO token was offered as something other than a security, the SEC stated “the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto.”⁵⁷ The SEC found it significant that the DAO token purchasers would rely on the significant managerial efforts of others to earn profits. As a result, the SEC concluded that the offer and sale of the DAO securities must comply with the requirements of Section 5 of the Exchange Act that offers and sales of securities be registered or qualify for an exemption from registration.. The SEC noted in passing that the offer and sale of the DAO token did not qualify for exemptions under the crowdfunding provisions of the JOBS Act and expressly declined to consider whether DAO was an “investment company.”

Since the DAO Report was released, the SEC has signaled its intent to police virtual coins. The SEC set up a Cyber Unit to investigate activities in the cryptocurrency/token space that might violate federal securities laws.⁵⁸ There have been media reports that the SEC has issued eighty or more subpoenas to obtain information concerning ICOs.⁵⁹ In the coming months, we will likely see through enforcement actions which tokens the SEC considers to be securities.

The SEC Staff considers the cooperation and remedial efforts of offerors in determining what enforcement action it may take. For example, Munchee, issuer of the MUN token, consented to a cease-and-desist order in early December 2017.⁶⁰ In determining not to impose a civil penalty, the SEC took into consideration Munchee’s cooperation and prompt remedial actions. But, the degree of consideration for cooperation is within the SEC’s discretion. The consideration given for cooperation may differ significantly depending on the individual staff and supervisors handling the case, other investigations and cases the SEC is pursuing at the time, and SEC priorities and resources. Credit for cooperation is not a certainty.

57. *Id.* at 11.

58. <https://www.sec.gov/news/press-release/2017-176>.

59. Cryptocurrency Firms Targeted in SEC Probe, Feb. 28, 2018, WSJ, available at <https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-151985626>.

60. *In the Matter of Munchee, Inc.*, Exchange Act Release No. 10445 (Dec. 11, 2017).

Unregistered securities exchanges

The SEC has also brought actions against operators of online trading platforms for failing to register as securities exchanges. In late 2014, the SEC brought an action against BTC Trading Corp and Ethan Burnside for operating two online platforms for trading securities that were not registered as securities exchanges.⁶¹ The SEC concluded that the tokens traded on those trading platforms were securities and sought disgorgement, a fine, and an industry bar.

In mid-2015, the SEC shut down an online trading platform for facilitating security-based swaps involving non-eligible persons and without an effective registration statement, which is prohibited under Dodd-Frank.⁶² Sand Hill was an entity created by two Silicon Valley entrepreneurs who were alleged to have made misrepresentations about their trading, operations, controls, and financial backing.

It remains to be seen what the SEC will do with virtual coin exchanges like Bittrex that may be operating as unregistered securities exchanges or unregistered broker-dealers.

D. Other Regulation

Other state and federal agencies are bringing actions to halt fraudulent offerings of virtual coins. Some of those actions have been brought by the Federal Trade Commission, the Texas Securities Department, and the North Carolina Securities Department.⁶³ Yet, people continue to pour money into virtual coins like “Ponzicoín” that clearly disclose the offering as a joke.⁶⁴ To

61. Order, *In the Matter of BTC Trading, Corp and Ethan Burnside*, Exchange Act Release No. 9685 (Dec. 8, 2014), available at <https://www.sec.gov/litigation/admin/2014/33-9685.pdf>.

62. 15 U.S.C. § 77e(e). *In Matter of Sand Hill Exchange*, June 17, 2015 Order, AP File No. 3-16598, available at <https://www.sec.gov/litigation/admin/2015/33-9809.pdf>.

63. See Press Release and related documents, *FTC v. BF Labs, Inc.*, 4:14-cv-00815-BCW (Sept. 23, 2014), available at <https://www.ftc.gov/enforcement/cases-proceedings/142-3058/bf-labs-inc>.

64. See Olivia Solon, *Bitcoin, titcoin, ponzi coin: jokes and scams fuel a cryptocurrency gold rush*, THE GUARDIAN (Feb. 2, 2018), available at <https://www.theguardian.com/technology/2018/feb/02/bitcoin-bananacoin-prodeum-cryptocurrencies>.

the extent that people are purchasing tokens for their amusement or novelty value, it would appear that tokens should be regulated by consumer protection agencies like the Federal Trade Commission. Perhaps people who purchase Ponzicoïn do it for the same reason people purchase pet rocks or Chia pets and the law should merely require that they get what they want.

Conclusions & Recommendations

In the near term, investors will continue to respond to the attraction of virtual coins as currencies, commodities, and securities. That puts the retirement savings of millions of customers at risk. Broker-dealers and registered investment advisory firms should immediately:

- prohibit virtual coins in retirement accounts and any fiduciary account;
- require heightened supervision of any customer accounts invested in virtual coins; and,
- implement adequate training, revised protocols, and supervisory systems that specifically address the potential risks of virtual coins.

FINRA should implement, on an expedited basis, rules that specifically address the heightened risks of virtual coins as investments to retail investors. Member firms should not wait for others like the FINRA, the SEC, and state securities commissioners to provide specific guidance. Virtual coins have been growing in popularity since 2008. The current Chairman of the SEC considers this issue cut and dried – all tokens that he has seen are securities. Members should have specific supervisory policies and procedures in place to address the risks of financial advisors inducing or assisting customer virtual coin transactions.

While blockchain technology may be more transformative than the internet, FINRA and firms must take affirmative steps to mitigate the risk of investor losses – particularly potentially devastating losses of retirement savings.