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# Recent Cryptocurrency Regulatory Developments

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## Introduction

In March 2019, the American Bar Association’s Derivatives and Futures Law Committee published a first-of-its-kind comprehensive legal guide on the complex web of federal and state statutes and precedents that have been applied to transactions in the fast-developing markets for “crypto” or “virtual” currencies, and the many other types of digital and digitized assets that exist or are recorded on blockchain platforms (“ABA White Paper”).<sup>1</sup> The white paper summarizes the current interpretations and applications of the federal securities, commodities, and derivatives trading laws, the federal anti-money laundering statutes, and the state statutes governing money services businesses. It also reviews the principal international statutory approaches to regulating crypto assets.

As the ABA White Paper points out, regulators face interpretative obstacles in determining the scope and application of longstanding laws and rules that do not contemplate financial products with the novel and varied characteristics of digital assets. Recognizing these challenges, multiple federal and state regulators—including the Securities and Exchange Commission (“SEC”), Commodity Futures Trading Commission (“CFTC”) and the Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”)—have issued guidance or interpretations concerning the application of their rules to digital asset products and market participants. Despite these efforts, the novel and unique characteristics of digital assets continue to pose challenges to regulators.

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This article addresses more recent developments in the cryptocurrency space that illustrate the continuing jurisdictional and interpretative issues arising from the regulatory gaps and novel features of digital assets identified in the ABA White Paper. In particular, this article focuses on whether and how new digital assets fit into the existing regulatory frameworks and the ways that federal regulators have grappled with these issues.

## SEC Regulation of Cryptocurrencies

While the SEC started bringing enforcement cases involving cryptocurrencies as early as 2013, the early SEC cases focused on run-of-the-mill fraud or other misconduct where the nature of the asset class was not crucial.<sup>2</sup> As a result, these cases did little to provide guidance to cryptocurrency market participants on how federal securities laws would apply to cryptocurrencies, if at all.

In July 2017, the SEC issued its first detailed guidance on whether and how federal securities regulations would apply to cryptocurrencies.<sup>3</sup> The DAO report, as the guidance has come to be known, confirmed that the SEC will apply the traditional investment contract analysis laid out in the U.S. Supreme Court’s 1946 decision in *SEC v. W.J. Howey Co.* (the “*Howey* test”) to digital assets that exist or are recorded on systems using distributed ledger or blockchain technology (“digital assets” or “tokens”). William Hinman, Director of the SEC Division of Corporate Finance, reaffirmed that approach in a speech in June 2018.<sup>4</sup> The speech is notable for Mr. Hinman’s acknowledgement that bitcoin and Ether are not securities under the *Howey* test, and that a digital asset that initially is an investment contract may change to a non-security as the facts and circumstances surrounding how it is subsequently resold may change. SEC Chairman Clayton later concurred that the analysis of a digital asset’s status under the *Howey* test is fluid and may change over time.<sup>5</sup> The SEC has used the *Howey* test in policing initial coin offerings (“ICOs”),

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unregistered broker-dealer activities involving cryptocurrencies,<sup>6</sup> and unregistered token exchanges.<sup>7</sup>

In April 2019, SEC staff in the Strategic Hub for Innovation and Technology (“FinHub”) in the Division of Corporate Finance provided the most extensive guidance to date on applying the *Howey* test to digital assets, when it published its *Framework for “Investment Contract” Analysis of Digital Assets* (“Framework”).<sup>8</sup> The *Howey* test has four prongs: (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) where the expectation of profits is based on the efforts of others. The Framework describes how each prong applies to digital assets, but most of the considerations relate to the last two, which the Framework combines and treats as a single prong. In total, the Framework identifies 38 separate considerations, listing sub-points under many of them. Many of the considerations focus on the presence and role of a “promoter, sponsor, or other third party (or affiliated group of third parties),” referred to as “Active Participants” (“APs”).

Consistent with the statements of Chairman Clayton and Director Hinman, the Framework recognizes that a digital asset’s status as an investment contract may change over time, and lists numerous considerations under *Howey* for both evaluating a digital asset at the initial offer stage and reevaluating a digital asset with respect to future transactions in the asset. The Framework also implies, however, that just as an investment contract digital asset could change to a non-investment contract, a non-investment contract digital asset could change (or change back) to an investment contract.

Among the many examples, the Framework cites the following characteristics as relevant for evaluating whether a digital asset could be an investment contract: (1) is an AP responsible for developing or improving the operation of the network on which the asset resides or for promoting that network; (2) does an AP create or support a market for the digital asset and do purchasers have an expectation that there will be a secondary market for trading the digital asset; (3) what is the degree of correlation between prices at which the digital asset is bought and sold and the market price of the specific goods or services that a holder may acquire in exchange for the digital asset; and (4) is the digital asset marketed by highlighting the AP’s expertise to grow or build the network’s or digital asset’s value, the intended use of the

proceeds to develop the network or digital asset, or the future development of the network’s or asset’s functionality. The Framework also identifies considerations for reevaluating a digital asset’s status under the *Howey* test, such as whether the AP’s efforts (or those of a successor) continue to be important to the digital asset’s value as an investment or continue to affect the success of the enterprise, or whether the digital asset’s value has a “direct and stable” correlation to that of the goods or services that may be purchased using the digital asset.

In a speech in May 2019, SEC Commissioner Hester Peirce criticized the Framework as doing little to advance legal certainty, expressing concern that the guidance “could raise more questions and concerns than it answers.”<sup>9</sup> Indeed, the multitude of considerations to evaluate under the Framework present a challenge in all but the rarest of cases for ever reaching a certain legal conclusion that a particular digital asset is *not* an investment contract. Even in the rare circumstance where one may confidently conclude that a particular digital asset is not an investment contract, the prospect that the asset could later change into one if circumstances change regarding how it is marketed and sold keeps a cloud of legal uncertainty hanging over whether the federal securities laws could potentially apply to transfers of the asset at some unpredictable time in the future.

The Framework obliquely acknowledges that the CFTC has also asserted jurisdiction over digital assets that are virtual currencies, by recognizing that digital assets possessing the Framework’s cited characteristics of a virtual currency are “less likely” to meet the *Howey* test. The Framework, however, does not explicitly acknowledge that the two agencies could assert conflicting jurisdictional claims over digital assets. In fact, it would be contrary to the existing federal statutory schemes for the same digital asset to be treated as a security by the SEC and as a non-security commodity by the CFTC.

On the same day that SEC FinHub announced the Framework, the Division of Corporate Finance issued a no-action letter to TurnKey Jet, Inc. stating that the Division would not recommend enforcement action if TurnKey Jet were to offer and sell tokens without registering them under the Securities Act of 1933 (“Securities Act”) or the Securities Exchange Act of 1934 (“Exchange Act”), in reliance on counsel’s legal opinion that the tokens are not securities.<sup>10</sup> As described

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in the letter, TurnKey Jet designed the token as a dollar-denominated stable coin that holders could use to purchase air travel services. The letter cites six separate factors supporting the no-action relief, including that the funds raised from the sale of the tokens would not be used to develop the platform; the tokens would be immediately usable to purchase air charter services as intended; and each token would be sold for one USD and represent TurnKey Jet's obligation to provide its air charter services at the price of one USD per token. The factors cited present the rare situation where one seemingly could safely conclude—without fear of SEC second guessing—that the token is not an investment contract, leading many to question why the letter was needed. The letter drew this very type of criticism from Commissioner Peirce in her May speech, in which she stated that she “did not believe there was anything gray about the area in which TurnKey planned to operate, but issuing this letter may give the false impression that there was.”<sup>11</sup>

More recently, the Division of Corporate Finance issued a similar no-action letter to Pocketful of Quarters, Inc.,<sup>12</sup> allowing the firm to sell tokens used in gaming, called Quarters, without registering them in reliance on counsel's opinion that the Quarters are not securities. The letter cites factors that are comparable to those cited in the Turnkey Jet letter, but also goes a bit further in allowing certain persons (Developers and Influencers) who receive Quarters from gamers in connection with participating in e-sport tournaments, to exchange their Quarters for Ether at pre-determined exchange rates.

In addition to no-action letters and other staff guidance, the SEC will also rely on litigation to establish the application of the securities laws to cryptocurrencies. For example, Kik Interactive, Inc. (“Kik”), a social media messaging company headquartered in Canada, is defending against the SEC's charge that Kik illegally offered and sold its digital token “Kin” without registering with the SEC.<sup>13</sup> The SEC's complaint alleges that Kik's 2017 offering and sale of one trillion Kins to more than “10,000 investors worldwide for approximately \$100 million in U.S. dollars and digital assets” (over half of which allegedly was received from U.S.-based investors) violated Section 5 of the Securities Act because the offer and sale of Kin constituted the sale of unregistered securities.

The SEC further alleges that Kik sold potential investors \$49 million worth of Kin in “pre-sales” pursuant to “Simple Agreements for Future Tokens” or “SAFTs.” Under the SAFTs, investors bought Kin at a discount to the price that the general public would pay, and Kik promised to deliver the tokens pursuant to a schedule, half at the time that it delivered tokens to the general public and half on the one-year anniversary of the first delivery. The SEC alleges that Kik also provided a private placement memorandum (“PPM”) to recipients of the SAFT that included, among other information, a company overview, biographies of Kik's directors and management, and a description of the Kin project, but did not contain information about the company's financial history or earlier failure to generate profits from prior endeavors, and that investors who purchased in the later, undiscounted, public sale of Kin did not receive this or any other PPM.<sup>14</sup>

The SEC's complaint further alleges that, although Kik's SAFT specifically stated that the SAFT was itself a security, it failed to state that the Kin to be delivered under the SAFT also was a security, and that, although Kik's PPM claimed that the offer and sale of the SAFTs were subject to an exemption from registration under Section 4(a)(2) of the Securities Act and Regulation D promulgated thereunder, Kik did not claim any exemption for the offer and sale of the Kin through the SAFT. The SEC therefore contends Kik's offer and sale of the Kin purchased under the SAFTs was required to be registered but was not.<sup>15</sup>

The SEC contends that the Kin tokens were an investment opportunity within the *Howey* test because allegedly:

- Kik told investors that (1) only a finite number of tokens would be created, (2) rising demand would drive up the value of Kin, and (3) Kik would undertake crucial work to spur that demand, including by incorporating the tokens into its messaging app, creating a new Kin transaction service, and building a system to reward other companies that foster the use of Kin.
- At the time Kik offered and sold the tokens, these services and systems did not exist and there was nothing to purchase using Kin.
- Kik declared that the company would share with buyers a common interest in profiting from Kin's

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success: in addition to selling one trillion tokens through its then-ongoing offering, Kik would create and allocate to itself three trillion Kin tokens over a two-and-a-half-year period. Kik told potential buyers that, by allotting 30 percent of the outstanding supply of Kin to itself, the company would align its financial interests with those of other Kin investors, which would give the company an incentive to take entrepreneurial and managerial steps to increase the demand for the token.

- Kik claimed that Kin tokens would immediately trade on secondary markets, such that Kik would profit alongside investors from the increased demand and enable conversion of Kin to either another digital asset (such as bitcoin or ether) or fiat currency.
- Kik sold Kin at a discounted price to wealthy purchasers.<sup>16</sup>

The SEC seeks a final judgment: (a) permanently enjoining Kik from engaging in acts, practices, and courses of business alleged in the complaint; (b) ordering Kik to disgorge its allegedly ill-gotten gains and to pay prejudgment interest thereon; and (c) imposing civil money penalties on Kik pursuant to Section 20(d) of the Securities Act.<sup>17</sup>

Kik reportedly will vigorously defend against the action. It can be expected to rely on the same arguments made in its Wells Submission that Kik filed with the SEC in December 2018 in an (unsuccessful) effort to persuade the agency not to commence an enforcement action.<sup>18</sup> Some of Kik's principal arguments in its Wells Submission were that:

- Kin was designed, marketed and offered primarily as a currency for consumptive use within a new digital economy and thus is exempt from the definition of security in the Section 3 of the Exchange Act;
- Kik's managerial efforts were not held out to be the central driver of Kin's success, but rather Kin's success was represented to depend on many developers other than Kik to join the ecosystem by offering products and services in exchange for Kin;
- There was no common enterprise with purchasers because purchasers had no claims to Kik's assets or future profits; and
- Kin became sufficiently decentralized as it became a widely used token in over thirty digital applications

and exceeded ether and bitcoin in daily blockchain activity.<sup>19</sup>

The SEC's legal theory in *Kik* is consistent with its application of the *Howey* test to prior ICOs that were designed to raise funds to support the development of a coin's ecosystem, as reflected in its settlement order in *In re Munchee Inc.*<sup>20</sup> and with the SEC staff's guidance in its Framework. But to grant relief, the court may be required to decide the merits of the SEC's legal positions that the presence of aligned interests between a seller and a purchaser in the commercial and financial success of a company satisfies the test for a "common enterprise" where the product does not also confer legal rights to company profits or control. The *Kik* litigation also might produce the first judicial analysis of the staff's concession in its Framework and in the 2018 Hinman speech that a virtual currency sold as a security investment can be transformed into a non-security when it gains sufficient use as a medium of exchange. If Kik can show sufficient use of Kin today as a virtual currency such that, even if Kin were once a security, it no longer is one today, the court might lack authority under the federal securities laws to impose prospective injunctive relief.

Other perceived regulatory gaps in the cryptocurrency arena continue to loom large for market participants. For example, the SEC has continuously rejected proposals to launch a cryptocurrency-based exchange-traded fund ("ETF") primarily due to the SEC's concerns that the underlying cash market for cryptocurrencies is largely unregulated. In January 2018, SEC staff issued a letter identifying its concerns with "a number of significant investor protection issues" that must be resolved before sponsors can start offering registered funds based on cryptocurrencies.<sup>21</sup> These issues include:

- (1) Valuation. Whether funds have the information necessary to adequately value cryptocurrencies or cryptocurrency-related products, given their volatility, the fragmentation and general lack of regulation of underlying cryptocurrency markets, and the nascent state of the cryptocurrency futures markets, whose trading volume still is modest.
- (2) Liquidity. Whether funds would need to assume an unusually sizable potential daily redemption amount in light of the potential for steep market declines in the value of underlying assets, given the

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fragmentation and volatility in the cryptocurrency markets.

- (3) Custody. To the extent a fund plans to hold cryptocurrency directly, how it would satisfy the custody requirements of the federal securities laws and how it would validate the existence, exclusive ownership and software functionality of private cryptocurrency keys and other ownership records.
- (4) Arbitrage. In light of the fragmentation, volatility, and trading volume of the cryptocurrency marketplace, how ETFs would comply with the requirement that they have a market price that would not deviate materially from the ETF's net-asset value.
- (5) Misconduct, including potential manipulation and other risks. Given that cryptocurrency markets feature substantially less investor protection than traditional securities markets, there are correspondingly greater opportunities for fraud and manipulation.

Chairman Clayton has voiced the same concerns before Congress, testifying that “issues around liquidity, valuation and custody of the funds’ holdings, as well as creation, redemption and arbitrage in the ETF space . . . need to be examined and resolved before we permit ETFs and other retail investor-oriented funds to invest in cryptocurrencies in a manner consistent with their obligations under the federal securities laws.”<sup>22</sup>

In March 2017, citing a similar set of concerns, the SEC denied an application by Bats BZX Exchange, Inc. to list and trade shares of the Winklevoss Bitcoin Trust and affirmed the denial on appeal in July 2018.<sup>23</sup> Since then, the SEC has denied at least 10 other applications to list and trade cryptocurrency ETFs for the same reasons.<sup>24</sup> Multiple cryptocurrency-based ETFs are pending before the SEC, but it is not clear whether the SEC will approve one until the regulatory gaps the SEC has identified in the cryptocurrency markets are closed.

In July 2019, the staffs of the SEC and Financial Industry Regulatory Authority (a self-regulatory organization in the securities market known as FINRA) issued a joint statement on the issue of cryptocurrency custody by broker-dealers.<sup>25</sup> Broker-dealers registered with the SEC are required to comply with financial responsibility rules that include custodial requirements designed to safeguard customer assets held by a broker-dealer. As noted above, the SEC has expressed concerns about a cryptocurrency-based fund's ability to secure customers'

cryptocurrencies in its possession. SEC and FINRA staff reiterated those concerns in their joint statement, noting that “[t]here are many significant differences in the mechanics and risks associated with custodying traditional securities and digital asset securities.” The joint statement further observed that these differences pose special challenges to broker-dealer custody of cryptocurrencies in the following areas: (1) keeping books and records and routinely preparing financial statements, (2) obtaining protection for customers under the Securities Investor Protection Act of 1970, and (3) having the issuer or the transfer agent of cryptocurrencies serve as the “control location” for secure ownership of customer assets.

While the SEC remains cautious, blockchain-based startup Blockstack obtained the agency's first approval to hold a public token offering in July 2019.<sup>26</sup> The offering aims to raise \$28 million under Regulation A+, an initial public offering alternative with more lenient regulatory obligations but hard caps on raised funds at \$50 million within a 12-month period. But even with relaxed regulatory requirements, Blockstack went through a costly process: Blockstack founders Muneeb Ali and Ryan Shea had reportedly spent 10 months and approximately \$2 million to gain the SEC's approval. It remains to be seen whether Blockstack's success indicates a shift in the SEC's attitude towards cryptocurrency regulations.

As the SEC's guarded approach to cryptocurrency ETFs and custody issues illustrates, federal regulators are grappling with at least two major issues in overseeing the burgeoning digital assets markets. First, in deciding the proper approach to regulation of digital assets, federal agencies with discrete regulatory responsibilities must take into account whether and how digital asset products that fall within their jurisdiction are regulated by other regulators. The fact that non-security cryptocurrency markets are largely unregulated today clearly is having an impact on the SEC's regulatory approach as illustrated by the agency's consistent rejection of cryptocurrency ETFs. Second, the unique features of digital assets raise difficult questions about whether and how laws and regulations written before the birth of cryptocurrencies should apply to them. Although laws are typically written broadly to account for changing circumstances, the rapid technological advances that the financial markets are experiencing today could not have

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been foreseen. In the face of radical changes to financial products and markets, regulators should not take a blinkered approach and instead recognize the limits of the preexisting legal regime and press for changes where appropriate.

### **CFTC Regulation of Cryptocurrencies**

Under the Commodity Exchange Act (“CEA”), the CFTC generally has full oversight jurisdiction over derivatives transactions involving commodities but no regulatory and only limited enforcement authority (*i.e.*, anti-fraud and anti-manipulation authority) over spot transactions involving commodities. Because the CEA does not explicitly grant the CFTC jurisdiction over virtual currencies, whether (and to what extent) the CFTC has jurisdiction over the cash market for a virtual currency depends largely on whether the virtual currency is a “commodity.”

The commodity definition includes two categories, one narrow and one that is potentially very broad: (i) an enumerated list of agricultural commodities; and (ii) “all other goods and articles, ... and all services, rights, and interests ... in which contracts for future delivery are presently or in the future dealt in” (with two limited exceptions).<sup>27</sup> In September 2015, the CFTC determined for the first time that “Bitcoin and other virtual currencies are encompassed in the [commodity] definition and properly defined as commodities” in its settlement agreement with Coinflip, Inc., a trading platform.<sup>28</sup> Since then, the CFTC has brought multiple enforcement actions to police fraud and manipulation in the cryptocurrency markets.<sup>29</sup>

While the CFTC has not issued formal guidance on whether and how its regulatory authority under the CEA would apply to cryptocurrencies generally, the agency’s important role in the development of financial technology (“FinTech”), blockchain and virtual currencies continues apace. For several years it has developed its expertise through the agency’s LabCFTC function and its Technology Advisory Committee (“TAC”). LabCFTC is dedicated to facilitating market-enhancing FinTech innovation, informing policy, and ensuring that the agency has the regulatory and technological tools and understanding to keep pace with changing markets. LabCFTC is designed to make the CFTC more accessible to all innovators and to inform the CFTC’s understanding of emerging

technologies and their regulatory implications. As part of these efforts, LabCFTC issued a primer on virtual currencies, which is an educational tool for the public, not intended to offer any guidance or policy positions of the CFTC.<sup>30</sup> In November 2018, LabCFTC issued a primer on smart contracts, which is intended to help explain smart contract technology and related risks and challenges.<sup>31</sup> One month later, LabCFTC published a request for public comments on crypto-asset mechanics and markets to help inform the CFTC in overseeing cryptocurrency markets and developing regulatory policy.<sup>32</sup>

The TAC, under the leadership of its Chair, Commissioner Brian Quintenz, brings together CFTC staff from its LabCFTC function and Office of the General Counsel and industry participants and academics expert in technology, the markets, finance, and law to focus on four areas: automated and modern trading markets, cybersecurity, distributed ledger technology and market infrastructure, and virtual currencies. Virtual currencies and blockchain were the particular subjects of the TAC’s March 2019 meeting. Peter Van Valkenburgh, Director of Research at Coincenter, gave a presentation on consensus blockchain mechanisms used for validating virtual currency transactions, and the editors of the ABA White Paper provided an overview of the white paper, with emphasis on issues relating to CFTC and SEC jurisdiction over digital assets.

Even without formal guidance, the CFTC’s regulatory jurisdiction over derivatives transactions is relatively clear because the CEA grants the agency exclusive jurisdiction over futures contracts and swaps on a commodity. Recognizing that jurisdiction, a number of firms have launched bitcoin futures contracts that are intended to provide more protections for investors under the aegis of the CFTC. The CME Group currently offers futures contracts on bitcoin. CME’s contracts are settled financially, requiring the buyers and sellers to exchange USD payments at the contracts’ expiration instead of delivering the underlying bitcoin. Physically-settled bitcoin futures, in contrast, would require the delivery of actual bitcoin from the seller to the buyer when the contract expires. Exchanges seeking to launch physically-settled bitcoin futures generally assert that due to the CFTC regulation of such contracts they can provide secure regulated custody.

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In April 2019, the CFTC's then-Chairman Christopher Giancarlo hinted that one of the CFTC's biggest concerns with physically-settled cryptocurrency contracts is the issue of custody—similar to the SEC's concerns with cryptocurrency-based ETFs.<sup>33</sup> To date, the CFTC has not announced standards for custody of digital assets, but likely will need to adopt such standards given the multiple exchanges intending to launch physically-settled bitcoin futures.

For example, the Intercontinental Exchange (“ICE”), a futures exchange registered with the CFTC as a designated contract market (“DCM”), is expecting to launch in the near future physically-settled futures contracts on bitcoin held in the digital warehouse of Bakkt Holdings, LLC (“Bakkt”), a private company partially owned by ICE that operates a global online platform for institutions, merchants, and consumers to store and transact in digital assets. The Bakkt futures will trade on ICE's CFTC-regulated futures exchange ICE Futures US and be cleared by its affiliated CFTC-regulated derivatives clearing organization (“DCO”), ICE Clear US. Bakkt futures settlement prices will be based on the futures prices themselves, not spot market prices. Bakkt has stated that the daily and the monthly futures will have no reliance on the bitcoin spot market. LedgerX, recently granted a DCM license by the CFTC, also plans to offer physically-settled bitcoin futures for trading.

The CFTC has an interest in the integrity and security of warehouse operations to the extent they can affect pricing and reliable delivery of physically-settled futures contracts, but the agency does not directly regulate those warehouses. Instead, it generally defers to the exchanges to develop appropriate qualification standards for warehouses that have a role in the delivery process under the contracts. The CFTC's regulatory role largely arises instead from its oversight of DCMs, and DCOs, which must comply with core regulatory principles to receive and maintain their CFTC licenses. DCM core principles include, among others, maintaining rules and procedures to enforce protection of customer funds and minimize operational risk.<sup>34</sup> The core principles for DCOs require that they establish rules that clearly state each obligation with respect to physical deliveries and ensure that each risk arising from a physical delivery be identified and managed.<sup>35</sup>

While the CFTC has not announced standards for digital custody, Bakkt in August 2019 obtained approval from the New York State Department of Financial Services (“NYDFS”) to form a limited-purpose trust company that would serve as a qualified custodian of bitcoin under New York banking law.<sup>36</sup> Seeking NYDFS's blessing may have been a purely voluntary decision on the part of Bakkt to buttress the protections its platform offers, but as the contract trades it will be interesting to see whether the CFTC will treat the NYDFS approval and compliance with its regulations as satisfying the CEA requirements or whether the CFTC will impose additional requirements or standards. The CFTC faces the same custody issue in addressing applications of other purveyors and marketers of digital assets for registration as a DCO. Former CFTC Chairman Christopher Giancarlo anticipated this issue in his congressional testimony, saying “The Commission anticipates new applications for clearinghouse registration resulting from the explosion of interest in cryptocurrencies; an area in which protection of the cryptocurrencies will be one of the highest risks.”<sup>37</sup>

### **The Libra Association's New Libra Virtual Currency**

One of Bakkt's stated objectives for the ICE Bakkt futures contracts is to attract more institutional participation in digital asset markets generally by establishing a regulated daily and monthly pricing mechanism for bitcoin separate from the largely unregulated spot markets. Institutional participation in digital markets would appear to take a giant leap forward if the Libra Association's new virtual currency named Libra is implemented for use by Facebook and other global companies, as envisioned in the White Paper recently published by the Libra Association. It describes Libra as a medium of exchange in addition to the use of fiat currencies for peer to peer commerce and applications and gaming within a blockchain network. The Association's objective is to provide a “low-volatility cryptocurrency” on a decentralized blockchain and a smart contract platform that will allow users to purchase and sell goods and services throughout the world with little of the cost and fees associated with today's transactions.<sup>38</sup> According to the White Paper, Libra's key features will be that:

- it is built on a secure, scalable and reliable blockchain known as the Libra Blockchain, which is an

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open-source software designed so that anyone can build on it and users can depend on it for their financial needs;

- the Libra Blockchain will use a new programming language called “Move” for implementing custom transaction logic and “smart contracts;”
- Libra is backed by a reserve of bank deposits and short-term government securities held in the “Libra Reserve,” which is designed to give it intrinsic value and be administered with the objective of preserving the value of Libra over time; and
- Libra and the Libra Blockchain will be governed by the Libra Association, which is an independent, not-for-profit membership organization headquartered in Geneva, Switzerland.

Given the potentially broad participation in the use of Libra, which could leverage the worldwide reach of Facebook and other established companies, Libra augurs a potential paradigm shift in the use of a virtual currency. Membership of the Libra Association is expected to include geographically distributed and diverse businesses, nonprofit and multi-lateral organizations, and academic institutions. The White Paper states that potential Founding Members include Mastercard, PayPal, Visa, and other prominent companies and institutions. The White Paper states that once the Libra network launches, Facebook, and its affiliates, will have the same commitments, privileges, and financial obligations as any other Founding Member, and that as one member among many, Facebook’s role in governance of the Association will be equal to that of its peers.<sup>39</sup>

The White Paper further explains that Facebook has created Calibra, described as a regulated subsidiary, to ensure separation between social and financial data and to build and operate services on its behalf on top of the Libra network.<sup>40</sup> Facebook separately announced that Calibra will build a Libra wallet and other tools that will enable Libra to be used on Facebook and that Calibra will require all users to comply with know-your-customer (“KYC”) requirements.<sup>41</sup> Presumably, other entities will create their own wallets and other tools for using Libra in their settings. U.S. financial regulators undoubtedly will be examining Libra to assess its compliance with U.S. law and it is too soon to evaluate here the focus of any regulatory review.

## **FinCEN Regulation of Cryptocurrencies**

The FinCEN, a bureau of the U.S. Department of the Treasury, is another federal agency that has weighed in on regulating cryptocurrencies based on its existing regulatory authority. FinCEN has the authority to implement the Bank Secrecy Act of 1970 (the “BSA”), a federal statute that primarily governs anti-money laundering (“AML”) efforts outside of criminal prohibitions. Under that authority, FinCEN has implemented regulations relating to money services businesses (“MSBs”), which FinCEN has defined broadly to include any person (including entities) doing business as a money transmitter, among others.<sup>42</sup> A money transmitter, in turn, is defined as any person that accepts “currency, funds, or other value that substitutes for currency” from one person and transmits them to another location or person “by any means.”<sup>43</sup> A person subject to FinCEN’s MSB regulations may need to comply with registration, anti-money laundering programs, recordkeeping, monitoring and reporting requirements.

When FinCEN issued its initial guidance on cryptocurrencies back in March 2013, it was one of the first federal agencies to describe whether and how it would regulate cryptocurrency based on MSB rules.<sup>44</sup> In the 2013 guidance, FinCEN concluded that “administrators” or “exchangers” of cryptocurrencies are subject to MSB regulations as money transmitters (while explicitly carving out users of cryptocurrencies). FinCEN noted that “[t]he definition of a money transmitter does not differentiate between real currencies and convertible virtual currencies,” and that “[a]ccepting and transmitting anything of value that substitutes for currency makes a person a money transmitter.”<sup>45</sup>

Fast forward to April 2019, when FinCEN assessed a civil monetary penalty against a peer-to-peer cryptocurrency exchange operator, Eric Powers of California, for violating reporting and registration obligations under the BSA.<sup>46</sup> FinCEN stated that Powers conducted over 1,700 transactions as a money transmitter over 22 months, buying and selling bitcoin on behalf of customers. Powers was ordered to pay a \$35,000 fine and permanently prohibited from providing money transmission services or engaging in a money services business.

In the following month, potentially signaling a more assertive approach in the cryptocurrency space,

FinCEN issued more detailed guidance that clarified how FinCEN would apply MSB regulations to certain cryptocurrency businesses.<sup>47</sup> There, FinCEN reiterated its position that transactions denominated in cryptocurrency “will be subject to FinCEN regulations regardless of whether the [cryptocurrency] is represented by a physical or digital token, whether the type of ledger used to record the transactions is centralized or distributed, or the type of technology utilized for the transmission of value” and that “whether a person qualifies as an MSB subject to BSA regulation depends on the person’s activities and not its formal business status.”<sup>48</sup> While FinCEN noted that ultimately “whether a person is a money transmitter depends on the facts and circumstances of a given case,” the May 2019 guidance provided examples of how FinCEN regulations can apply to common business models involving the transmission of cryptocurrencies. These examples included: (1) natural persons operating peer-to-peer exchanges, (2) providers of “hosted” cryptocurrency wallets, (3) electronic terminals for transmitting cryptocurrencies (such as cryptocurrency ATMs), (4) cryptocurrency transmission services provided through decentralized applications (“DApps”), (5) anonymity-enhanced cryptocurrency transactions, (6) payment processing services involving cryptocurrency transmission, and (7) cryptocurrency transmission performed by Internet casinos.

Similar to other regulators, FinCEN also must grapple with overlaps and gaps in various regulators’ jurisdiction over digital assets markets as well as the unique characteristics of digital assets. For example, FinCEN’s broad interpretation of its jurisdiction over transmission of cryptocurrencies, regardless of the technology used or particular characteristics of the cryptocurrency, may collide with rules of the SEC, CFTC or other federal regulators. Moreover, despite FinCEN’s assertion of broad jurisdiction, certain blockchain-based products may not clearly qualify as representing “value that substitutes for currency” and require the agency to adapt its regulations as appropriate.

## Notes

1. American Bar Association Derivatives and Futures Law Committee Innovative Digital Products and Processes Subcommittee Jurisdiction Working Group, *Digital and Digitized Assets: Federal and State Jurisdictional Issues* (March 2019), [https://www.americanbar.org/content/dam/aba/administrative/business\\_law/buslaw/committees/CL620000pub/digital\\_assets.pdf](https://www.americanbar.org/content/dam/aba/administrative/business_law/buslaw/committees/CL620000pub/digital_assets.pdf).
2. See Press Release (No. 2013-132), SEC, SEC Charges Texas Man With Running Bitcoin-Denominated Ponzi Scheme (July 23, 2013), <https://www.sec.gov/news/press-release/2013-132>; Complaint, *SEC v. Homero Joshua Garza*, Civil Action No. 3:15-cv-01760 (D. Conn. Dec. 1, 2015), <https://www.sec.gov/litigation/complaints/2013/comp-pr2013-132.pdf>; Press Release (No. 2017-123), SEC, SEC Files Fraud Charges in Bitcoin and Office Space Investment Schemes (June 30, 2017), <https://www.sec.gov/news/press-release/2017-123>.
3. SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207 (2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf>.
4. William Hinman, Dir., Div. of Corp. Fin., SEC, Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>.
5. Letter from Jay Clayton, Chairman, SEC, to Hon. Ted Budd, Rep., House of Representatives, (March 7, 2019), <https://coincenter.org/files/2019-03/clayton-token-response.pdf>. In the letter, Chairman Clayton stated that the “analysis of whether a digital asset is offered or sold as a security is not static and does not strictly inhere to the instrument.” *Id.* at 2. He further observed that “[a] digital asset may be offered or sold initially as a security because it meets the definition of an investment contract, but that designation may change over time if the digital asset later is offered and sold in such a way that it will no longer meet the definition.” *Id.*
6. See, e.g., *Tökenlot, LLC*, Securities Act Release No. 10,543, Exchange Act Release No. 84,075, Investment Company Act Release No. 33,221, Admin. Proc. File No. 3-18739 (Sept. 11, 2018), <https://www.sec.gov/litigation/admin/2018/33-10543.pdf>; *Crypto Asset Mgmt., LP*, Securities Act Release No. 10,544, Investment Advisers Act Release No. 5004, Investment Company Act Release No. 33,222, Admin. Proc. File No. 3-18740 (Sept. 11, 2018), <https://www.sec.gov/litigation/admin/2018/33-10544.pdf>.
7. See *In re Zachary Coburn*, Exchange Act Release No. 84,553, Admin. Proc. File No. 3-18888 (Nov. 8, 2018), <http://www.sec.gov/litigation/admin/2018/34-84553.pdf>.
8. SEC, *Framework for “Investment Contract” Analysis of Digital Assets*, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> (last updated Apr. 3, 2019). The Framework is not a Commission rule, statement or guidance, and is not binding on the Commission or its Divisions.
9. Hester M. Peirce, Comm’r, SEC, How We Howey, Speech by video at the Securities Enforcement Forum, East Palo Alto, Cal. (May 9, 2019) [hereinafter Commissioner Peirce Speech], <https://www.sec.gov/news/speech/pierce-how-we-howey-050919>.
10. SEC, Response of the Div. of Corp. Fin. Re: Turnkey Jet, Inc. Letter dated Apr. 2, 2019 (Apr. 3, 2019), <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm>.
11. Commissioner Peirce Speech, *supra* note 9.
12. SEC, Response of the Div. of Corp. Fin. Re: Pocketful of Quarters, Inc. Letter dated July 25, 2019, <https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1>.
13. Complaint, *SEC v. Kik Interactive, Inc.* (“Kik”), Case No. 1:19-cv-05244 (S.D.N.Y. June 4, 2019) [hereinafter *Kik* Complaint],

- <https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf>.
14. Kik Complaint, *supra* note 12, at ¶¶ 12, 90-91.
  15. *Id.* at ¶ 91.
  16. *Id.* at ¶¶ 9-11 and 13.
  17. 15 U.S.C. § 77t(d).
  18. Wells Submission Response Letter from Robert A. Cohen, Chief, Cyber Unit, Div. of Enf't, SEC, to Patrick Gibbs, Esq., Cooley LLC, and Ken Lench, Esq., Kirkland & Ellis LLP (Counsel for Kik Interactive) (Nov. 16, 2018), [https://www.kin.org/wells\\_response.pdf](https://www.kin.org/wells_response.pdf).
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  20. Securities Act Release No. 10,445, Admin. Proc. File No. 3-18304 (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.
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  22. SEC, Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC (Feb. 6, 2018), <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission>.
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  27. 7 U.S.C. § 1a(9).
  28. *In re Coinflip*, CFTC No. 15-29, 2015 WL 5535736, at \*2 (Sept. 17, 2015).
  29. These include, for example, enforcement actions brought against Bitfinex (June 2016), Gelfman Blueprint Inc. (Sept. 2017), Patrick McDonnell (Jan. 2018), My Big Coin Pay Inc. (Jan. 2018), and Control-Finance Limited (June 2019).
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  39. The Libra White Paper further states that Facebook will not directly control Libra; rather, it will share control with members of the Libra Association and others and that "[w]hile final decision-making authority rests with the association, Facebook is expected to maintain a leadership role through 2019." *Id.* at p. 4.
  40. *Id.* at p. 4.
  41. Calibra website (<https://calibra.com/#intro>) link to "Calibra: Customer Commitment;" Facebook June 18, 2019 press release: "A New Digital Wallet for a New Digital Currency," <https://newsroom.fb.com/news/2019/06/coming-in-2020-calibra/>.
  42. 31 C.F.R. § 1010.100(ff).
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