

# **Virtual Currency Regulation in the Context of Investment Intermediaries: How to Effectively Police Progressively Global, Decentralized Markets**

By Lisa LeFever  
Prepared for Broker-Dealer Regulation  
Professor Ronald Filler  
May 1, 2018

## **ABSTRACT**

*Virtual currencies have evolved into a meaningful component of our international financial markets after experiencing a tremendous surge in popularity in 2017, prompting the emergence of many diverse platforms for their trade. Unlike typical stock exchanges, however, these platforms, are often not registered with regulators and cannot provide the same safety and security assurances to users. Additionally, the assets they purport to host are so nascent and intricate that their markets suffer from pervasive volatility, illiquidity, fraud, and uncertainty as to their legal standing. Despite inconsistent approaches among regulatory bodies, authorities are united in positioning cryptocurrency-related matters as a chief priority in the coming months, where the future of the industry will be shaped by ongoing investigations, enforcement actions, and regulatory and legislative efforts. This article asserts that regulators should adopt a light touch approach to virtual currency regulation that prioritizes open dialogue, considers timely modernization to securities regulation with attention to the decentralized nature of virtual currencies, and balances investor protection with facilitating innovation in the budding global cryptocurrency markets. It further explores the impact of virtual currency regulation on investment intermediaries, such as broker-dealers and exchanges, and advocates for the development of compliance programs focused on blockchain products that closely follow ongoing developments.*

## **TABLE OF CONTENTS**

- I. INTRODUCTION
- II. OVERVIEW OF BROKER-DEALERS REGULATION
  - a. *Regulating Investment Intermediaries*
  - b. *Broker-Dealer Registration*
  - c. *Exchange Registration*
  - d. *Neither Fish Nor Fowl: The Emergence of Alternative Trading Systems*
  - e. *Regulation ATS*
  - f. *Liability for Unregistered Securities*
- III. PRIMER ON VIRTUAL CURRENCIES AS INVESTMENTS
  - a. *Virtual Currency Products*
    - i. *Pure Virtual Currencies*
    - ii. *Tokens*

- iii. *Securities*
    - iv. *Derivatives*
  - b. *Virtual Currency Exchanges*
    - i. *The Rise of Coinbase*
    - ii. *Other Centralized Virtual Currency Exchanges*
    - iii. *Decentralized Exchanges*
    - iv. *Registered Exchanges Offering Virtual Assets*
- IV. CRYPTO EXCHANGES UNDER FIRE
  - a. *Federal Regulators: The SEC and FINRA*
  - b. *State Regulators: New York's "Virtual Currency Integrity Initiative"*
- V. PROBLEMS IN THE CURRENT REGULATORY ENVIRONMENT
  - a. *Indeterminate Status of Assets and Excessive Compliance Costs*
  - b. *Regulation by Enforcement Ineffective*
  - c. *Hasty, Patchwork Regulation Exceedingly Harmful*
- VI. REGULATING VIRTUAL ASSETS AND THEIR PLATFORMS OF TRADE
  - a. *To Legislate Or Not To Legislate?*
  - b. *A "Light Touch" Approach to Virtual Currencies: Regulators Working With The Industry to Provide Clarity*
  - c. *Informed Regulation to Modernize Securities Laws*
- VII. IMPLEMENTING CRYPTO COMPLIANCE PROGRAMS
  - a. *Registered Entities*
  - b. *Unlicensed Broker-Dealers*
- VIII. CONCLUSION

## I. INTRODUCTION

Blockchain systems continue to alter traditional notions of investing and trade, ushering in an era of revolutionary value transfer illustrated by an entirely new class of assets, loosely referred to as “virtual currencies” or “cryptocurrencies.” Cryptocurrencies operate under breeds of distributed ledger and blockchain technology, which involve intricate programming using complex mathematical code to effectively transfer and verify transactions while creating shared, immutable databases of transaction history.<sup>1</sup> “Blocks” correspond to transactions effectuated by special codes, called “keys,” and are connected in a chronological manner using cryptography and consensus mechanisms to form a perpetual “chain” of transparency.<sup>2</sup> The decentralized nature of the technology acts to replace centralized “backroom” operations traditionally performed by banks and other financial intermediaries.<sup>3</sup>

In 2008, an author going by the name Satoshi Nakamoto introduced bitcoin, the most popular cryptocurrency, dubbing it a “peer-to-peer electronic cash system” that bypasses

<sup>1</sup> See European Securities and Markets Authority, *The Distributed Ledger Technology Applied to Securities Markets* 8 (Feb. 6, 2016), [https://www.esma.europa.eu/sites/default/files/library/2016-773\\_dp\\_dlt\\_0.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-773_dp_dlt_0.pdf).

<sup>2</sup> See CHRIS BURNISKE & JACK TATAR, CRYPTOASSETS: THE INNOVATIVE INVESTOR’S GUIDE TO BITCOIN AND BEYOND 18 (Oct. 19, 2017) (describing consensus mechanisms as the process through which code establishes a means to agreeing to the validity of transactions).

<sup>3</sup> See Finextra, *Banking on the Blockchain* 14 (Jan. 2016) (stating that the “transformational opportunity” created by blockchains is the fact that “we can now attach behavior to money—which opens the gate for new capital market instruments”).

third-party intermediaries and prevents double spending issues.<sup>4</sup> By the end of 2017, bitcoin's price reached highs close to \$20,000.<sup>5</sup> Bitcoin's mainstream incline prompted the onset of a slew of derivative means of value creation and transfer, a new class of assets to rival legacy financial products.<sup>6</sup>

As more consider investments in the form of virtual assets, broker-dealers will inevitably encounter such products in their practice. Offering novel financial instruments to clients in the course of one's business, however, presents a multitude of regulatory issues and legal risks.<sup>7</sup> Broker-dealers who integrate cryptocurrencies into existing their existing business structures developed around legacy investment products must adequately deliberate how their customers can be best protected in the face of the new technology propelling virtual currencies. Likewise, startups and new decentralized networks facilitating virtual currency transactions face the immediate, powerful threat of regulatory enforcement and potential hackings, necessitating thorough and detailed procedures aimed at mitigated such risks.<sup>8</sup>

Regulators have begun to take substantial steps in determining how investors can be best protected in the developing virtual currency market, taking steps to absolve legal uncertainty and prevent fraud and manipulation.<sup>9</sup> The Securities and Exchange Commission (SEC) launched a probe into the space earlier this year, warning that virtual currency exchanges that host products deemed to be securities must register as an exchange with the SEC or face regulatory consequences.<sup>10</sup> Similarly, the Attorney General's Office of the State of New York began an investigation, targeting the 13 largest virtual currency exchanges.<sup>11</sup> Other states have moved forward with legislation aimed at clarifying the status of blockchain products for investors, professionals, and exchanges alike.<sup>12</sup>

---

<sup>4</sup> Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* 1 (2008).

<sup>5</sup> Coinmarketcap.com (Dec. 17, 2017).

<sup>6</sup> See *infra* Section III(a)(i)–(iv) (describing the various virtual currency products).

<sup>7</sup> “[T]here is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation.” SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017). See also Alexander B. Lindgren, *Blockchain Regulation: Growing Pains of a Financial Revolution*, Orange County Lawyer, at 1 (Oct. 2017) (“The new and unusual nature of crypto-currencies have led to substantial confusion on how to treat them for regulatory purposes.”).

<sup>8</sup> Coinbase, the most popular virtual currency exchange that permits the exchange of fiat currency into cryptocurrencies like bitcoin and ether, faced legal troubles in 2017. A lawsuit in filed in California alleged that insiders profited from the exchange's initial launch of the cryptocurrency bitcoin cash. See *Jeffrey Berk v. Coinbase, Inc. et al*, No 18-CV-01364 (N.D. Cali. Mar. 1, 2018). Coinbase also faced heat from the IRS, who ordered the exchange to release user information, arguing that the exchange's customers were evading tax obligations. *United States v. Coinbase, Inc. et al.*, No. 17-CV-01431 (N.D. Cali. Nov. 28, 2017). See also *Brandon Leidel et al. v. Coinbase, Inc.*, No. 9:16-cv-81992 (S.D. Fla. Dec. 13, 2016).

<sup>9</sup> See *infra* Section IV (addressing the increased regulatory scrutiny at the state and federal level targeted at virtual currency exchanges).

<sup>10</sup> See Nathaniel Popper, *Subpoenas Signal S.E.C. Crackdown on Initial Coin Offerings*, NY TIMES (Feb. 28, 2018), available at <https://www.nytimes.com/2018/02/28/technology/initial-coin-offerings-sec.html>.

<sup>11</sup> New York State Office of the Attorney General, *A.G. Schneiderman Launches Inquiry Into Cryptocurrency “Exchanges,”* Press Release (April 17, 2018), available at <https://ag.ny.gov/press-release/ag-schneiderman-launches-inquiry-cryptocurrency-exchanges>.

<sup>12</sup> Wyoming enacted state legislation exempting utility tokens, calling them “open blockchain tokens,” from the definition of a security when they are not marketed as investments, exchangeable for goods or services when issued, and the seller does not actively promote a secondary market for their trading. H.B. 0070, 2018 Gen. Sess., Budget Sess. (Wyo. 2018).

Even with the persistent regulatory concerns, the blockchain frenzy has not slowed down—token sales continue to raise substantial funds, bypassing 2017’s figures,<sup>13</sup> despite the SEC’s assertion that most tokens are unregistered securities.<sup>14</sup> Most virtual currency exchanges have not registered with the SEC, but rather facilitate millions of transactions without undergoing the lengthy disclosure process involved in filing with the SEC to become a regulated broker-dealer that can properly conduct business in securities markets, such as that is required of exchanges like the New York Stock Exchange (NYSE).<sup>15</sup>

This article investigates the legal and regulatory issues surrounding virtual currencies in relation to investment intermediaries registered, and those not so registered but conducting business in the United States. It begins with an introduction to the mania of virtual currency markets. Part II highlights key directives in the regulation of securities brokers and exchanges. Part III describes the range of virtual products in the marketplace and the many diverse platforms that have emerged for their purchase and trade. Part IV addresses recent regulatory action targeted at virtual currency exchanges and investment professionals handling them.

Subsequently, this article details outstanding problems in current approaches to policing the industry and suggests a possible remedy—it proposes that, after thorough and necessary investigation, authorities partner with innovators and embrace guidelines that promote clarity, compliance, and efficiency. Section VI further posits the benefits of decentralized methods of value transfer and discusses how regulators should nurture the market by adopting a light touch approach to regulation, favoring the progression of an informed and unified global system of oversight. Part VII recommends compliance policies for intermediaries engaged in the space. This article concludes with a synopsis of the recommendations made herein for financial authorities to consider in fulfilling their objective of balancing investor protection with the freedom of innovation, entrepreneurship, and trade.

## **II. OVERVIEW OF BROKER-DEALERS REGULATION**

The following section provides a brief background into the laws, regulations, and policing bodies that investment intermediaries, like broker-dealers and exchanges, deal with in the course of their business. It described the pertinent provisions of federal securities laws that impose registration obligations among other duties, as such are relevant in considering the regulatory landscape of the virtual currency marketplace.

### *a. Regulating Investment Intermediaries*

---

<sup>13</sup> See David Floyd, *\$6.3 Billion: 2018 ICO Funding Has Passed 2017's Total*, COINDESK (April 19, 2018), available at <https://www.coindesk.com/6-3-billion-2018-ico-funding-already-outpaced-2017/> (providing that ICO funding in the first quarter of 2017 has surpassed the total raised in 2017 at \$6.3 billion).

<sup>14</sup> See Jay Clayton, SEC Chairman, Testimony on “Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission,” Before the Committee on Banking, Housing, and Urban Affairs United States Senate (Feb. 6, 2018).

<sup>15</sup> See SEC, Divisions of Enforcement and Trading and Markets, *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* (Mar. 7, 2018), available at <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

The appropriate regulator for investment intermediaries in the United States is dictated by the product that the individual or entity is involved with, as such product is defined in the relevant provisions of federal law and interpreted through precedent.<sup>16</sup> The Securities Act of 1933 (1933 Act) and the Exchange Act of 1934 (Exchange Act or 1934 Act) together created the SEC and granted it authority over “securities.”<sup>17</sup> Legislation also provided for the development of self-regulatory organization (SROs) that play important roles in policing professional conduct.<sup>18</sup>

Broker-dealers, professionals that conduct business in securities markets for clients, and exchanges that facilitate securities transactions contend with SEC rules and regulations, as well as the supervision of the Financial Industry Regulatory Authority (FINRA).<sup>19</sup> The oversight of broker-dealers is primarily effectuated by FINRA, who investigates and adjudicates disputes as to broker-dealer misconduct.<sup>20</sup> Platforms that connect buyers and sellers of securities are likewise regulated by the SEC and FINRA respectively, though the allocation of responsibility between the can become blurred at times.<sup>21</sup> The SEC retains special authority when it comes to exchange regulation.<sup>22</sup>

#### *b. Broker-Dealer Registration*

---

<sup>16</sup> Legislation has historically reflected the principle that different markets and different products necessitate varying degrees of regulation—speculative instruments, like derivatives and securities, are ones that lawmakers deem especially important to regulate due to their ability to wreak havoc on world economies. *See e.g.*, *Justh v. Holliday*, 2 Mackey 346 (D.C. 1883) (discussing the reason to outlaw contracts that do not contemplate actual delivery of an asset, but rather obligate payment based on the rise and fall of the market); *see also* *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 390 (1982) (stating that “[a]lthough the speculator has never been the favorite of Congress, Congress recognized his crucial role in an effective and orderly futures market and intended him to be protected by the statute as much as the hedger”). *See also*, *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (describing how securities laws were intended to reach “[n]ovel, uncommon, or irregular devices, whatever they appear to be” if the surrounding circumstances suggest such is the case).

<sup>17</sup> Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2012). Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-nn (2012). 15 U.S.C. § 78d.

<sup>18</sup> Congress opted to permit broker-dealers to self-regulate as a first line of control under the supervision of the SEC. FINRA resulted from the 2007 merger of the National Association of Securities Dealers (NADS) and the regulatory unit of the New York Stock Exchange (NYSE). *See* JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 16–17, 1021–23 (5<sup>th</sup> ed. 2006).

<sup>19</sup> JOHN C. COFFEE, JR. ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 685 (13<sup>th</sup> ed. 2015). Futures commission merchants (FCMs), professionals that make a market in derivatives, face regulation from the CFTC and the National Futures Association (NFA), the futures equivalent to FINRA. RONALD H. FILLER AND JERRY W. MARKHAM, *REGULATION OF DERIVATIVE FINANCIAL INSTRUMENTS (SWAPS, OPTIONS, AND FUTURES)* 63–64 (West Academic 2014).

<sup>20</sup> However, brokerages and individuals can face simultaneous enforcement actions from both entities. *See* Samuel Rubinfeld, *Compliance Officers Targeted in SEC Action Against Broker-Dealer*, *THE WALL STREET JOURNAL* (Mar. 29, 2018), available at

<https://blogs.wsj.com/riskandcompliance/2018/03/29/compliance-officers-targeted-in-sec-action-against-broker-dealer/> (describing how the brokerage had to pay a \$750,000 fine to the SEC a \$550,000 one to FINRA for failing to report suspicious transactions related to money laundering and market manipulation). Two of the brokerage’s compliance officer were charged with aiding and abetting the violations. *Id.*

<sup>21</sup> *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, *GEORGETOWN LAW FACULTY WORKING PAPERS* 5 (Sept. 2008) (“Because there are important exceptions and a substantial level of SEC oversight, there is a blurring of any clear distinction in the allocation of responsibility.”).

<sup>22</sup> COFFEE, JR. ET AL. at 640.

The Exchange Act defines a “broker” generally as “any person engaged in the business of effecting transactions in securities for the account of others.”<sup>23</sup> It defines a “dealer” as more like a principal than an agent, describing them as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.”<sup>24</sup> The phrase “in the business” distinguishes professionals in the industry from active private investors.<sup>25</sup> A person executing orders on a securities exchange clearly acts as a broker; however, in many other arrangements, the answer is less clear.<sup>26</sup>

With few exceptions, the Exchange Act requires broker-dealers to register with the SEC on Form BD, which requires extensive information regarding the broker’s finances, control persons, policies and procedures aimed at effectuating compliance, and certain information regarding criminal or civil proceedings against the brokerage or involved individuals.<sup>27</sup> Even if securities are “exempted securities” under the Exchange Act, such as those sold pursuant to Regulation D, brokers-dealers must still register.<sup>28</sup> Brokers must additionally register with a SRO)and in each state the broker plans to conduct business—both of which are also accomplished through Form BD.<sup>29</sup>

### *c. Exchange Registration*

“Exchange” is defined in the Act as “any organization, association, or group of persons” that “constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities” or performs the functions “with respect to securities” usually associated with a stock exchange “as the term is generally understood.”<sup>30</sup> The language was carefully selected to give the SEC maximum authority over the markets.<sup>31</sup>

Section 5 of the 1934 Act makes it unlawful for brokers or dealer to conduct business on an “exchange” unless it is registered with the SEC pursuant to Section 6 or is exempt from registration.<sup>32</sup> Section 6 treats exchanges as “organizations created and run by broker-members.”<sup>33</sup> Entities deemed to be exchanges must observe specific self-regulatory obligations and SEC approval mechanisms.<sup>34</sup> Once registered, exchanges must comply with a

---

<sup>23</sup> See § 3(a)(4).

<sup>24</sup> See § 3(a)(5).

<sup>25</sup> JOHN C. COFFEE, JR. ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 693 (13th ed. 2015).

<sup>26</sup> See *e.g.*, *SEC v. Ridenour*, 913 F. 2d 515 (8th Cir. 1990)(holding that the trader was “in the business” considering his “level of activity” in trading bonds on his own account and for institutional clients and the open, public, and regular characteristics of his behavior).

<sup>27</sup> See SEC, *Guide to Broker-Dealer Registration*, Division of Trading and Markets (April 2008), available at <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html#1>.

<sup>28</sup> See 17 CFR 230.500 (Regulation D).

<sup>29</sup> SEC, *Uniform Application for Broker Dealers (Form BD)*, available at <https://www.sec.gov/files/formbd.pdf>. See also SEC, *Guide to Broker-Dealer Registration*, Division of Trading and Markets (April 2008), available at <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html#1>.

<sup>30</sup> See § 3(a)(1).

<sup>31</sup> See *Board of Trade of the City of Chicago v. SEC*, 923 F.2d 1270 (7th Cir. 1991).

<sup>32</sup> *Id.* at 527.

<sup>33</sup> *Id.* at 528.

<sup>34</sup> COFFEE, JR. ET AL. at 640.

lity of obligations, such as adopting rules that “assure a fair representation of its members” on its board and prevent “unfair discrimination” between brokers.<sup>35</sup>

d. *Neither Fish Nor Fowl: The Emergence of Alternative Trading Systems*<sup>36</sup>

Innovative trading platforms produced by advances in computer technology challenged general understandings of what a “stock exchange” is.<sup>37</sup> Increased institutional trading, together with new technology, provided for the development of proprietary trading systems, also called the “fourth market,” where large traders could transact directly without any “specialist” or “market maker” on the floor placing orders.<sup>38</sup> The SEC appeared to accept the development of proprietary trading.<sup>39</sup>

Delta, a proprietary trading system that emerged to host options on government securities, posed a striking dilemma for the Seventh Circuit with regards to the confines of the term “exchange.”<sup>40</sup> Delta was an “ingenious device” made up of several entities, including a bank, broker, and clearing agency, that provided an electronic marketplace for facilitating the matching of trades on the options.<sup>41</sup> In determining that Delta was not an exchange under the 1934 Act, the Court seemed to take into account that the particular market would have ceased to exist if registration was required.<sup>42</sup>

e. *Regulation ATS*

In 1998, the SEC memorialized modified rules for electronic exchanges that entail reduced registration requirements and self-regulatory obligations.<sup>43</sup> Regulation ATS permits broker-dealers to operate automated trading platforms, or “alternative trading systems,” to collect and execute securities orders electronically without registering as a national securities exchange under Section 6 or an exempt exchange under Section 5.<sup>44</sup>

f. *Liability for Unregistered Securities*

Brokers owe certain regulatory duties to its clients such as the duty to “conduct a reasonable inquiry” into the status of products offered as part of their services—whether they

---

<sup>35</sup> See § 6(b)(3)-(5).

<sup>36</sup> See *Board of Trade of the City of Chicago v. SEC*, 883 F. 2d 525, 535 (7th Cir. 1989) (describing the proprietary system at issue as “neither an exchange after the pattern of the New York Stock Exchange nor an over-the-counter market after the fashion of the NASDAQ). “A desire to keep the law ‘up to date’ does not justify departure from its rules.” *Id.* at 535.

<sup>37</sup> *Id.*

<sup>38</sup> COFFEE, JR. ET AL. at 640–641 (describing Instinet as the initial alternative trading systems, which commenced operations in 1969 and allowed subscribers to execute transactions automatically based upon the prices of primary exchanges or advertise another price through its computer facility and engage in direct negotiations with parties).

<sup>39</sup> *Id.*

<sup>40</sup> See *Board of Trade of the City of Chicago v. SEC*, 923 F.2d 1270 (7th Cir. 1991).

<sup>41</sup> *Id.* at 1271.

<sup>42</sup> *Id.* at 1272–1273 (stating that the “system would be kaput” and also noting the adequacy of existing regulation as it applied to parties involved with the Delta platform).

<sup>43</sup> 17 CFR 242.300 et seq.

<sup>44</sup> *Id.*

were securities or not.<sup>45</sup> Platforms that host products that constitute securities and are not properly licensed to do such will face the crushing liability of enforcement by the SEC.<sup>46</sup>

### III. PRIMER ON VIRTUAL CURRENCIES AS INVESTMENTS

#### a. *Virtual Currency Products*

The emergence of complex blockchain assets places special importance on the defining qualities of such instruments, as those attributes will dictate the proper jurisdiction of regulatory authority.<sup>47</sup> While some virtual currencies in fact operate like actual currency, others broadly categorized as virtual currencies represent something more like securities, commodities, software applications, access to certain products or services, or like completely novel hybrid instruments.<sup>48</sup>

The inherent novelties of cryptocurrencies make it difficult to ascertain their standing under the law and the appropriate agency of oversight. The SEC asserted that, while not all virtual currencies constitute securities, most of the blockchain tokens resulting from so-called initial coin offerings (ICOs) involve the sale of unregistered securities.<sup>49</sup> The Commodity Futures Trading Commission (CFTC) purported that virtual currencies like bitcoin are properly categorized as “commodities” under the Commodity Exchange Act (CEA).<sup>50</sup> The Internal Revenue Service (IRS) calls them “property” and taxes them as such.<sup>51</sup> States have also attempted to define virtual currencies, varying from classifications as “alternative currency” to explicit exclusions from the definition of “money.”<sup>52</sup> According to one U.S. representative, virtual currencies are simply just a “crock,” allowing men to sit in their pajamas all day and tell

---

<sup>45</sup> SEC Press Release, Merrill Lynch Charged With Gatekeeping Failures in the Unregistered Sales of Securities (Mar. 8, 2018), available at <https://www.sec.gov/news/press-release/2018-32> (describing the important “gatekeeping” functions of broker-dealers).

<sup>46</sup> *Id.*

<sup>47</sup> See *Chicago Mercantile Exchange v. Securities & Exchange Commission*, 883 F.2d 537 (7<sup>th</sup> Cir. 1989).

<sup>48</sup> *Id.*

<sup>49</sup> See Dave Michaels, Paul Vigna, *SEC Chief Fires Warning Shot Against Initial Coin Offerings*, THE WALL STREET JOURNAL (Nov. 9, 2017), available at <https://www.wsj.com/articles/sec-chief-fires-warning-shot-against-coin-offerings-1510247148>.

<sup>50</sup> See *In the Matter of Coinflip Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (Sept. 17, 2015); *In re TeraExchange LLC*, CFTC Docket No. 15-33, 2015 WL (CFTC Sept. 24, 2015); CFTC, *A CFTC Primer on Virtual Currencies*, Lab CFTC, 14 (Oct. 17, 2017). The CFTC’s jurisdiction is invoked where a virtual currencies are used “in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.” *Id.* “Beyond instances of fraud or manipulation, the CFTC generally does not oversee ‘spot’ or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing.” *Id.*

<sup>51</sup> IRS Virtual Currency Guidance: Virtual Currency Is Treated As Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply, IR-2014-36 (March 25, 2014).

<sup>52</sup> See e.g., Illinois Department of Financial and Professional Regulation, Digital Currency Regulatory Guidance, (July 13, 2017) (stating digital currencies are not “money” under the Transmitters of Money Act and therefore “[a] person or entity engaged in the transmission of solely digital currencies” would not be required to obtain license); Cal. AB-129 (the “Alternative Currencies Act”) (amending Cal. Corp. Code § 107 which previously stated that “[n]o corporation, social purpose corporation, association, or individual shall issue or put in circulation, as money, anything but the lawful money of the United States”).



their wives they're going to be millionaires.”<sup>53</sup> The following section describes some of the various virtual currency products available in the marketplace.

*i. Pure Virtual Currencies*

As their name implies, some virtual currencies provide an alternate to traditional fiat currencies—bitcoin can be classified as a pure virtual currency that can function as a medium of exchange, unit of account, or store of value.<sup>54</sup> The IRS identified virtual currencies that have “an equivalent value in real currency” or “act as a substitute for real currency” convertible virtual currencies.<sup>55</sup>

*ii. Tokens*

Businesses and entrepreneurs have cashed in on the enthusiasm surrounding cryptocurrencies among investors by using blockchain technologies to modernize means of capital formation through token sales or so-called initial coin offerings (ICOs) utilizing Ethereum’s blockchain.<sup>56</sup> ICOs gained mainstream notoriety in 2017 where upwards of \$5 billion was raised.<sup>57</sup> ICOs involve a form of crowdfunding that employs fundamental aspects of bitcoin’s underlying infrastructure for the distribution, or promised distribution, of tokenized assets over a decentralized network.<sup>58</sup> Whereas pure cryptocurrencies utilize their own native

---

<sup>53</sup> Rep. Brad Sherman (D-Calif.), Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled “Examining Cryptocurrencies and ICO Markets” (March 14, 2018) (stating that ICOs have been used to commit fraud, evade taxes, and support terrorist and criminal organizations).

<sup>54</sup> Financial Crimes Enforcement Network, Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FIN-2013-G001 (March 18, 2013). FinCEN alerted Congress that it perceives many ICO issuers to be unlicensed money transmitters, violations punishable by criminal sanctions. FinCEN, Drew Maloney, Assistant Secretary of Legislative Affairs, Letter to Senator Ron Wyden (Feb. 13, 2018).

<sup>55</sup> IRS Virtual Currency Guidance: Virtual Currency Is Treated As Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply, IR-2014-36 (March 25, 2014) (noting that bitcoin can “can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies”).

<sup>56</sup> The development of the Ethereum network provided an infrastructure upon which any number of “smart contracts” and decentralized applications (dApps) could be programmed. *Id.* at 52 (describing “smart contracts” as “conditional transactions” based on logic written into code). The scalability of the network allowed for the development of tokens on Ethereum’s public blockchain, typically using the ERC-20 infrastructure. *See* Dmitry Khovratovich, Mikhail Vladimirov, *Secure Token Development and Deployment*, University of Luxembourg and ABDK Consulting (2015).

<sup>57</sup> *See* Daniel Diemers, Initial Coin Offerings, A Strategic Perspective: Global and Switzerland, PWC, Crypto Valley (Dec. 21, 2017), available at [https://cryptovalley.swiss/wp-content/uploads/20171221\\_PwC-S-CVA-ICO-Report\\_December\\_final.pdf](https://cryptovalley.swiss/wp-content/uploads/20171221_PwC-S-CVA-ICO-Report_December_final.pdf).

<sup>58</sup> Token developers typically announce their sale through “whitepapers,” akin to the piece that introduced Bitcoin in 2008, which usually describe the team behind the project, the business’s operations, the offering’s goals and limits, the duration of the sale, and the technology behind the product. *See e.g.*, Protocol Labs, Filecoin: A Decentralized Storage Network (Aug. 14, 2017). Developers may also face liability for statements in whitepapers—for example, participants in the “ATB Coin” ICO filed a class action lawsuit alleging violations of Sections 12(a)(1) and 15(a) of the 1933 Act. ATB’s whitepaper promised “the fastest blockchain-based cryptographic network in the Milky Way galaxy” that would “deliver blazing fast, secure and near-zero cost payments to anyone in the world. While ATB’s blockchain did eventually launch, it failed to live up to the hype of the promoters with minimal adoption and slow speeds. *See* Complaint, Raymond Balestra v. ATBCOIN LLC, et al., No. 17-10001 (Dec. 21, 2017). Between June

blockchains, tokens are typically developed on top of existing networks and possess little to no value outside of their respective network.<sup>59</sup>

### *iii. Securities*

Some tokens will clearly constitute securities, though most do not purport to confer any equity or dividend rights.<sup>60</sup> In some instances, tokens serve a “functional use that is unregulated, such as prepayment for access to a product or service that is to be developed using funds raised in the ICO.”<sup>61</sup> Many argue that this utility distinguishes certain tokens from securities, though purchasers may still seek return on their investment through increased adoption of the network or the value of exchange on the secondary market.<sup>62</sup>

Scarce tokens operate like “digital commodities” whereas “promises of future tokens are securities.”<sup>63</sup> Anyone engages in the business of trading products that could constitute as security tokens must consider whether their activities require them to register with the SEC as a broker-dealer, exchange, or ATS.<sup>64</sup>

### *iv. Derivatives*

---

12, 2017 and September 15, 2017, the unregistered offering purportedly raised over \$20 million in cryptocurrencies from investors through multiple rounds of funding. *Id.* at 2.

<sup>59</sup> ANTONOPOULOS at 109 (“Bitcoin isn’t what you think it is. It’s a platform. It’s not a payment network. It’s not a currency. It’s not a banking system. It’s a platform that guarantees certain trust functions.”). Additionally, bitcoin serves different purposes for different individuals—recent research reveals that approximately two-thirds of bitcoin is held as a store of value, whereas only one-third is used as a means of exchange. *See* Jeff John Roberts and Nicolas Rapp, *Nearly 4 Million Bitcoins Lost Forever, New Study Says*, FORTUNE (Nov. 25, 2017), available at <http://fortune.com/2017/11/25/lost-bitcoins/>. *See* Peter Van Valkenburg, *Framework for Securities Regulation of Cryptocurrencies*, COIN CENTER, 1–2 (Jan. 2016).

<sup>60</sup> *See* Overstock Registration Statement (Form S-3), at 34 (Nov. 10, 2015) (describing how the shares will have the same rights, but be settled differently).

<sup>61</sup> Gibraltar Financial Services Commission, Statement on Initial Coin Offerings (Sept. 22, 2017), available at <http://www.gfsc.gi/news/statement-on-initial-coin-offerings-250>.

<sup>62</sup> *See e.g.*, Complaint, Jacob Zowie Thomas Rensel v. Centra Tech, Inc. et al., 20 (S.D. Fla. Dec. 13, 2017) (addressing how Centra’s whitepaper described the CTR Tokens as utility tokens such that they are not securities). *See also* Mike Orcutt, *2017 Was the Year of the ICO—Now What?*, MIT TECHNOLOGY REVIEW (Dec. 28, 2017), available at <https://www.technologyreview.com/s/609633/2017-was-the-year-of-the-ico-now-what/>. Several regulatory bodies have explicitly excluded utility tokens from securities regulation. *See e.g.*, Swiss Financial Market Supervisory Authority (FINMA), *Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)*, 4–5 (Feb. 16, 2018); H.B. 0070, 2018 Gen. Sess., Budget Sess. (Wyo. 2018). Switzerland’s financial regulator released guidelines in which it provided that utility tokens will not be treated as securities when “their sole purpose is to confer digital access rights to an application or service” and the token can be used in that way at the point of issue.” FINMA at 4–5. FINMA stated that, in that case, the tokens function to grant access rights and the link to capital markets typically present in the case of securities is missing. *Id.*

<sup>63</sup> Peter Van Valkenburgh, Director of Research, CoinCenter, Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled “Examining Cryptocurrencies and ICO Markets” (March 14, 2018).

<sup>64</sup> Lee A. Schneider, Steven J. Slutzky, Samuel E. Proctor, Lilya Tessler, *Debevoise & Plimpton Discusses SEC View of Blockchain Tokens as Securities*, The CLS Blue Sky Blog (Aug. 2, 2017), available at <http://clsbluesky.law.columbia.edu/2017/08/02/debevoise-plimpton-discusses-sec-view-of-blockchain-tokens-as-securities/>.

New and existing exchanges have begun to offer cryptocurrency-based derivatives, a type of financial instrument that offers risk-mitigating functions and allows parties to exchange values based on an asset without necessarily owning it.<sup>65</sup> With CFTC approval, LedgerX officially became the first federally-regulated bitcoin derivatives clearing and execution facility.<sup>66</sup> LedgerX co-founder and CEO, Paul Chou, emphasized the role of the CFTC in setting an example, globally, of what a “well-licensed clearinghouse and exchange based around digital currencies will look like.”<sup>67</sup> Chou clarified that LedgerX will likely not host products of ICOs.<sup>68</sup>

### *b. Virtual Currency Exchanges*

Just as the products loosely categorized as virtual currencies vary in their types and purposes—some function as alternative currencies, some represent stakes in companies, and some give the holder access to software, goods, and services—the exchanges that facilitate their transactions differ in their qualities and features.<sup>69</sup> Some appear very similar to legacy exchanges, like the NYSE, though they are typically not similarly registered with the SEC and thus cannot provide investors with the same level of confidence.<sup>70</sup> The next section provides an introduction to the variety of platforms that facilitate transactions in virtual assets.

#### *i. The Rise of Coinbase*

Coinbase, the San Francisco startup founded in 2012, is one of the largest virtual currency exchanges with over 10 million users and daily transactions volumes reaching \$215

---

<sup>65</sup> A derivative is defined as “a bilateral contract or payments exchange agreement whose value derives...from the value of an underlying asset or underlying reference rate or index.” Global Derivatives Study Group of the Group of Thirty, *Derivatives: Practices and Principles* 28 (1993). Derivatives occupy a unique position under the law in that some will be regulated by the SEC and others by the CFTC, depending on the intricacies of the contract. See RONALD H. FILLER AND JERRY W. MARKHAM, *REGULATION OF DERIVATIVE FINANCIAL INSTRUMENTS (SWAPS, OPTIONS, AND FUTURES)* 63–64 (West Academic 2014).

<sup>66</sup> CFTC, CFTC Grants DCO Registration to LedgerX LLC, Press Release (July 24, 2017) available at <http://www.cftc.gov/PressRoom/PressReleases/pr7592-17> (last visited Nov. 7, 2017). In granting this, the Commission acknowledged LedgerX’s compliance with its “Core Principles” through its fully-collateralized clearing model. See CFTC, Letter No. 17-35, RE: Request for Exemptive Relief for Certain Derivatives Clearing Organization Regulations (July 24, 2017).

<sup>67</sup> Michael del Castillo, *Start Your Hedging: LedgerX to Begin Trading Cryptocurrency Derivatives*, COINDESK (July 24, 2017) (quoting LedgerX co-founder and CEO Paul Chou), available at <https://www.coindesk.com/start-hedging-ledgerx-begin-trading-cryptocurrency-derivatives/> (last visited Nov. 7, 2017).

<sup>68</sup> *Id.*

<sup>69</sup> See *infra* Section III(b)(i)–(iv) (juxtaposing different types of virtual currency exchanges).

<sup>70</sup> “[T]here is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation.” SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017).

million.<sup>71</sup> It provides liquidity and access to the previously niche market to millions.<sup>72</sup> It provides a platform for the exchange of various fiat currencies into the digital assets bitcoin, bitcoin cash, ether, and Litecoin.<sup>73</sup> Released in late 2017, its Digital Asset Framework outlines the analysis entailed in considering new assets for listing.<sup>74</sup> Coinbase announced the development of support for ERC-20 tokens, though it reiterated no concurrent plans to list any new “assets.”<sup>75</sup>

## *ii. Other Centralized Virtual Currency Exchanges*

Other virtual currency exchanges, such as Kraken, Bittrex, Poloniex, and Binance to name a few, have exchanges emerged to rival Coinbase, operating under similar centralized frameworks comparable to legacy stock exchanges.<sup>76</sup> The exchanges have varied in their approaches to compliance—Bittrex purports to use a “robust digital token review process to ensure the tokens listed on the exchange are compliant with U.S. law and are not considered securities.”<sup>77</sup>

## *iii. Decentralized Exchanges*

Decentralized exchanges such as EtherDelta, Airswap, and BitShares, aim to solve the intermediary problem in virtual asset markets where private keys or assets are stored by central parties, increasing the risk for theft and hacking.<sup>78</sup> Decentralized exchanges bring the undeniable benefits found at the core of blockchain technologies and virtual currencies, though they may be disfavored by regulators due to the complexities in regulating them due, in part, to difficulty in

---

<sup>71</sup> Sam Bourgi, *Coinbase Is Helping the SEC Determine Which Crypto Assets are Security Tokens*, HACKED (April 10, 2018), available at <https://hacked.com/coinbase-is-helping-the-sec-determine-which-crypto-assets-are-security-tokens/> (asserting that, based upon market capitalization, Coinbase is the ninth largest exchange in world). Coinbase recently acquired virtual currency startup Earn.com, pursuant to which it valued itself at about \$8 billion, following its \$1.6 billion evaluation in summer 2017. Theodore Schleifer, *Cryptocurrency Exchange Coinbase Recently Tried to Value Itself at \$8 Billion*, RECODE (April 27, 2018), available at <https://www.recode.net/2018/4/27/17287184/coinbase-earn-acquisition-stock-valuation-eight-billion-earn>.

<sup>72</sup> Coinbase, “About Coinbase,” available at <https://www.coinbase.com/about?locale=en-US>.

<sup>73</sup> *Id.*

<sup>74</sup> Global Digital Asset Exchange, GDAX Digital Asset Framework (Nov. 2017).

<sup>75</sup> See Evelyn Cheng, *The SEC Just Made it Clearer that Securities Laws Apply to Most Cryptocurrencies and Exchanges Trading Them*, CNBC (Mar. 7, 2018), available at <https://www.cnbc.com/2018/03/07/the-sec-made-it-clearer-that-securities-laws-apply-to-cryptocurrencies.html>; Coinbase, *Adding ERC20 Support to Coinbase* (Mar. 26, 2018), available at <https://blog.coinbase.com/adding-erc20-support-to-coinbase-fe9cba6782b>.

<sup>76</sup> See Cheng *supra* note 66.

<sup>77</sup> *Id.* See also Canadian cryptocurrency exchange CoinField claims to analyze and evaluate each coin it lists to certify that they are commodities and not securities—it indicated that the 10 new crypto products it announced in April 2018 met that standard. See Della Dibaj, *CoinField, the Canadian Cryptocurrency Exchange, Adds 10 New Coins in 2018*, NASDAQ GLOBAL NEWSWIRE (April 18, 2018), available at <https://globenewswire.com/news-release/2018/04/19/1482111/0/en/CoinField-the-Canadian-Cryptocurrency-Exchange-Adds-10-New-Coins-in-2018.html>.

<sup>78</sup> See Lindsay Lin, *Regulatory Strategy for Tokenization and ICOs*, Stellar (Oct. 4, 2017), available at <https://www.stellar.org/blog/regulatory-strategy-for-tokenization-and-ico/> (“[I]t is uncertain whether decentralized systems would escape SEC jurisdiction. If an organization controls the hosting, maintenance, and operation of a decentralized exchange protocol, this may invoke broker-dealer and ATS regulatory requirements.”).

determining their location of origin.<sup>79</sup> Some decentralized exchanges can be categorized as Electronic Communication Networks (ECN), which are regulated by the SEC as ATSs pursuant to Regulation ATS.<sup>80</sup>

#### *iv. Registered Exchanges Offering Virtual Assets*

Some crypto exchanges have noted the shifting regulatory ecosystem and registered with the SEC as a broker-dealer or ATS.<sup>81</sup> Coinbase is not currently registered with the SEC as a broker-dealer, though it is allegedly considering registration as a means to allow it to host additional assets such as security tokens produced by ICOs.<sup>82</sup>

Additionally, many legacy financial professionals and entities have begun offering virtual currency products to clients, battling for valuable business with industry newcomers whose practice is specifically tailored to the neoteric asset class.<sup>83</sup> The Chicago Mercantile Exchange (CME), the largest futures exchange, began offering bitcoin derivatives in 2017.<sup>84</sup> Nasdaq announced that it will consider establishing a virtual currency exchange once the outstanding regulatory issues are better settled.<sup>85</sup>

### **IV. CRYPTO EXCHANGES UNDER FIRE**

Virtual currency exchanges have faced increased regulatory scrutiny recently due to increased transaction volumes, the indeterminate legal status of the assets they host, several widely-publicized and injurious hackings, and instances of suspected fraudulent behavior.<sup>86</sup> This

---

<sup>79</sup> See Coinist, *Decentralized Exchanges* (2018), available at <https://www.coinist.io/decentralized-exchanges/> (purporting that bitcoin was created as an alternative to centralized currency such that the evolution of decentralized exchanges is a natural phenomenon).

<sup>80</sup> *Id.*

<sup>81</sup> See e.g., TechStartups Team, *Cryptocurrency Startup VRBex is Launching U.S. Regulatory Compliant Cryptocurrency and Security Token Exchange*, TechStartups.com (April 23, 2018), available at <https://techstartups.com/2018/04/23/cryptocurrency-startup-vrbex-launching-u-s-regulatory-compliant-cryptocurrency-security-token-exchange/> (describing a domestic exchange with plans to register as a fully-compliant platform for virtual currency transactions).

<sup>82</sup> See Dave Michaels, *Cryptocurrency Firm Coinbase in Talks to Become SEC-Regulated Brokerage*, THE WALL STREET JOURNAL (APRIL 6, 2018), available at <https://www.wsj.com/articles/cryptocurrency-firm-coinbase-in-talks-to-become-sec-regulated-brokerage-1523043315> (explaining how tokens have made it harder “for platforms to continue shunning regulation”). It has been reported that one other firm dealing in cryptocurrencies, Templum, has registered with the SEC as a broker-dealer and ATS. Templum has allegedly requested that the SEC allow illegal tokens to remediate their status through proper registration. *Id.*

<sup>83</sup> See *infra* Section III(b)(i)–(iv) (describing exchanges that facilitate virtual currency transactions).

<sup>84</sup> CME Group, *CME Group Announces Launch of Bitcoin Futures*, News Release (Oct. 31, 2017), available at [http://www.cmegroup.com/media-room/press-releases/2017/10/31/cme\\_group\\_announceslaunchofbitcoinfutures.html](http://www.cmegroup.com/media-room/press-releases/2017/10/31/cme_group_announceslaunchofbitcoinfutures.html).

<sup>85</sup> Kate Rooney, *Nasdaq is open to becoming cryptocurrency exchange, CEO says*, CNBC (April 25, 2018), available at <https://www.cnbc.com/2018/04/25/nasdaq-is-open-to-becoming-cryptocurrency-exchange-ceo-says.html>.

<sup>86</sup> Coincheck, one of the largest Asian cryptocurrency exchanges, was hacked in December 2017 to the detriment of \$530 million, impacting close to 300,000 investors. See *How to Steal \$500 Million in Cryptocurrency*, BLOOMBERG (Jan. 31, 2018), available at <http://fortune.com/2018/01/31/coincheck-hack-how/>.

section depicts the present and evolving regulatory atmosphere facing exchanges and professionals that enable virtual currency transactions.

*a. Federal Regulators: The SEC and FINRA*

SEC Chairman Jay Clayton warned market professionals against promoting the offer or sale of cryptocurrencies, coins, or tokens “without first determining whether the securities laws apply to those actions.”<sup>87</sup> He cautioned that those who operate platforms to facilitate transaction in those products may be operating as unregistered broker-dealers.<sup>88</sup> Pursuant to its sweeping virtual currency probe, the SEC issued subpoenas and information request to players in the crypto space, including token issuers, exchanges, lawyers, advisers, and investors.<sup>89</sup>

The SEC’s Office of Compliance Inspections and Examinations (OCIE)’s 2018 report asserted that as the number of broker-dealers and investment advisors engaged in the space continues to grow, it will focus on “whether financial professionals maintain adequate controls and safeguards to protect these assets” and “whether financial professionals are providing investors with disclosure about the risks associated with these investments.”<sup>90</sup> Similarly, in FINRA’s 2018 regulatory examination and policies letter, FINRA’s president, Robert Cook, promised to focus on high-risk brokers and continue to investigate “broker-dealers’ involvement with initial coin offerings and related activities.”<sup>91</sup>

*b. State Regulators: New York’s “Virtual Currency Integrity Initiative”*

Following suit of the SEC, New York Attorney General Eric Schneiderman announced his office’s “Virtual Currency Integrity Initiative,” which seeks to investigate the operations of the platforms that facilitate trading in cryptocurrencies to ensure that they adequately serve and protect investors.<sup>92</sup> Schneiderman reported that his office sent information requests and questionnaires to 13 major cryptocurrency exchanges, including Coinbase’s GDAX exchange and the New York-based Gemini exchange.<sup>93</sup> The inquiries request information regarding the exchanges’ operations, security, disclosures, internal controls, conflicts of interests, and other

---

<sup>87</sup> SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

<sup>88</sup> *Id.*

<sup>89</sup> See Richard M. Rosenfeld, Matthew Rossi, and Alex C. Lakatos, Mayer Brown LLP, *The SEC and Virtual Currency Markets*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 24, 2018), available at <https://corpgov.law.harvard.edu/2018/03/24/the-sec-and-virtual-currency-markets/#3b>. These requests typically instruct the recipient to supply the SEC with an array of information, such as lists of investors, organizational structures, the amount raised and its location, marketing materials, and people involved. The SEC often provides no basis for the request and sets a 14-day deadline for compliance, whereby failure to comply can lead to an enforcement action, injunction, asset freeze, or other charge. See Jean Eaglesham and Paul Vigna, *Cryptocurrency Firms Targeted in SEC Probe*, WALL STREET JOURNAL (Feb. 28, 2018).

<sup>90</sup> SEC, 2018 National Exam Program Examination Priorities, Office of Compliance Inspections and Examinations (Feb. 7, 2018).

<sup>91</sup> FINRA, 2018 Regulatory and Examination Priorities Letter (Jan. 8, 2018), available at <https://www.finra.org/industry/2018-regulatory-and-examination-priorities-letter>.

<sup>92</sup> See Rob Daly, *New York AG Launches Crypto Investigation*, MARKETSMEDIA (April 17, 2018), available at <https://www.marketsmedia.com/new-york-ag-launches-crypto-investigation/>.

<sup>93</sup> *Id.*

policies in order to “increase transparency and accountability in the virtual currency marketplace.”<sup>94</sup>

The Initiative follows the state’s earlier attempt at regulating the unregulated virtual currency industry. In 2015, the New York State Department of Financial Services (NYSDFS) enacted its controversial BitLicense, which entails extensive licensure requirements for businesses handling virtual currencies.<sup>95</sup> The regulation was challenged in the court and condemned for its chilling effect on New York businesses.<sup>96</sup> With only three companies being granted BitLicenses as of January 2017, some state representatives have expressed openness to reform of the statute.<sup>97</sup>

While it is uncertain whether the Attorney General’s investigation will yield any enforcement proceedings or impact legislative reform at the state level, it indicates that regulators will continue to pay close attention to conduct in the virtual currency space that challenges the fairness and integrity of the financial markets. The exchanges’ responses will be telling with regards to whether self-regulation in the virtual currency industry is adequate to achieve the goals of regulators or whether additional steps need to be taken to police these new products. Entities that fail adopt some method of self-regulation will likely not make it through the ongoing investigations unscathed.

## **V. PROBLEMS IN THE CURRENT REGULATORY ENVIRONMENT**

Presuming that all tokens are securities in a hasty response to prevalent fraud in the market operates to obscure the intentions of securities laws. Likewise, asserting that all virtual currencies are properly defined as commodities misinterprets the complexities involved in the array of products called virtual currencies. The proceeding section details issues lingering in the current regulatory approaches to regulating cryptocurrencies in the United States.

### *a. Indeterminate Status of Assets and Excessive Compliance Costs*

*As soon as there is more regulatory clarity than there currently is you would expect us to start listing more assets.*<sup>98</sup>

Broker-dealers have petitioned the SEC for clearer guidelines when it comes to blockchain products, asserting that in the context of the highly-regulated industry you can’t leave it to “facts and circumstances.”<sup>99</sup> The prevalent uncertainty operates as a market distraction and

---

<sup>94</sup> *Id.*

<sup>95</sup> 23 NYCRR § 200.

<sup>96</sup> See Theo Chino v. Dep’t of Fin. Serv. et al., Index No. 101880/15 (N.Y. Sup. Ct. Oct. 10, 2017).

<sup>97</sup> See *infra* Section V(c) (addressing the inconsistencies among different states’ treatments of virtual currencies).

<sup>98</sup> See Dave Michaels, *Cryptocurrency Firm Coinbase in Talks to Become SEC-Regulated Brokerage*, THE WALL STREET JOURNAL (APRIL 6, 2018), available at <https://www.wsj.com/articles/cryptocurrency-firm-coinbase-in-talks-to-become-sec-regulated-brokerage-1523043315> (quoting Coinbase President Asiff Hirji).

<sup>99</sup> Stan Higgins, *Broker-Dealer Renews Call for ICO Rules After SEC Release*, COINDESK (Aug. 3, 2017), available at <https://www.coindesk.com/broker-dealer-renews-call-blockchain-ico-rules-sec-release/>.

source of excessive compliance costs—Coinbase promoted that 20 percent of its workforce is dedicated towards compliance.<sup>100</sup>

Mike Lempres, Coinbase’s Chief Legal Officer, relayed to Congress that Coinbase is “waiting for the dust to settle between the SEC and CFTC,” arguing that the industry needs to know what the approach of regulators is going to be.<sup>101</sup> He purported that the SEC and CFTC need to be able to draw a line to clearly determine which tokens are securities and which are commodities for compliance purposes.<sup>102</sup> Lempres asserted, however, that the products offered by Coinbase have been sufficiently deemed by regulators to not be securities.<sup>103</sup>

Coinbase’s determinations are based significantly on the SEC’s July 2017 Report on The DAO, where it appeared to distinguish The DAO Tokens, which it deemed unregistered securities, from ether, a virtual currency.<sup>104</sup> The Report was the first regulatory indication that not all virtual assets constitute as securities.<sup>105</sup> It is possible, though, that ether is a security or was a security at some point and became a commodity.<sup>106</sup> In fact, a CFTC Commissioner supported the assertion that virtual assets may “transform” from securities to commodities or they may be

---

<sup>100</sup> See Mike Lempres, Chief Legal Officer, Coinbase, Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled “Examining Cryptocurrencies and ICO Markets” (March 14, 2018). Some asserted that these excessive compliance costs were nothing to be celebrated. See Robert Rosenblum, Partner, Wilson Sonsini Goodrich & Rosati, Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled “Examining Cryptocurrencies and ICO Markets” (March 14, 2018).

<sup>101</sup> Mike Lempres, Chief Legal Officer, Coinbase, Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled “Examining Cryptocurrencies and ICO Markets” (March 14, 2018).

<sup>102</sup> *Id.*

<sup>103</sup> “We are studiously avoiding listing tokens that could be determined to be securities because we are not currently licensed to trade securities and cannot take the risk of inadvertently trading an asset that is later found to be a security.” *Id.* But see SEC, Divisions of Enforcement and Trading and Markets, *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* (Mar. 7, 2018), available at <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading> (stating that “[a] number of these [virtual currency] platforms provide a mechanism for trading assets that meet the definition of a ‘security’ under the federal securities laws”).

<sup>104</sup> See Lee A. Schneider, Steven J. Slutzky, Samuel E. Proctor, Lilya Tessler, *Debevoise & Plimpton Discusses SEC View of Blockchain Tokens as Securities*, The CLS Blue Sky Blog (Aug. 2, 2017), available at <http://clsbluesky.law.columbia.edu/2017/08/02/debevoise-plimpton-discusses-sec-view-of-blockchain-tokens-as-securities/>.

<sup>105</sup> See Securities Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities and Exchange Act of 1934: The DAO (July 25, 2017) (stating that the DAO tokens qualified as “securities” under the *Howey* test but attempting to distinguish ether as a pure virtual currency), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>. Regulators are allegedly examining whether ether should be treated as a security under precedent and the law. See Kate Rooney, *Ethereum falls on report that the second-biggest cryptocurrency is under regulatory scrutiny*, CNBC (May 1, 2018), available at <https://www.cnbc.com/2018/05/01/ethereum-falls-on-report-second-biggest-cryptocurrency-is-under-regulatory-scrutiny.html> (describing ether’s 2014 creation as “probably an illegal securities sale,” which raised more than 31,000 bitcoins worth approximately \$18.3 million at that time). Additionally, Japan’s Financial Services Regulator (FSA) is contemplating whether privacy-focused virtual currencies, like Monero and Dash, should be banned due to their anonymity features, such that exchanges may be forced to cease hosting them. See Wilma Woo, *Japan Could Pressure Exchanges to Drop Monero and Dash: Reports*, BITCOINIST.COM (April 30, 2018), available at <http://bitcoinist.com/japan-pressure-exchanges-drop-monero-dash-reports/>.

<sup>106</sup> See Mechanical Markets, *If ETH Isn’t a Security Then Nothing Is* (Mar. 13, 2018), available at <https://mechanicalmarkets.wordpress.com/2018/03/13/ether-is-a-security/>.



securities that transform into commodities.<sup>107</sup> The timing of this transformation would have extensive implications for securities laws.<sup>108</sup>

*b. Regulation by Enforcement Ineffective*

Proponents for reform of America's securities laws describe SEC regulation of the securities industry as "heavy-handed, overly intrusive and enforcement dominated," calling it ineffective and unduly burdensome to global competitiveness.<sup>109</sup> Regulation by enforcement in this emerging and intricate arena is simply not effective.<sup>110</sup> Further, modern institutionalization of securities markets presents the questions of whether financial regulators are effectively protecting retail investors who invest through an intermediary and whether, in the face of new products that push jurisdictional bounds, the overarching framework is still ideal.<sup>111</sup>

*c. Hasty, Patchwork Regulation Exceedingly Harmful*

In response to assertion that Congress is not going to "sit by idly with a lack of protection for investors" in the virtual currency space,<sup>112</sup> several lawmakers expressed dismay with hasty laws from uninformed politicians.<sup>113</sup> Researchers and industry practitioners likewise cautioned against rushed, uncoordinated legislation that could create unnecessary harm and legal conflict.<sup>114</sup>

---

<sup>107</sup> Brian Quintenz, Comm'r, CFTC, Address to Georgetown University Law Center (Oct. 19, 2017) (stating that "[t]hey may start their life as a security from a capital-raising perspective but then at some point—maybe possibly quickly or even immediately—turn into a commodity").

<sup>108</sup> On one hand, if cryptocurrencies are "commodities" under the CEA, markets contend with the "principles-based" approach utilized by the CFTC, which promotes general principles and allows for flexibility in attaining general regulatory goals. On the other hand, if cryptocurrencies are "securities," participants encounter the "prescriptive-based" approach of the SEC, which entails specific and lengthy rules aimed at prohibiting specific conduct. See RONALD H. FILLER AND JERRY W. MARKHAM, REGULATION OF DERIVATIVE FINANCIAL INSTRUMENTS (SWAPS, OPTIONS, AND FUTURES) 61–68 (West Academic 2014). It was proposed that the SEC adopt a more principles-based regulatory approach like that of the CFTC. *Id.* at 68.

<sup>109</sup> See Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, Georgetown Law Faculty Working Papers, 6 (Sept. 2008).

<sup>110</sup> Robert Rosenblum, Partner, Wilson Sonsini Goodrich & Rosati, Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled "Examining Cryptocurrencies and ICO Markets" (March 14, 2018) (arguing that an immediate set of legislation is needed to to authorize the SEC and other regulators to modify the rules to facilitate capital development).

<sup>111</sup> *Id.* at 27.

<sup>112</sup> Rep. Bill Huizenga (R-Mich.), Chairman, Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled "Examining Cryptocurrencies and ICO Markets" (March 14, 2018).

<sup>113</sup> See Rep. Tom Emmer, Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled "Examining Cryptocurrencies and ICO Markets" (March 14, 2018) (arguing that Congress should avoid establishing a new agency of oversight for virtual currencies that could frustrate development); Annaliese Milano, *US Congressman: 'Race to Regulate' Won't Solve Crypto Fraud*, COINDESK (April 25, 2018), available at [https://www.coindesk.com/us-congressman-race-regulate-wont-solve-crypto-fraud/?utm\\_content=buffercb6b3&utm\\_medium=social&utm\\_source=twitter.com&utm\\_campaign=buffer](https://www.coindesk.com/us-congressman-race-regulate-wont-solve-crypto-fraud/?utm_content=buffercb6b3&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer) (discussing U.S. Congressman Patrick McHenry's statements cautioning against rushed virtual currency regulation and instead promoting that "existing rules should be aligned with new technology").

<sup>114</sup> See e.g., Mike Orcutt, *States that are passing laws to govern "smart contracts" have no idea what they're doing*, MIT TECHNOLOGY REVIEW (Mar. 29, 2018), available at <https://www.technologyreview.com/s/610718/states-that-are-passing-laws-to-govern-smart-contracts-have-no-idea-what-theyre-doing/>.

The regulation of virtual currencies is “not just anarchic between federal agencies potentially, it’s anarchic between federal and state regulators.”<sup>115</sup> States, like New York, have attempted to regulate in the space in “ambitious” efforts that have “chilled” development, while others have practiced more restraint in establishing working forces to study the technology and consider proper regulation.<sup>116</sup> For example, the Uniform Money Services Act expressly provides that registered broker-dealers and clearing agencies are exempted from money transmitter licensure requirements, whereas New York’s BitLicense contains no exemption.<sup>117</sup>

The potential for inconsistency stems not only from state legislation, but also from the rulings of the judiciary.<sup>118</sup> Investors have fled to the courts to file class actions in connection with virtual currency and ICO-related activities and state securities regulators have taken active stances in the space to varying degrees.<sup>119</sup> A recent Supreme Court case affirmed the jurisdiction of state courts to oversee class action claims brought under the 1933 Act, prompting some to argue that state courts could emerge as the preferred venue for class actions for cryptocurrency investors.<sup>120</sup>

## V. REGULATING VIRTUAL ASSETS AND THEIR PLATFORMS OF TRADE

*Sometimes the old fields must be fertilized by regulators in order to maximize their fruitfulness.*<sup>121</sup>

---

<sup>115</sup> See Peter Van Valkenburgh, Director of Research, COINCENTER, Securities, and Investment Hearing Entitled “Examining Cryptocurrencies and ICO Markets” (March 14, 2018); see also Daniel S. Alter, *BankThink SEC Can Help Clear Regulatory Path for Cryptocurrencies*, AMERICAN BANKER (April 5, 2018), available at <https://www.americanbanker.com/opinion/sec-can-help-clear-regulatory-path-for-crypto-trading> (“[I]n order to operate on a national scale, crypto exchanges and trading businesses have had to secure dozens of separate state permits — a complicated and expensive process that hardly promotes regulatory efficiency.”).

<sup>116</sup> *Id.* Maryland H.B. 1634; S.B. 1068.

<sup>117</sup> See Daniel S. Alter, *BankThink SEC Can Help Clear Regulatory Path for Cryptocurrencies*, AMERICAN BANKER (April 5, 2018), available at <https://www.americanbanker.com/opinion/sec-can-help-clear-regulatory-path-for-crypto-trading> (stating that it is unclear “whether and to what extent registered broker-dealers that engage in Virtual Currency Business Activity are exempt from licensing and other requirements” prescribed by BitLicense).

<sup>118</sup> See e.g., *CFTC v. McDonnell*, et al., No. 18-cv-361, ECF No. 29 (E.D.N.Y. Mar. 6, 2018) (holding that virtual currencies are “commodities”).

<sup>119</sup> Complaint, *Raymond Balestra v. ATBCOIN LLC*, et al., No. 17-10001 (Dec. 21, 2017); *StormsMedia, LLC v. Giga Watt, Inc.*, et al., No. 17-00438-SMJ (E.D. Wa. Dec. 28, 2017); Complaint, *Jacob Zowie Thomas Rensel v. Centra Tech, Inc.*, et al., No. 17-24500-JLK (S.D. Fla. Dec. 13, 2017).

<sup>120</sup> See *Cyan, Inc. v. Beaver Cty. Emples. Ret. Fund*, 2018 U.S. LEXIS 1912 (Mar. 20, 2018) (rejecting the argument that securities reform was meant to divest state courts of jurisdiction over claims in connection with 1933 Act public offerings); Justin Wales, Carlton Fields, *The US Supreme Court Just Opened the Gates to Filing Crypto Class Actions in State Courts*, THE DAILY BUSINESS REVIEW (Mar. 22, 2018), available at <https://www.law.com/dailybusinessreview/2018/03/22/the-us-supreme-court-just-opened-the-gates-to-filing-crypto-class-actions-in-state-courts/?slreturn=20180302101117>.

<sup>121</sup> Commissioner Michael S. Piwowar, Remarks at the 2018 RegTech Data Summit - Old Fields, New Corn: Innovation in Technology and Law, Washington D.C. (March 8, 2018), available at <https://www.sec.gov/news/speech/piwowar-old-fields-new-corn-innovation-technology-law> (paraphrasing Chaucer to describe how precedent can inform the regulation of new technologies).

The following section proposes that regulators and lawmakers resist the urge to fashion quick and sloppy remedies in the name of fraud deterrence and market integrity. It asserts that a more favorable approach entails vast investigatory efforts that endeavor to nurture a meaningful, lasting relationship among industry participants and regulators. Timely regulation, informed by the dynamic regulator-industry partnership, could instill uniformity across the states with regards to policing virtual currency markets, better positioning the nation as a welcoming jurisdiction to innovation in modern financial technology.

*a. To Legislate Or Not To Legislate?*

Regulators face several distinct options when it comes to the oversight of virtual currency markets. They could operate under the premise that existing regulatory frameworks adequately address crypto products—clear guidelines of how that functions in practice would be fleshed out through regulatory enforcement, judicial decisions, and the development of custom in the industry. Alternatively, Congress could seek to enact wholly separate legislation especially directed towards the oversight of virtual currencies.<sup>122</sup> The SEC could also use its existing legislative authority to promulgate new regulations that guide the interpretation of securities laws as applied to virtual assets.<sup>123</sup> This sort of regulatory interventions could take the form of a safe harbor for certain virtual products or transactions.<sup>124</sup>

*b. A “Light Touch” Approach to Virtual Currencies: Regulators Working With The Industry to Provide Clarity*

Hasty state or federal legislation is not the answer to uncertainty in the marketplace. Likewise, the formation of additional regulatory units only contributes to the chaos of the already balkanized system of financial regulation that innovators contend with when conducting business subject to domestic jurisdiction.<sup>125</sup> Neither is rushed regulation the solution to contemporary issues—it could pose a long-lasting detriment to innovation on American soil.<sup>126</sup>

The SEC could benefit by adopting a “light touch” approach to regulation, like that observed by the U.K.’s Financial Services Authority (FSA), where regulators partner with the

---

<sup>122</sup> Some argue that immediate legislation is necessary to authorize the SEC and other regulators to modify their rules to accommodate virtual currencies. See Robert Rosenblum, Partner, Wilson Sonsini Goodrich & Rosati, Subcommittee on Capital Markets, Securities, and Investment Hearing Entitled “Examining Cryptocurrencies and ICO Markets” (March 14, 2018).

<sup>123</sup> See e.g., Nathaniel Popper, Venture Capitalists Seek ‘Safe Harbor’ for Virtual Currencies, THE NEW YORK TIMES (April 19, 2018), available at <https://www.nytimes.com/2018/04/19/technology/virtual-currency-securities.html>.

<sup>124</sup> *Id.* (describing the efforts of a group of entrepreneurs and two of the largest venture capital firms in advocating before the SEC for a regulatory safe harbor for utility tokens and those that achieve “full decentralization” or “full functionality”). The group advocates that “full decentralization” occurs “when the token creator no longer has control of the network based on its ability to make unilateral changes to the functionality of the tokens” and a token is “fully functional” when it can be used for its intended purpose and “is not just useful as a speculative investment, which is the case with many tokens today.” *Id.*

<sup>125</sup> See e.g., Charles Schumer and Michael Bloomberg, *Sustaining New York’s and the U.S.’s Global Financial Services Leadership*, THE WALL STREET JOURNAL (Jan. 2007) (calling for broad reform and implementation of a principles-based system to eliminate duplicity and inefficiencies). “[O]ur regulatory framework is a thicket of complex rules, rather than a streamlined set of commonly understood principles.” *Id.*

<sup>126</sup> See e.g., United States’ Economy: Over-regulated America, THE ECONOMIST (Feb. 18, 2012), available at <http://www.economist.com/node/21547789>.

community and engage in meaningful dialogue to overcome informational disadvantages authorities contend with in fast-changing markets.<sup>127</sup> A “light touch” approach, or type of “new governance” strategy, provides flexibility for entities to experiment with compliance programs in an environment that values remediation and principles over ex post punishment.<sup>128</sup> A focus on anti-fraud protections could reduce overly burdensome compliance costs, while preserving the SEC’s authority to protect all investors, regardless of net worth.<sup>129</sup>

Investigation is a proper and necessary step in policing the underdeveloped cryptocurrency market with a light touch—existing regulatory needs and issues must be analyzed and understood before the contemplation of regulatory or legislative remedies. After pursuing their inquiries, regulators will wrestle with the information and contemplate the outstanding issues posed by exchanges’ conduct to provide guidance to the industry. Their next steps must be deliberated with patience and resolve for their profound impact on a progressively integral piece of cross-border trade. Rushed and uninformed rules and legislation will impede the emergence of a healthy and functional market at the national level.

### *c. Informed Regulation to Modernize Securities Laws*

The exchanges and investment professionals that look to facilitate transaction in products beyond pure virtual currencies should be properly surveilled. Balance regulation undoubtedly has its benefits and could usher the novel asset class into its adolescence age, though the rules and regulations promulgated by the SEC in the decades since the enactments of the 1933 and 1934 Acts are arguably not compatible with many aspects of the modern platforms where virtual assets and exchanged and traded.<sup>130</sup>

Just as Regulation ATS provided for reduced regulatory burdens for electronic trading platforms spawned by the internet, the SEC can utilize existing legislative authority to promulgate timely and informed regulation that offers more certainty in the industry without

---

<sup>127</sup> See Eilis Ferran, *Examining the United Kingdom’s Experience in Adopting the Single Financial Regulator Model*, 28 BROOKLYN J. INT’L L. 257 (2003) (describing the history of the FSA); Christie L. Ford, *New Governance, Compliance and Principles-based Securities Regulation*, 45 AM. BUS. L.J. 1 (2008). The conception of the SEC stemmed from jurisdictional conflict and a market in turmoil. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 95–99 (3d ed. 2003) (describing how the SEC was borne out of a Wall Street effort to take jurisdiction over securities away from the Federal Trade Commission, to whom jurisdiction was granted under the first federal securities statutes). The FSA, on the other hand, resulted from a specific, decade-long effort by U.K. to establish a comparative advantage in the financial services industry. Langevoort at 12.

<sup>128</sup> See Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, Georgetown Law Faculty Working Papers, 6–7 (Sept. 2008).

<sup>129</sup> *Id.* at 34–35. See also Linda Chatman Thomsen, Speech by SEC Staff: True to Our Mission: Why We Need the SEC, Remarks at the Ninth Annual A.A. Sommer, Jr. Corporate, Securities and Financial Law Lecture, Fordham University Law School (Nov. 6, 2008) (quoting Former SEC Chairman Joseph Kennedy). The SEC should act as “neither coroners nor undertakers . . . not prosecutors of honest business, nor defenders of crookedness.” It should curtail “only the senseless, vicious, and fraudulent activities.” *Id.*

<sup>130</sup> See e.g., *Board of Trade v. SEC*, 883 F.2d 525, 535 (7th Cir. 1989) (describing how federal securities laws were a product of the 1930s and the exchange at the heart of the action was a product of the 1980s). “When Congress establishes the rules, an agency must carry them out. A desire to keep the law “up to date” does not justify departure from its rules. Administrative power depends on delegation, and delegation comes from Congress rather than a desire, however keen, to innovate.” *Id.*

being unduly burdensome.<sup>131</sup> It could quiet obscurity in the virtual currency market and offer a durable resolution for technology that it only going to flourish in the future.<sup>132</sup> Reasoned regulatory modifications could aid in the development of a comprehensive regulatory landscape to replace the fragmented framework created by contemporary balkanized regulatory regimes.<sup>133</sup>

## VI. IMPLEMENTING CRYPTO COMPLIANCE PROGRAMS

Entities that heed the contemporary warnings of regulators will be prepared for the future regulatory environment where virtual currency matters contend with strict scrutiny from authorities. Despite the assertion of some, compliance efforts to ensure the integrity of the marketplace by preventing fraud and manipulation will be taken into account by exchange customers and regulators as they analyze currency industry practices.<sup>134</sup>

The following section proposes how entities registered with the SEC and those not so registered can begin to approach virtual currencies in their business with the principles of existing laws, rules, and regulations in mind. It specifically discusses how intermediaries can reduce liability in the wake of the legal and regulatory uncertainty plaguing the virtual currency market.

### *a. Registered Entities*

Compliance departments at registered entities cannot ignore the integration of virtual currencies into our existing financial markets—they have already impacted our notions of global securities, derivatives, and commodities trade. Regulated broker-dealers and exchanges must consider the implications of virtual currency investments on their duties as to anti-money laundering, investor suitability, disclosures, and asset protection.<sup>135</sup> Existing brokers must develop virtual currency compliance programs tailored at achieving the same principles informing their current programs.<sup>136</sup>

### *b. Unlicensed Broker-Dealers*

---

<sup>131</sup> See *supra* Section II(d) (introducing the promulgation of Regulation ATS).

<sup>132</sup> “I believe that digital currencies will continue to persist it's just a matter of how long it will take for that space to mature.” Kate Rooney, *Nasdaq is open to becoming cryptocurrency exchange, CEO says*, CNBC (April 25, 2018), available at <https://www.cnbc.com/2018/04/25/nasdaq-is-open-to-becoming-cryptocurrency-exchange-ceo-says.html> (quoting Nasdaq’s CEO Adena Friedman); see also ANDREAS M. ANTONOPOULOS, *THE INTERNET OF MONEY*, Vol. 7–8 (March 20, 2017) (stating that “[c]ryptographic currencies are going to be a mainstay of our financial future. You cannot uninvent this technology. You cannot turn this omelette back into eggs”).

<sup>133</sup> See e.g., RONALD H. FILLER AND JERRY W. MARKHAM, *REGULATION OF DERIVATIVE FINANCIAL INSTRUMENTS (SWAPS, OPTIONS, AND FUTURES)* 62 (West Academic 2014)

<sup>134</sup> See e.g., KrakenFX, *Kraken’s Position on Regulation* (April 22, 2018), available at <https://blog.kraken.com/post/1561/krakens-position-on-regulation/> (stating that Kraken believes crypto traders do not care about licenses, regulatory approval, or being protected from market manipulation).

<sup>135</sup> See SEC, Divisions of Enforcement and Trading and Markets, *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* (Mar. 7, 2018), available at <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-tradin>

g.

<sup>136</sup> *Id.*

Participants not licensed as broker-dealers with the SEC must consider whether their conduct in the crypto space prompts state or federal registration requirements.<sup>137</sup> Compliance programs are patently crucial at new platforms developed specifically for virtual currency trade—though, in the future, it will ideally not be necessary for entities to dedicate twenty percent of their workforce towards compliance.<sup>138</sup> These platforms must foster a relationship with regulators in order to seamlessly integrate into the fabric of our regulated market system. Such a program must pay acute attention to the current legal and regulatory environment, as well as forth coming developments in the field.

Compliance personnel must be especially cautious with regards to evaluating the cryptocurrencies and tokens that the exchange will host. A comprehensive compliance program will necessarily need thorough, explicit standards that describe the process and criteria for listing new products on the exchange. By detailing the steps taken in providing novel products to the investing product, exchanges could limit liability for instruments that are improperly categorized as pure virtual currencies or utility tokens.

## VII. CONCLUSION

Products of blockchain technology are increasingly infiltrating international financial markets, gaining interest from investors, investment professionals, and regulators. Federal and state regulators have started targeting platforms that facilitate virtual currency transactions.<sup>139</sup> Widespread investigatory operations aim to determine if the exchanges' current policies and procedures adequately protect investors.<sup>140</sup> Regulators are, simultaneously, pursuing enforcement actions against individuals and entities for various virtual currency-related offenses,<sup>141</sup> while states and federal legislators are contemplating the need for further grants of power to effectively police the volatile market.<sup>142</sup>

Authorities have acted properly in pursuing investigations of exchanges and platforms that facilitate transactions in novel virtual assets—failure to do so would ignore explicit legislative directives.<sup>143</sup> Regulatory inquiries are a positive step in the extensive process of

---

<sup>137</sup> *Id.*

<sup>138</sup> See *supra* Section V(a) (discussing Coinbase's excessive compliance costs in the face of persistent uncertainty as to the legal status of blockchain products).

<sup>139</sup> See *supra* Section IV (describing the heat being placed on virtual currency exchanges by regulators).

<sup>140</sup> See Nathaniel Popper, *Subpoenas Signal S.E.C. Crackdown on Initial Coin Offerings*, NY TIMES (Feb. 28, 2018), available at <https://www.nytimes.com/2018/02/28/technology/initial-coin-offerings-sec.html>; New York State Office of the Attorney General, *A.G. Schneiderman Launches Inquiry Into Cryptocurrency "Exchanges,"* Press Release (April 17, 2018), available at <https://ag.ny.gov/press-release/ag-schneiderman-launches-inquiry-cryptocurrency-exchanges>.

<sup>141</sup> *United States v. Zaslavskiy*, No. 1:17-cr-00647 (E.D.N.Y. Mar. 19, 2018); *CFTC v. McDonnell, et al.*, No. 18-cv-361, ECF No. 29 (E.D.N.Y. Mar. 6, 2018); *SEC v. Jon E. Montroll and Bitfunder*, 18-cv-1582 (S.D.N.Y. Feb. 21, 2018); *SEC v. PlexCorps, et al.*, Civil Action No. 17-cv-07007 (E.D.N.Y., filed Dec. 1, 2017); *SEC v. REcoin Group Foundation, et al.*, Civil Action No. 17-cv-05725 (E.D.N.Y., filed Sep. 29, 2017).

<sup>142</sup> See *supra* note 114 (stating how some legislators think immediate legislative is necessary to adequately protect investors and the integrity of the markets in the wake of virtual currencies' growing popularity and interconnected fraud and manipulation).

<sup>143</sup> The SEC is tasked "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-nn (2012). 15 U.S.C. § 78d. See also SEC, The

establishing how these instruments should be treated under the law where responses from industry leaders will inform the appropriate remedy. The inquiries should be viewed as the initiation of a significant, long-term partnership between regulators and the crypto industry, where open channels of dialogue provide the basis for balanced regulation and oversight.

This article has suggested that, after regulators obtain information pursuant to their queries, they act with a light touch in policing the young industry, noting the unique properties of the technologies that propels virtual currency and the benefits provided by decentralized means of electronic trade. This article has further discussed the dangers of hasty legislation and continued bifurcation of the jurisdictional boundaries of federal regulatory agencies. Future regulation should be reasoned, shaped around support for global innovation and the retiring of oppressive, disintegrated regulatory regimes that fail to facilitate capital formation.

---

Laws That Govern the Securities Industry, available at <https://www.sec.gov/answers/about-lawsshtml.html>. *See* 15 U.S.C. § 78b (2012) (recognizing that securities laws aim “to insure the maintenance of fair and honest markets”).