

## Financial Services Litigation

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## TAKING A TRIP AROUND THE REGULATORY BLOCK: U.S. REGULATION OF BLOCKCHAIN AND DIGITAL ASSETS

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Blockchain – a distributed electronic ledger that facilitates decentralized transaction networks – has the potential to transform finance and business not unlike the World Wide Web in the 1990s or the smartphone in the 2000s. This article provides a brief overview of the U.S. regulatory agencies that certain blockchain companies and participants should expect to encounter, either because the regulators have publicly stated their intentions, or because they may determine after-the-fact that their mandate applies to blockchain transactions and operations.

For now, most blockchain projects are inextricably linked to digital assets such as cryptocurrency, altcoins, tokens, or virtual currencies (there are important distinctions among such assets but no universal definitions; hereinafter such terms are used interchangeably). This association is often because (1) many blockchains are powered with bespoke tokens that act as environmental currencies; (2) certain tokens are intended to be decentralized currencies supported by a blockchain; or (3) the project itself is funded by pre-sales of such tokens, in public or private offerings commonly called ICOs. Other projects – such as exchanges, wallets, and funding – revolve around the purchase, sale, and management of tokens and ICOs.

Until recently, the majority of token funding happened outside of the United States, or within the United States but under the radar of market regulators. This is no longer the case. U.S.

regulators have recognized the importance, and the permanence, of blockchain projects, and have determined that their own mandates apply to this field to protect the public from market risk, fraud, and theft. Meanwhile, blockchain proponents have realized that they cannot ignore the world's largest economy, and the home to major universities, financial markets, infrastructure, governments, and private enterprise. Going forward, blockchain companies and U.S. regulators will have to find ways to live with each other, and to bring this technology to fruition in a safe and effective manner.

In short, U.S. regulatory agencies adapt over time to meet new market challenges. Regulators often have overlapping missions, differing political incentives, and wide variances in jurisdiction and powers. Blockchain and cryptocurrency practitioners no longer have the luxury (or burden) of operating in a vacuum, and must adjust quickly to a patchwork of regulation. The most successful projects going forward will be the most nimble, and the most prepared to assure regulators that they are in compliance and that they pose no threat to public welfare. For now, business leaders must assess the applicability of federal and state regulations including those concerning securities, commodities, anti-money laundering, wire fraud, broker-dealers, consumer fraud, and tax compliance.

The following government entities are some of the primary regulators that blockchain and digital asset practitioners are most likely to encounter.

#### Securities and Exchange Commission (SEC)

The SEC regulates all securities offerings in the United States. It oversees the inspection of securities firms, broker-dealers, and investment advisors. It promulgates rules and regulations concerning the issuance, sale and trading of securities, including those concerning filing requirements. It enforces securities laws with its powers to investigate, review, and bring enforcement actions both within its own agency and in federal courts.

The SEC has not yet approved any exchange traded funds holding cryptocurrencies or other assets relating to cryptocurrencies for listing or trading. While the Chairman has expressed concern about the offer and sale of tokens, and even about market participants that hold or permit customers to deal in tokens, the SEC has stated that whether or not a token sale constitutes a sale of securities would be based on the individual facts and circumstances of each situation, commonly referred to as the *Howey Test*. The SEC is willing to bring enforcement actions against ICO sponsors for misusing an ICO and/or for fraud. See, e.g., *SEC v. Plexicorps*, 1:17-cv-07007-DLI-RML (E.D.N.Y. Dec. 1, 2017).

#### Commodity Futures Trading Commission (CFTC)

The CFTC is an agency created to regulate futures and option markets. The CFTC is organized around four main categories: (1) Clearing and Risk, which includes the oversight of derivatives clearing organizations and other market participants; (2) Enforcement, including the investigation and prosecution of alleged violation of the Commodities Exchange Act and other CFTC regulations; (3) Market Oversight, conducting trade surveillance and the oversight of the trading facilities such as futures exchanges; and (4) Swap Dealer and Intermediary Oversight, including the oversight of the registration and compliance by self-regulatory organizations, such as futures exchanges, and registration of swap dealers and major swap participants.

The CFTC announced that it has designated certain virtual currencies as commodities, and that fraud

and manipulation involving tokens traded in interstate commerce and the regulation of commodity futures tied to tokens fall under its authority. As recently as March 2018, a U.S. District Court found that the CFTC has the jurisdiction to regulate such currencies as commodities, as well as to regulate fraud in many virtual currency transactions, even where they are not futures transactions. See *CFTC v. McDonnell et al*, No. 18-CV-0361 (E.D.N.Y. Mar. 6, 2018) (recognizing CFTC's concurrent jurisdiction with other agencies, based on the multi-faceted nature of virtual currencies).

The CFTC has allowed the Chicago Mercantile Exchange and the Chicago Board Options Exchange to launch Bitcoin futures. The CFTC also approved a platform for the trading and clearing of virtual currency derivatives for LedgerX LLC, which is a swap execution facility and clearing organization.

More recently, the CFTC has issued specific guidance to exchanges and clearinghouses when listing a virtual currency derivative, focusing on (a) enhanced market surveillance; (b) coordination with CFTC staff; (c) large trader reporting; (d) outreach to stakeholders; and (e) risk management. The CFTC has also announced enhanced cooperation with state regulators.

#### Financial Crimes Enforcement Network (FinCEN)

FinCEN is a bureau of the U.S. Department of Treasury whose mission is to protect the U.S. financial system from illicit use, to combat money laundering, and to promote national security. FinCEN receives and maintains financial transactions data and analyzes and disseminates this data for law enforcement purposes. FinCEN also builds global cooperation with its foreign counterpart agencies.

FinCEN has recently indicated that it will apply its regulations to those who conduct ICOs. Further, it indicated that both developers, and also those involved in the sale of an ICO-derived token, may be liable to register as a transmitter and to comply with the relevant statutes regarding anti-money laundering and know-your-customer (KYC) rules. This could mean that those who conduct an ICO, but have not registered or complied with KYC rules, could be charged with a felony under federal law. FinCEN has already assessed a nine-figure fine (\$110,003,314) against an entity acting as a

cryptocurrency exchanger, for violation of regulations concerning anti-money laundering and suspicious activity reports.

#### Department of Justice (DOJ)

DOJ, among other functions, is the federal government's primary criminal prosecutor. It has the power to investigate crimes through the FBI, to present cases to federal grand juries and trial courts through its criminal division and its 94 U.S. Attorney's Offices across the U.S., and to oversee criminals' incarceration through the U.S. Marshall's Service and Bureau of Prisons. DOJ is very adept at using criminal statutes, such as those addressing wire fraud (18 U.S.C. §1343) and money laundering (18 U.S.C. §§1956-57) to prosecute a wide array of financial crimes, regardless of context. In addition, its powers of civil forfeiture recover between \$1.5 billion and \$4.5 billion annually.

DOJ announced in 2018 that its cybercrime task force is developing a comprehensive strategy for cryptocurrency. DOJ made a splash in the cryptocurrency world several years ago by prosecuting the use of Bitcoin as funds used on Silk Road, the criminal online marketplace. See *U.S. v. Faiella*, 39 F.Supp.3d 544 (S.D.N.Y. 2014). DOJ is currently prosecuting at least one ICO fraud case and has challenged the defendant's assertion that the U.S.'s securities laws do not apply to the sale of tokens tied to two ventures – one backed by real estate and the other by diamond holdings. See *U.S. v. Zaslavskiy*, 1:17-cr-00647-RJD-RER, (E.D.N.Y. Mar. 19, 2018).

#### Financial Industry Regulatory Authority (FINRA)

FINRA regulates broker-dealers in an effort to protect investors and market integrity. It writes and enforces rules governing the activities of thousands of broker-dealers with hundreds of thousands of brokers. FINRA also examines firms for compliance with its rules, promotes market transparency, and educates investors. In 2017, FINRA brought over 1,300 disciplinary actions against registered brokers and firms and levied over \$66 million in fines and restitution to harmed investors.

FINRA has issued warnings to investors to about potential Bitcoin and other cryptocurrency scams. FINRA's 2018 Regulatory and Examination Priorities Letter highlights ICOs and

cryptocurrencies among the sales practice risks that it will focus on in 2018. FINRA intends to keep a close eye on the role that firms and registered representatives play in ICOs and other token activities. It has indicated that federal regulators may start targeting secondary actors in ICOs that likely have a wide variety of insurance products, including Directors and Officers, Errors and Omissions, professional liability, cyber, crime, and other specialized policies.

#### Federal Trade Commission (FTC)

The FTC is a bipartisan federal agency whose mission is to protect consumers and promote competition. The FTC investigates issues of fraud raised by reports from consumers and businesses, pre-merger notification filings, congressional inquiries, or reports in the media. The FTC can investigate a single business or an entire industry. When an FTC investigation reveals unlawful conduct, the FTC may seek voluntary compliance through a consent order, file an administrative complaint, or commence federal litigation. The FTC also has rulemaking authority to address concerns of industry-wide practices.

The FTC has created a Blockchain Working Group to identify and target fraudulent schemes which affect the FTC's consumer protection and competition missions. The FTC indicated that this Group has three goals: (1) to build FTC staff expertise in cryptocurrency and blockchain technology; (2) to assist internal and external communication on enforcement actions; and (3) to provide a forum for discussing potential influences on the FTC's objectives and how to respond to them. Recently the FTC brought a lawsuit against four individuals who used Bitcoin in fraudulent chain referral schemes. In 2016, the FTC brought a case against Butterfly Labs, operators of Bitcoin mining operations, for deceiving customers about the availability, profitability and age of mining machines.

#### Internal Revenue Service (IRS)

The IRS collects taxes, issues fines, and promulgates rulings. As complex as the tax code appears, it is even more complex to administer. Questions regarding revenue often devolve into thorny issues of timing, public policy, minutiae of statutory interpretation, and even questions about the nature of money itself. While only a competent

tax lawyer or accountant can offer a bespoke opinion, be assured that the IRS intends to calculate blockchain-related revenue as carefully as it does any other revenue.

If a token is not deemed a security, either by the SEC or by court opinion, it may be because that token instead offers purchasers a simple advance right to a product or service, like a coupon. This might make the revenue derived from the sale of that token simple income, subject to taxation when received.

The IRS has indicated that it treats virtual currency as property for tax purposes, meaning a gain or loss should be recorded as any other exchange of property. It may be treated as a capital asset, but also may be treated like inventory if held for resale. It is possibly treated like currency if used for payment, similar to other property, but it may first have to be converted and the fair market value checked on an exchange.

#### U.S. State Department

The State Department is the U.S.'s federal executive department that advises the President and represents the country in international affairs and foreign policy issues. Its main job is to promote American foreign policy throughout the world. The State Department negotiates treaties and agreements with foreign entities and represents the U.S. at the United Nations.

While not a regulator in the same manner as some other institutions listed here, the State Department is an example of an agency that has embraced blockchain technology to promote its mission. Blockchain technology could play a key role in the restructuring that was initially proposed by former Secretary of State Rex Tillerson. The State Department is looking into how blockchain technology can help provide foreign aid, promote democracy and improve governance and political institutions in U.S.-allied countries. In March 2018 the State Department and Coca-Cola, along with several other companies, announced the launch of a blockchain-based project to fight forced labor.

#### Individual U.S. States

Some states are planning to approve the acceptance or promotion of the use of digital currency and blockchain technology, while others have passed laws regulating or restricting token

use. The National Conference of Commissioners on Uniform State Laws voted in July 2017 to approve a model act providing for the regulation of digital currency businesses at the state level. Arizona has passed a law recognizing "smart contracts" using blockchain technology, and has taken measures to ease the regulatory burdens on new financial technologies. A California law makes it illegal to buy or exchange a raffle ticket for any kind of cryptocurrency. Delaware has a pending initiative authorizing registration of shares of Delaware companies in blockchain form. New York currently uses a "Bitlicense" regulating digital currency within the state. Oklahoma's legislature determined that a seller who accepts Bitcoin does not take it free of an existing security interest. Vermont recognized blockchain as evidence. Illinois has authorized the use of blockchain for real estate records. Wyoming is considering a bill to make the state more digital currency friendly. ♦

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