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Digital Assets Regulatory Challenges

Bill Reilly and Donald Horwitz

The complexity and global popularity of cryptocurrencies, or digital assets, has initiated cooperative efforts between the SEC and CFTC to understand and regulate these products. The agencies have jointly testified before Congress and displayed interest in developing meaningful regulations; both agencies have promised additional working groups to pursue joint regulations.

On January 24, 2018, the SEC and CFTC issued a joint statement to describe the efforts both agencies are taking to regulate this market and root out fraud in the offer and sale of digital assets. The SEC's Division of Investment Management also issued a letter raising concerns about registered investment companies' investments in cryptocurrencies and cryptocurrency-related assets.

CFTC

In January 2018 the CFTC filed two complaints in the United States District Court Eastern District of New York (USDCEDNY), CFTC v. Dillon Michael Dean and The Entrepreneurs Headquarters Limited and CFTC v. Patrick K. McDonnell and Cabbagetech, Corp. d/b/a Coin Drop Markets, sending a strong message to alleged fraudulent actors that the agency believes it has jurisdiction over digital assets under the Commodity Exchange Act ("CEA"), notwithstanding that the activity is unrelated to futures products.

Relying on the CEA definition of a commodity, on March 6, 2018 the court upheld the CFTC's authority to exercise its enforcement power over fraud of digital assets sold in interstate commerce and granted the CFTC an injunction against Patrick McDonnell and Cabbagetech, Corp. The court held that digital assets are commodities under applicable law, and that the CFTC has standing to sue persons for fraud relating to spot sales of digital assets, even where such sales do not involve the sale of futures or derivatives contracts. The court, however, acknowledged that the CFTC's oversight of spot digital assets is limited and not exclusive. Other regulators might include state and federal criminal authorities, the Department of Justice, the SEC, FinCEN, and the states.

SEC

The SEC announced it will continue to handle digital asset offerings based on a "facts and circumstance" test that judges each case individually to determine if the offering is a security subject to SEC regulation or, if not, which regulatory agency, if any, has jurisdiction.

At the same time, the SEC has divided its enforcement actions against Initial Coin Offering ("ICO") issuers into two "buckets": those whose offerings are viewed by the agency as "outright frauds," and those whose offerings need to be registered as securities with the SEC.

In a January 18, 2018 letter to the Investment Company institute and the Securities Industry and Financial Markets Association, the SEC's Division of Investment Management responded to inquiries on behalf of sponsors regarding offering registered funds which hold as assets of these new digital products. Although the SEC indicated a willingness to work with these sponsors and industry representatives, the SEC indicated based upon concerns including valuation, custody, liquidity, arbitrage and potential manipulation and other risks that these concerns would need to be overcome before moving forward on this issue.

For investment advisors, rules pertaining to conduct requirements for advice provided to clients are currently in place per the Advisors Act of 1940.

About the Authors
Bill Reilly is an Associate Director at Oyster Consulting. He can be reached at bill.reilly@oysterllc.com.
Donald Horwitz is an independent consultant associated with Oyster Consulting. He can be reached at donald.horwitz@oysterllc.com.

It should be noted that both FINRA and the NFA are looking for direction from the SEC and CFTC, respectively. However, regulations such as due diligence of products sold, policies and procedures, suitability, electronic records and supervision are currently in place to regulate firm conduct as it relates to the sale of any product, including cryptocurrencies.

States

A review of state regulations reveals one common theme: states generally require firms and individuals engaging in the offer/sale of digital assets to register as money transmitters. However, some states have either enacted legislation providing an exemption to the money transmitter registration or have not addressed the issue with respect to digital assets. The need to understand the regulations in any state in which a digital asset may be offered is critical.

Some states have become proactive in protecting, regulating and monitoring digital assets. New York has established a comprehensive written regulatory framework applicable to all digital asset-related entities operating in the state. In February 2018, the state issued guidance to all registered businesses highlighting the importance of effectively preventing and responding to fraud and similar wrongdoing regarding such assets. On May 21, 2018 the North American Securities Administrators Association ("NASAA") announced the signing of a Memorandum of Understanding ("MOU") with the CFTC. The MOU is designed to share information and assist the co-signers in enforcing the Commodity Exchange Act, which state securities regulators and state attorneys general are statutorily authorized to do alongside the CFTC. Each state may need to execute their own MOU directly with the CFTC to engage in the information sharing. Information shared under the MOUs could generate enforcement actions under state securities laws, common law fraud, or other areas of law.

On May 21, 2018 NASAA announced coordinated enforcement actions by state and provincial securities regulators in the United States and Canada to crack down on fraudulent ICOs, digital asset-related investment products, and those behind such schemes. NASAA members from more than 40 jurisdictions participated in "Operation Cryptosweep," which has resulted in nearly 70 inquiries and investigations and 35 pending or completed enforcement actions related to ICOs or digital assets since the beginning of May 2018.

FINRA

On July 6, 2018, FINRA issued guidance Regulatory Notice 18-20 (the "Notice") regarding Digital Assets. The Notice's headline states that "FINRA Encourages Firms to Notify FINRA if They Engage in Activities Related to Digital Assets". The predicate for the Notice is to assist FINRA in monitoring Member's involvement with digital assets. To accomplish this, FINRA is requesting that each firm promptly notify its Regulatory Coordinator if it, or its associated persons (including activities under Rules 3270 and 3280) or affiliates, currently engages, or intends to engage, in activities related to digital assets, including digital assets that are non-securities.

The types of activities of interest to FINRA if undertaken (or planned) by a member, its associated persons or affiliates, include, but are not limited to:

- purchases, sales or executions of transactions in digital assets;
- purchases, sales or executions of transactions in a pooled fund investing in digital assets; creation of, management of, or provision of advisory services for, a pooled fund related to digital assets;
- purchases, sales or executions of transactions in derivatives (e.g., futures, options) tied to digital assets;
- participation in an initial or secondary offering of digital assets (e.g., ICO, pre-ICO);
- creation or management of a platform for the secondary trading of digital assets;
- custody or similar arrangement of digital assets;
- acceptance of cryptocurrencies (e.g., bitcoins;
- recommend, solicit or accept orders in cryptocurrencies and other virtual coins and tokens;
- display indications of interest or quotations in cryptocurrencies and other virtual coins and tokens;
- provide or facilitate clearance and settlement services for cryptocurrencies and other virtual coins and tokens; or
- recording cryptocurrencies digital assets and other virtual coins and tokens using distributed ledger technology or any other use of blockchain technology.

While the Notice appears on the surface to be a benign request for Members to provide information regarding their activities in the digital asset space, it does add the following caveat:

> FINRA encourages firms to promptly notify their Regulatory Coordinator in writing (including email) of its or its associated persons' or affiliates' involvement in activities related to digital assets. A material change in a firm's business operations also requires the submission and approval of a CMA.

Finally, the Notice concludes with this cautionary statement:

> Until July 31, 2019, each firm is encouraged to keep its Regulatory Coordinator updated if it, or its associated persons or affiliates, *begins or intends to begin, engaging in a new type of activity relating to digital assets not previously disclosed.* [Emphasis added.]

The Notice, that seems to be straightforward, is both broad and comprehensive in its coverage. It appears to capture all forms of digital asset activity in its net. It seeks information related to both securities and non-securities related activities and products such as futures, options and other derivative products, as well as the use of blockchain technology. Moreover, while the Notice requests the disclosure of all activities "undertaken (or planned)" it is not clear whether approval is required from FINRA, through the Regulatory Coordinator, before the planned activity can be started.

We urge anyone affected by this Notice to read it carefully and contact their Legal, Compliance or other such advisors.

Conclusion

It seems to us that the regulators, cooperatively, need to lay out as soon as possible guidance and rules that bring clarity to everyone in the digital asset ecosystem about the expectations of regulations. While most prosecutors can put together a fraud case for taking money unlawfully, it's the fundamentals (registration, customer funds, capital, underwriting, trading, etc.) that require interpretation and codification adopted under a transparent and proper rulemaking structure.

Looking for more coverage on this topic? Consider attending Oyster Compliance Consulting, LLC's follow-up webinar on August 21st at 2pm ET.

Register Here