

The SEC, CFTC and Virtual Currencies

The public interest in anything relating to virtual currencies, blockchain technology or bitcoin is not just very high but reaching near hysteria. For example, the Long Island Iced Tea Corporation saw its share price jump as much as 289% after changing its name to Long Blockchain Corp. Kodak, Inc., the one-time film and camera giant, saw its share price triple after announcing the development of KodakCoin, a form of virtual currency, according to a recent CNBC report. Even the SEC is looking at jumping on board according to a tweet from its Fort Worth Texas office (in jest) stating that the agency is considering adding “Blockchain” to its name to improve its popularity, according to a Bloomberg report.

Regulators such as the SEC and CFTC have expressed repeated concern in the face of these and other public responses while monitoring the situation and at times struggled to craft the appropriate response. As the CFTC recently admitted, U.S. law does not provide for “direct, comprehensive U.S. regulation of virtual currencies. To the contrary a multi-regulatory approach is being used.” CFTC Backgrounder on Oversight and Approach to Virtual Currency Futures Markets, dated January 4, 2018 (“Backgrounder”), available [here](#). Those U.S. regulators include:

- Banking regulators,
- The Internal Revenue Service,
- Treasury’s Financial Crimes Enforcement Network,
- The Securities and Exchange Commission, and
- The Commodity Futures Trading Commission.

While the SEC and CFTC have worked to develop a regulatory approach to the issues within their jurisdiction, each agency has repeatedly cautioned investors regarding the significant potential for fraud. See, e.g., SEC Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, Dec. 11, 2017 ([here](#)); CFTC Chairman J. Christopher Ciancario, *Commending SEC Chairman Clayton on ICO Statement*, Dec. 11, 2017 ([here](#)). At the same time, each has limited regulatory authority in the area.

Related Capabilities

- Securities & Financial Services Litigation & Enforcement

The SEC

The SEC's approach keys to the question of whether a security is involved, central to its jurisdiction under the federal securities laws. In a Report of an Investigation issued under Exchange Act Section 21(a), The DAO ([here](#)) the agency detailed its approach to determining whether a security is involved. The investigation sought to determine if The DAO, an unincorporated organization, Slock.it UG, a German entity, Slock.it's co-founders and certain intermediaries violated the federal securities laws. The inquiry focused on the sale by The DAO, an autonomous organization that used blockchain technology to operate as a "virtual entity," of tokens. Those tokens represented interests in its enterprise and could be paid for with virtual currency. The tokens could also be held as investments and had certain voting and ownership rights. In addition, the tokens could be sold on web-based secondary platforms.

The Commission's analysis of the question centered on whether the tokens were an "investment contract," a form of a security under the definitions in the federal securities laws. The seminal decision in this regard is *SEC v. H.J. Howey Co.*, 328 U.S. 293 (1946). There the Court used a multi-prong test centered on the question of whether the investors were pooling their money with the expectation of making a profit through the efforts of others. Utilizing this approach in view of the economic reality of the transactions, the Commission concluded that the tokens involved were in fact an investment contract and thus a security subject to the federal securities laws. Exchange Act Release No. 81207 (July 25, 2017) ("21(a) Report").

Most of the cases brought by the SEC in this area both before and after the 21(a) Report have been offering fraud actions, often involving a Ponzi scheme. For example, *SEC v. Plexcorps*, Civil Action No. 1:17-cv-07007 (E.D.N.Y. Filed Dec. 1, 2017) centers on the claimed sale of a cryptocurrency by individuals enjoined from such sales by a Canadian court before implementing their scheme in the U.S., according to the SEC's complaint.

The complaint names as defendants the company, an unincorporated entity, and Dominic Lacroix, a securities law recidivist who controlled the entity. Sabrina Paradis-Royer, believed to be a romantic interest of Mr. Lacroix, is also named as a defendant. The action centers on the sale of what the defendants call PlexCoin, claimed to be the next cryptocurrency. In the United States the defendants began their offering of unregistered interests in August 2017. It continues to the present.

Prior to the U.S. offering defendants initiated sales of the securities in Quebec, Canada. In July 2017 the Quebec Financial Markets Administrative Tribunal entered an injunction against Mr. Lacroix, prohibiting him from future violations of the Quebec Securities Act, based on his sales efforts. Subsequently, defendants began offering interests in Plexcorps' claimed cryptocurrency in this country.

Since August 2017 defendants have engaged in over 1,500 investor transactions, selling about 81 million PlexCoin Tokens for about \$15 million. Investors were induced to enter into these transactions through a series of claims which included: a representation that a team of experts around the world were involved; that the firm's executives were hidden to

avoid poaching by competitions; that new products were being developed; and that the potential returns were enormous.

The representations were false, according to the SEC. Defendants misappropriated much of the investor funds. The complaint alleges violations of Securities Act Sections 5(a), 5(c) and 17(a) and Exchange Act Section 10(b). This case is in litigation. *See also SEC v. Gara*, Civil Action No. 3:15-cv-01760 (D. Conn. Filed Dec. 1, 2015) (scheme offering opportunity to mine virtual currency attracted 10,000 investors and raised about \$19 million in four months; it was a Ponzi scheme); *In the Matter of Erik T. Voorhees*, Adm. Proc. File No. 3-15902 (June 3, 2014) (settled administrative proceeding involving the offering of unregistered shares valued in bitcoin).

The Commission's most recent case in this area centers on the failure to register the interests offered as required by Section 5 of the Securities Act based on an analysis similar to the one in the 21(a) Report. *In the Matter of Munchee Inc.*, Adm. Proc. File No. 3-18304 (Dec. 11, 2017). Munchee is a privately held firm based in San Francisco. In late 2015 it began developing an iPhone app that was launched two years later. The app allowed users to post photographs and reviews of restaurant meals on-line.

Munchee created a plan to improve the app. Part of the plan called for raising capital through the sale of tokens or MUN on the Ethereum blockchain. Munchee created 500 million MUN tokens. The plan was to raise about \$15 million in Ether by selling 225 million MUN tokens out of the 500 million MUN tokens created by the company. Munchee marketed the coins through a website, a white paper and other means, promising that as others became involved and the tokens circulated the value would increase. A key part of the plan was the trading of MUN on an exchange. Munchee represented that MUN tokens would be available for trading on at least one U.S. based exchange within thirty days of the close of the initial coin offering.

Munchee offered the coins to the public beginning on October 17, 2017. Potential investors were told that they could profit on the investment based on the potential development of the ecosystem, the efforts of the firm and the future exchange listing of the coins. As the ecosystem expanded the value of the coins would increase, according to the firm. The firm stopped selling the coins on November 1, 2017 after being contacted by the staff.

Under Section 2(a)(1) of the Securities Act the MUN tokens are securities, according to the Order because they are investment contracts. Accordingly, in offering the tokens for sale in the absence of an effective registration statement, or an exemption from registration, Munchee violated Section 5(a) of the Securities Act. The case will be set for hearing.

The SEC has also received a number of applications related to the trading of virtual currency. For example, in March of last year the Commission denied such a request from Cameron and Tyler Winklevoss, owners of Gemini Bitcoin exchange. At present about 14 applications for bitcoin ETFs or related products are pending, according to a Reuters

inquiry dated January 10, 2018. None have been approved.

The CFTC

The CFTC concluded in 2015 that virtual currencies are a commodity within the meaning of the Commodity Exchange Act. Accordingly, they are subject to regulation by the agency. Since that date the CFTC has brought enforcement actions involving virtual currencies centered on fraud charges and for unregistered trading that are similar to those brought by the SEC. See, e.g., *CFTC v. Gelfman Blueprint, Inc.*, Case No. 17-7181 (S.D.N.Y. Filed Sept. 21, 2017)(action against the firm and its CEO centered on a Bitcoin Ponzi scheme supposedly using a high-frequency, algorithmic trading strategy to trade; case is in litigation); *In the Matter of BFXNA Inc., d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016)(settled administrative proceeding centered on trading or exchanging cryptocurrencies, mainly bitcoins, on an unregistered platform).

The agency also granted a request by LedgerX, LLC for registration as a derivatives clearing organization under the Commodity Exchange Act on July 24, 2017. The order authorizes LedgerX to provide clearing services for fully-collateralized digital currency swaps. The CFTC also granted an order of registration for LedgerX under which it registered as a Swap Execution Facility in July 2017. The firm plans to clear bitcoin options, according to the CFTC announcement. Under the order LedgerX is required to comply with the applicable provisions of the Commodity Exchange Act and other undertakings presented in its application that relate to CFTC regulations. In issuing the order the CFTC disclaimed any endorsement of digital currencies.

Subsequently, the Chicago Mercantile Exchange Inc. and the CBOE Futures Exchange self-certified new contracts for bitcoin future products on December 1, 2017. The Cantor Exchange also self-certified a new contract for Bitcoin binary options. The product self-certification process was designed by Congress to “give the initiative to DCMs [Designated Contract Markets] to certify new products . . . [which] is consistent with a DCM’s role as a self-regulatory organization . . .” according to the Backgrounder. The process does not allow for public comment. The CFTC has only limited input.

Within the limits of the self-certification process, the CFTC staff has engaged in what the Backgrounder calls “heightened review for virtual currency.” That process, largely centered on strengthening oversight and monitoring, includes: derivatives clearing organizations setting substantially high initial and maintenance margin for cash-settled Bitcoin futures; setting large trader reporting thresholds at five bitcoins or less; entering into information sharing agreements with spot market platforms; monitoring data from cash markets; and other, similar steps. The CFTC “expects that any registered entity seeking to list a virtual currency derivative product would follow the same process, terms and conditions” the Backgrounder notes.

Conclusion

Public and investor interest in blockchain technology, virtual currency, Bitcoin, and similar processes and products is at near fever pitch. The technology and products in

this area are rapidly evolving while the depth of investor knowledge and sophistication in the area, in general, may not be keeping pace.

At the same time the regulatory approach is fragmented and evolving with a number of agencies working hard to get on top of this recent investment craze. Some think this is a bubble that will blow-up quickly and crash. Others believe this is the newest and greatest investment opportunity. Regardless of which view is correct, it is clear that the investment risks are high and the protections few as the market for these products rapidly evolves.

