Cryptocurrency Alert

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Developments in Cryptocurrency in 2018

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Key Points

- The U.S. Securities and Exchange Commission (SEC) staff made official statements regarding when a token may or may no longer be a security
- The SEC continued to bring actions related to cryptocurrency offerings against market participants, including an adviser to a fund organized to invest in cryptocurrencies that was not structured to rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 and a website that acted as a broker and a dealer in cryptocurrency offerings and secondary trading
- A court ruled that a particular cryptocurrency may be a security such that securities fraud claims may be brought
- Another court ruled that a cryptocurrency may be a commodity so that the Commodity Futures Trading Commission (CFTC) would have jurisdiction
- The CFTC proposed an interpretation of what "actual delivery" constitutes for cryptocurrency forward contracts making it more difficult to trade in or offer cryptocurrency tokens in the spot markets on a delayed basis
- The National Futures Association (NFA) required immediate notice to the NFA if a member planned to engage in cryptocurrency or cryptocurrency derivatives transactions
- The NFA also required specified disclosure by its members to clients regarding cryptocurrency risks and regulation
- The SEC continues to reject the listing of exchange-traded funds that hold cryptocurrency.

In addition to the above, the SEC, the U.S. Department of the Treasury ("Treasury") and their respective staffs are still trying to determine how their respective current rules apply to cryptocurrency. The SEC staff sent a sweep letter to inquire into the current practices of investment advisers regarding cryptocurrencies, including with respect to custody practices and personal trading rules and valuation practices. The Treasury released a report on July 31, 2018, making several recommendations regarding emerging financial technologies (Fintech) —including cryptocurrencies—for anti-money laundering (AML) and counter-terrorism financing (CTF) purposes. Unlike

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the SEC, the CFTC, the NFA and the Treasury's Financial Crimes Enforcement Network (FinCEN), the Internal Revenue Service (IRS) has not published new specific guidance since 2014.

Security Status

SEC Director of Corporate Finance WilliamHinman provided insight into the SEC's approach to cryptocurrency regulation at Yahoo Finance's All Market Summit: Crypto.[1] In his speech, Mr. Hinman noted that he does not believe that Bitcoin and Ether, two of the largest cryptocurrencies, in terms of market cap, should be treated as securities. Power over the two coins is now so decentralized that no one entity has control over the value of the coins, a key factor in labeling an instrument a security under the investment contract paradigm. This was an important acknowledgment that coins and tokens can, at certain points, transition from being securities into commodities.

Factors to consider in determining whether a coin or token is a security include, among others:

- Centralized control or ownership of the coin: A coin is likely a security if one company or close group of people are responsible for making the coins valuable. If control is decentralized, then the coin appears more similar to a commodity.
- Motives of purchasers: If an investor purchases coins for the utility of the coin, be it a discount at the company's store or access to some sort of functionality, then the coin would be less likely to be a security. If the coin were instead purchased with the hope of earning the investor a profit, the coin would more likely be a security.
- Marketing of the token: If the coins are targeted at the public instead of the potential users of the token or if the offering price of the token is not correlated with the market value of the good or service in the network, these factors would all point towards the coin being a security.[2]

Enforcement Actions

The SEC brought noteworthy enforcement actions based on the security status of cryptocurrency tokens in September of 2018 against market participants beyond the issuers ofcryptocurrencies. The SEC brought and settled an action against an adviser to a pooled vehicle organized to invest in cryptocurrency, due to (i) its general solicitation of investors, (ii) its failure to perfect any exclusion from "investment company" status under the Investment Company Act of 1940, as amended, despite more than 40 percent of its assets consisting of investment securities (treating the cryptocurrency as securities for this purpose) and (iii) fraudulent statements made in connection with the sale of interests regarding being the first token investment company registered with the SEC.[3] The SEC brought and settled an enforcement action in September 2018 against a website that sold tokens to the public on an

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[1] Available at https://www.youtube.com/watch?v=HJyRATEXpMQ and in written form at https://www.sec.gov/news/speech/speech-hinman-061418.

[2] For more information, see https://www.akingump.com/en/experience/practices/corporate/ag-deal-diary/sec-division-director-provides-long-awaited-guidance-on-initial.html.

[3] See Securities Act Release 10544 (Sept. 11, 2018) available at https://www.sec.gov/litigation/admin/2018/33-10544.pdf.

agency basis and on a principal basis in connection with the initial coin offerings of tokens in both "presales" and in secondary sales. The enforcement action alleged failure to register as a broker-dealer and violations of Section 5 of the Securities Act of 1933, as amended, for a distribution of securities that was not registered or properly exempt.[4]

Criminal Action

A court in the Eastern District of New York in September 2018 refused to dismiss a criminal case brought for alleged fraudulent statements in connection with the sale of securities related to the sale of tokens claimed to be backed by real estate and diamonds. The court noted that whether a particular token is a "security" that is subject to the securities laws is a factual question, but found that the token at issue was a security for the purposes of adjudicating the motion to dismiss, using the Howey "investment contract" analysis.[5] The court also found that labeling a token as a "currency" does not take an offering outside of the scope of the definition of a security if it otherwise satisfies the traditional "investment contract" analysis and value is provided in connection with the acquisition of a token.

CFTC Regulation

Regardless of whether a certain cryptocurrency is a security, it may be subject to the jurisdiction of the CFTC. On March 9, 2018, a judge in a New York federal district court held that virtual currencies are commodities that can be regulated by the CFTC, enjoining the defendants—an individual and an affiliated entity—from tradingcryptocurrencies on their own or others' behalf or soliciting funds from others, and ordering an expedited accounting.[6] While the CFTC announced its position that cryptocurrencies are commodities in 2015, this case marks the first time a court has weighed in on whether cryptocurrencies are commodities. We note that, whereas, CFTC jurisdiction is normally limited to commodity futures and other derivatives, the court found the CFTC had jurisdiction over physical "spot" trading in bitcoin when that trading, or solicitation of funds to engage in trading, is conducted for fraudulent purposes. Also, the court did not preclude other regulatory agencies from having concurrent jurisdiction over cryptocurrencies.

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[4] See Release Securities Act Release 10543 and Exchange Act Release 84075 (Sept. 11., 2018) available at https://www.sec.gov/litigation/admin/2018/33-10543.pdf. It is notable that this case did not involve an allegation of misappropriation, as opposed to many earlier actions, such as the action brought in federal court in February of 2018 against a website platform and its principal in federal court alleging that it operated as an unregistered online securities exchange and that the principal committed fraud when he misappropriated cryptocurrency. See Litigation Release 24078 (Mar. 23, 2018) available at https://www.sec.gov/litigation/litreleases/2018/lr24078.htm.

[5] In particular, the court found that the facts, if proven, were sufficient to show that the investments were made for the purposes of obtaining a reasonable expectation of profits from the principal's managerial efforts in selecting real estate and would be securities, even if market forces might contribute to the token's value as well.

[6] *CFTC v. McDonnell*, No. 18-cv-0361, Dkt. 29 (E.D.N.Y. Filed Jan 18, 2018).

The CFTC also proposed an interpretation of "actual delivery" in December 2017 with respect to virtual currencies[7] that would clarify its jurisdiction over "retail" forward transactions inbitcoin. The CFTC's position is fortified by the above case regarding cryptocurrency's status as a commodity.[8] The CFTC has jurisdiction over contracts or transactions in any commodity that is entered into with a person that is not an eligible contract participant[9] or eligible commercial entity and that is offered on a leveraged or margin basis. An exception applies to transactions if (i) the commodity is actually delivered within 28 days or (ii) the agreement creates an enforceable obligation between buyers and sellers, each of which have the ability to take and accept delivery, in connection with their respective lines of business. In determining whether actual delivery has occurred, the CFTC proposed that it would "employ a functional approach and examine how the agreement, contract or transaction is marketed, managed and performed, instead of relying solely on language used by the parties in the agreement, contract or transaction." Within the virtual currency space, the proposed interpretation would require that the customer has the ability to take possession and control of the virtual currency and use it freely in commerce (both within and away from the platform) no later than 28 days from the date of the transaction,[10] with the offeror or counterparty not retaining any interest in or control over any of the virtual currency at the expiration of the 28 days. For example, the free movement of virtual currency from one virtual wallet to the other person's wallet or the transfer to a depositary with the ability to remove the virtual currency from the depositary would satisfy the requirements for actual delivery.

NFA Requirements

The NFA also joined the cryptocurrency fray in late 2017 and in 2018. A notice to members in December of 2017 required any commodity pool operator (CPO) or commodity trading adviser (CTA) that executes a transaction involving a cryptocurrency or any cryptocurrency derivative to immediately notify the NFA and amend its annual questionnaire.[11] In July of 2018, the NFA also published an

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[7] The CFTC interprets the term virtual currency for this purpose to include digital or virtual currencies and as "any digital representation of value that functions as a medium of exchange, and any other digital unit of account that is used as a form of a currency (i.e., transferred from one party to another as a medium of exchange) that may be manifested through units, tokens, or coins, among other things, and may be distributed by way of "smart contracts," among other structures. See https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2017-27421a.pdf, text at note 46.

[8] This is important because the CFTC has jurisdiction over trading in commodity interests (consisting of retail commodity transactions described above, retail foreign exchange contracts, futures, swaps other than securities-based swaps and leveraged metals transactions) and, if they are being manipulated, spot markets.

[9] An eligible contract participant includes, among other things, an entity with more than $10 million in total assets.

[10] Netting by going opposite way in connection with virtual currency transactions would not satisfy the requirement for actual delivery.

[11] NFA Notice I-17-28 available at https://urldefense.proofpoint.com/v2/url?u=https-3A__www.nfa.futures.org_news_newsNotice.asp-3FArticleID-3D4974&d=DwMCaQ&c=YOHA32qHoO0MIaoXxJhqDw&r=hXsS-G5GgNMmEWic-lKwhxagSSrtTn1ABQypYoczxGY&m=j_eX22dr6AkVMYlXgASrn1TEb12wXsdyTec6VS09G44&s=2uWkAdo1fVh_eDrDcL28qGZ7UZhPVBAVWbxOL2FjR0g&e=

interpretation[12] that requires CPOs and CTAs who are members of the NFA that trade virtual currencies or virtual currency derivatives to (i) include mandated disclosures regarding virtual currencies for their exempt and non-exempt pools and managed accounts that describe the unique risks of trading virtual currencies and (ii) include a standardized legend that must be prominently displayed on any promotional materials, offering memorandum or disclosure document regarding the risks of virtual currency trading and, if applicable, the lack of jurisdiction over the spot virtual currency market. The interpretation will become effective on October 31, 2018.[13]

Bitcoin Listing

The SEC disapproved trading of bitcoin for retail clients on stock exchanges through exchange-traded products (ETPs) that trade physical bitcoin or bitcoin futures in July 2018. In its disapproval for both physical bitcoin and bitcoin futures, the SEC rejected the listing principally due to concerns regarding whether there is a large enough regulated market in bitcoin that is closely monitored enough to protect against manipulation.[14] The SEC has delayed one potential approval of a bitcoin exchange-traded fund until September 30, 2018. If no bitcoin ETP registrations are approved, this "disapproval" is expected to negatively impact future demand for bitcoin.

SEC Open Issues

The SEC and its staff are considering how the typical rules for custody and personal trading and requirements for valuation will work withcryptocurrencies.[15] The custody rules technically only apply to securities and funds of clients. As stated above, certain cryptocurrencies may not be securities and may not be "funds" because they generally are not backed by the "full faith and credit" of a nation. From a policy perspective, this answer is not completely satisfactory because cryptocurrencies can be used in transactions and could be misappropriated by unscrupulous investment advisers. The typical custodians of cash and securities do not commonly provide custody solutions for cryptocurrencies. Compliance with the custody rule would require procedures that differ from those of, e.g., equity securities because of cryptocurrency's disintermediated design, which poses problems for verifying the existence of the cryptocurrency and potentially introducing cybersecurity issues in securing the cryptocurrency keys. Additionally, imposing a more traditional approach to cryptocurrencies through intermediating a custodian would involve administrative burdens that would likely decrease the utility of the token being custodied. Including cryptocurrency trading in personal trading policies may be required if the initial coin offerings are securities and are being sold as either private placements or limited or full public offerings. Even for some tokens that are not technically covered by the

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[12] See https://www.nfa.futures.org/news/PDF/CFTC/InterpretiveNoticeRegardingMembersVirtualCurrencyDisclosures.pdf

[13] https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5036

[14] https://www.federalregister.gov/documents/2018/08/01/2018-16427/self-regulatory-organizations-bats-bzx-exchange-inc-order-setting-aside-action-by-delegated

[15] See 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. While the letter deals with issues relating to registered investment companies, the issues for registered investment advisers are similar.

personal trading rule, such as bitcoin or ether, some investment advisers have banned trading due to their volatility and distraction. Finally, the SEC staff has expressed concern about the reliability of the valuation of cryptocurrencies because of (i) the volatility of the value of tokens, (ii) the current trading volume of many tokens, (iii) the potential significant divergence (or "forks") into cryptocurrencies with different valuations and (iv) potential manipulation.

Treasury Developments

On July 31, 2018, the Treasury released a report outlining recommended regulatory improvements to support nonbank financial institutions and encourage Fintech. In the report, the Treasury makes more than 80 regulatory and legislative recommendations in four broad categories of Fintech activity. In particular, new firms planning their entrance into the financial services industry should be prepared to address and implement existing rules on anti-money laundering and counter-terrorist financing, along with the customer due diligence obligations that accompany them. Global regulatory authorities have repeatedly singled out Fintech (and, in particular, financial products incorporating cryptocurrencies and anonymization) as an increased risk to AML and CTF efforts worldwide—in part because these products often fall outside the scope of more stringent rules covering banks and other traditional financial institutions. As the Treasury attempts to bring these new innovative firms and products into the fold, we would expect the government to leverage new technologies and data to enhance monitoring and reporting for AML/CTF purposes.

International Developments

In July 2018, G20 finance ministers and central bank governors called on the Financial Action Task Force (FATF) to articulate, by October 2018, how its global AML/CTF standards apply to cryptocurrencies and related assets. The request follows the G20's March 2018 request to develop standards pertaining to cryptocurrencies, on which the FATF reported in its July meeting. In addition to considering how its standards (also known as the "40 Recommendations") apply to cryptocurrencies and related assets, the FATF will also consider whether it needs to update those same standards to reflect certain "technical aspects" of cryptocurrencies and crypto assets. The FATF's report also surveys the G20's regulatory approaches on cryptocurrencies and assets, and notes in particular that national law enforcement authorities should "significantly improve" their understanding of and approaches to investigations involving cryptocurrencies and assets.

On July 9, 2018, the EU's Fifth AML Directive (5AMLD) went into effect. Among other changes, 5AMLD extends or adjusts the scope of the EU's AML regime as to virtual currency exchanges and wallet providers. 5AMLD also reduces the threshold to identify customers using prepaid cards from EUR 250 to EUR 150 (or EUR 50 in the case of remote payment), and it imposes enhanced due diligence measures on transactions involving certain high-risk countries, including Iran and North Korea. Member States have 18 months, or until January 10, 2020, to implement 5AMLD into national law.

Tax Treatment

Contrary to the recent actions of other agencies, the Treasury and the IRS have not provided any specific guidance on cryptocurrency transactions and their tax treatment

since issuing Notice 2014-21. However, the IRS did publish certain Frequently Asked Questions (FAQs) on its web site reminding taxpayers that transactions of the type described in Notice 2014-21 (with respect to cryptocurrencies that have an equivalent value in fiat currency, or that act as a substitute for fiat currency, also known as "convertible virtual currencies," such as Bitcoin) are generally expected to be treated as "property" transactions for U.S. federal income tax purposes. As a practical matter, the IRS therefore reminds taxpayers that it is of the view that cryptocurrencies may give rise to U.S. federal tax or information reporting requirements in the same manner as other transactions involving property. For example, payments made using cryptocurrency may be subject to reporting on an IRS Form 1099-MISC, and sales or exchanges that give rise to capital gain or loss may be required to be reported by taxpayers on an IRS Form 8949.