Digital and Digitized Assets:  
Federal and State Jurisdictional Issues

Prepared By:

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PREFACE

This White Paper, and the March 2019 version that it updates, were prepared by members of the Jurisdiction Working Group of the Innovative Digitized Products and Processes Subcommittee (IDPPS) and their colleagues, who generously contributed substantial time and effort to this ambitious undertaking. The authors have sought to provide a comprehensive explanation of federal and state laws that may apply to the creation, offer, uses, and trading of digital assets in the United States, along with summaries of key initiatives outside the United States. The White Paper also recommends an analytic framework for considering potential issues of jurisdictional overlap between the Commodity Futures Trading Commission and the Securities and Exchange Commission under the separate federal statutes they each are responsible for administering.

IDPPS was established in March 2018 as a subcommittee of the Derivatives and Futures Law Committee of the Business Law Section of the American Bar Association. We have over 80 members, comprised of attorneys who work extensively in the areas of derivatives law and securities law and related legal fields. We are organized into three working groups, which include, in addition to the Jurisdiction Working Group, a Blockchain Modality Working Group and an SRO Working Group.

IDPPS was formed with the following objectives:

- To educate ourselves, policymakers, and the public about current issues raised by innovative digitized products and processes, such as cryptocurrencies, smart contracts, and blockchain or other distributed ledger technologies;
- To identify and study emerging legal and regulatory issues and their implications for such products and processes;
- To study and understand how the Commodity Exchange Act framework and other statutory and regulatory frameworks may intersect, and identify areas of conflict or other issues that overlapping laws may create; and
- To make appropriate recommendations to address material issues identified.

We offer our appreciation and thanks to the members of the Jurisdiction Working Group and their colleagues who contributed to the original White Paper and the updates reflected in this White Paper. We hope that the White Paper (like its predecessor) will be a valuable resource for legal practitioners and others active in the digital asset arena, as well as for policymakers.

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With respect to this 2020 White Paper, Daren F. Stanaway and her colleague at Paul Hastings, Michael L. Spafford, with the assistance of Jonathan L. Marcus of Skadden Arps, took on primary responsibility as editors for integrating the various updated Sections contributed by the authors into a single, cohesive, updated White Paper and also drafted the updates to the Executive Summary. Contributing authors received the opportunity to review and provide comments on the full updated White Paper.
# DEFINED TERMS

## A

AIF · alternative investment fund  
AIFMD · Alternative Investment Fund Managers Directive  
AMF · Autorité des Marches Financiers  
AML · anti-money laundering  
AP · associated person  
ASIC · Australian Securities and Investments Commission  
ATS · alternative trading system

## B

BaFin · Federal Financial Supervisory Authority in Germany  
BCBS · Basel Committee on Banking Supervision  
BIS · Bank for International Settlements  
BitLicense · The license required to be obtained by the New York State Department of Financial Services regulations, for any person that is a resident of or located in, or has a place of business or is conducting business in, New York and is engaged in a virtual currency business activity.  
Blockchain · a shared, immutable record of transactions, frequently referred to as a digital ledger  
BSA · Bank Secrecy Act, as amended

## C

CBDC · Central Bank Digital Currency  
Cboe · Cboe Global Markets, Inc.  
CBOT · Chicago Board of Trade  
CCP · central counterparty  
CEA · U.S. Commodity Exchange Act, as amended  
CFD · contract for differences  
CFMA · U.S. Commodity Futures Modernization Act of 2000  
CFT · combating the financing of terrorism  
CFTC · U.S. Commodity Futures Trading Commission  
CME · Chicago Mercantile Exchange Inc.  
CME Group · CME Group Inc., public company parent of CME  
CPMI · Committee on Payments and Market Infrastructures  
CPO · commodity pool operator  
Cryptocurrency · same meaning as virtual currency; the two terms are used interchangeably in this White Paper  
CTA · commodity trading advisor  
CTF · counter-terrorist financing  
CTP · cryptoasset trading platform
D

DAO · Decentralized Autonomous Organization
DCE · Digital Commodity Exchange
DCEA · U.S. Digital Commodity Exchange Act of 2020
DCM · designated contract market
DCO · derivatives clearing organization
DeFi · decentralized finance movement
DFS · New York State Department of Financial Services
DFSA · Danish Financial Supervisory Authority
digital asset · an electronic record in which an individual has a right or interest; the term also is used generically to refer to both digital assets and digitized assets
digital asset funds · investment vehicles designed for the purpose of providing investors with investment exposure to digital assets
digitized asset · a physical asset for which ownership is represented in an electronic record
DLT · distributed ledger technology
Dodd-Frank · U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act
DOJ · U.S. Department of Justice

E

ECP · eligible contract participant
EMIR · European Market Infrastructure Regulation
ESMA · European Securities Markets Authority
ETFs · exchange-traded funds
ETPs · exchange-traded products
EU · European Union

F

FATF · Financial Action Task Force
FBOT · foreign board of trade
FCA · UK Financial Conduct Authority
FCM · futures commission merchant
FinCEN · U.S. Department of the Treasury’s Financial Crimes Enforcement Network
FinHub · U.S. SEC Strategic Hub for Innovation and Financial Technology
FINMA · Swiss Financial Market Supervisory Authority
FINRA · Financial Industry Regulatory Authority
FMA · Austria Financial Market Authority
FSA · Japanese Financial Services Agency
FSB · Financial Stability Board
FSC · South Korea Financial Services Commission
FSMA · Belgium Financial Services and Markets Authority
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<th>Acronym</th>
<th>Full Form</th>
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<td>IAA</td>
<td>U.S. Investment Advisers Act of 1940, as amended</td>
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<tr>
<td>IB</td>
<td>introducing broker</td>
</tr>
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<td>ICA</td>
<td>U.S. Investment Company Act of 1940, as amended</td>
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<td>ICO</td>
<td>Initial Coin Offering</td>
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<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<td>IRS</td>
<td>U.S. Internal Revenue Service</td>
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<td>Malta Financial Services Authority</td>
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<td>MiFID</td>
<td>EU Markets in Financial Instruments Directive</td>
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<td>miners</td>
<td>network participants that run a series of complex algorithms to verify the transaction, ensuring that it is valid and matches the blockchain’s history</td>
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<td>MOU</td>
<td>memorandum of understanding</td>
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<tr>
<td>MSB</td>
<td>money services business</td>
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<tr>
<td>MSP</td>
<td>major swap participant</td>
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<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>NAV</td>
<td>net asset value</td>
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<tr>
<td>NDF</td>
<td>non-deliverable forward</td>
</tr>
<tr>
<td>NFA</td>
<td>National Futures Association</td>
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<tr>
<td>NYMEX</td>
<td>New York Mercantile Exchange</td>
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<thead>
<tr>
<th>Acronym</th>
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<tbody>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>OTC</td>
<td>over-the-counter</td>
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<tr>
<th>Acronym</th>
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<tbody>
<tr>
<td>Ripple</td>
<td>Ripple Labs Inc.</td>
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<tr>
<td>RMG</td>
<td>Royal Mint Gold</td>
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<tr>
<th>Acronym</th>
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<tbody>
<tr>
<td>SAFE</td>
<td>Simple Agreement for Future Equity</td>
</tr>
<tr>
<td>SAFT</td>
<td>Simple Agreement for Future Tokens</td>
</tr>
<tr>
<td>SAR</td>
<td>Suspicious Activity Report</td>
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</table>
**SD** · swap dealer  
**SDR** · swap data repository  
**SEC** · U.S. Securities and Exchange Commission  
**Securities Act** · U.S. Securities Act of 1933, as amended  
**SEF** · swap execution facility  
**SOC** · System and Organization Controls  
**SRO** · self-regulatory organization  
**stablecoin** · cryptocurrency backed by fiat currency  
**STO** · Security Token Offering  
**Supplemental Act** · Uniform Supplemental Commercial Law for the Uniform Regulation of Virtual-Currency Businesses Act  

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**T**

**Token** · Used to refer to both digital and digitized assets

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**U**

**ULC** · National Conference of Commissioners on Uniform State Laws (also known as the Uniform Law Commission)  
**URVCBA** · Uniform Regulation of Virtual-Currencies Businesses Act

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**V**

**VASP** · virtual asset service provider  
**Virtual currency** · defined broadly to include any type of digital assets, with few exceptions such as digital units that are used on gaming platforms or digital units that are used as part of a customer rewards program
EXECUTIVE SUMMARY

Introduction

This White Paper summarizes the existing federal and state regulatory regimes governing digital assets in the United States, discusses the emerging issues that affect digital asset markets and their participants, and outlines analogous efforts taken by international regulators and other national governments. It follows the organization of the original version dated March 2019, and contains much of the original text, updated to reflect material developments. Parts of the discussion are specific to a particular type of digital asset referred to as virtual currencies or cryptocurrencies, because they have received the most attention from U.S. and global regulators.

There is not a consistent set of terms used by regulators, market participants, or others to describe assets that are represented on a blockchain platform. We have endeavored to use the terms “digital asset” and “token” interchangeably and consistently in this White Paper to refer generally to any such type of assets. As explained in Section 1, the term digital asset also can have a narrower meaning, differentiating electronic records that are themselves the asset from “digitized assets” that are electronic records of ownership of an underlying asset.

The growth of the digital asset market has been rapid and volatile. The total estimated market capitalization of virtual currency, a subset of digital assets, soared from $17.7 billion at the end of 2016 to $612.9 billion at the end of 2017; although it dropped to $130.2 billion as of December 30, 2018, it rebounded to $194.9 billion as of December 31, 2019.¹ While the size of the virtual currency market pales in comparison to the overall global economy,² sharp increases

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² As a comparison, Apple Inc. alone commands a market capitalization of more than $1 trillion. See Apple hangs onto its historic $1 trillion market cap, CNBC (last updated Aug. 2, 2018, 4:11 PM), https://www.cnbc.com/2018/08/02/apple-hits-1-trillion-in-market-value.html; see also Virtual Currencies: The Oversight Role of the U.S. SEC and U.S. CFTC: Hearing Before the S. Comm. on Banking, Housing, and Urban
in the value of virtual currencies reflect the interest of a wide variety of market participants, including general retail investors.³

Multiple regulators are considering responses to this new area of commerce.⁴ The current issues that regulators must resolve generally fall into two categories. First, because digital assets are novel and in many ways unlike other regulated products, each regulator faces interpretative obstacles in determining whether—and to what extent—its existing statutory authority permits it to assert jurisdiction. Second, each regulator needs to manage possible jurisdictional overlaps with other regulators. In the United States, the CFTC, the SEC, FinCEN, the IRS, and state regulators such as the DFS have issued guidance or interpretations concerning digital asset products and market participants. Similarly, in Europe, compliance obligations at both the EU and member state levels are expected to apply, depending on the type of digital asset or virtual currency business. Each regulator and standard-setting body also needs to consider the cross-border implications of its respective regulations.

This White Paper addresses these themes in the following sequence: (1) factual background; (2) CFTC jurisdiction over digital assets, with an emphasis on virtual currencies; (3) potential SEC regulation of digital assets under the Securities Act and Exchange Act;


⁴ Jay Clayton & J. Christopher Giancarlo, Regulators Are Looking at Cryptocurrency: At the SEC and CFTC We Take Our Responsibility Seriously, WALL ST. J. (Jan. 24, 2018), https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363 (stating that while the virtual currency market continues to evolve, it calls for regulators to monitor the market for “fraud and abuse”); see also Beyond Silk Road: Potential Risks, Threats, and Promises of Virtual Currencies: Hearing Before the S. Comm. on Homeland Sec. and Gov’t Affairs, 113th Cong. 48–62 (statement of Jennifer Shasky Calvery, Dir., FinCEN) (explaining various attributes of virtual currencies that make them attractive as a medium for illegal activity).
(4) regulatory implications under other federal securities laws, specifically, the Investment
Company Act and the Investment Advisers Act; (5) issues created by jurisdictional uncertainty
between the CFTC and SEC, and potential tools for resolving jurisdictional issues; (6) FinCEN’s
regulation of digital assets; (7) international regulation of digital assets and blockchain
technology; and (8) state regulation of digital assets. These Sections lay out the varying and
diverse approaches taken by federal, international, and state regulators with respect to digital
asset uses and markets as well as interpretative issues associated with each approach, given that
digital asset markets are still in the early stages of development. As these Sections together
suggest, U.S. and international regulators likely will need to be both flexible and nimble.

Summary of Topics Covered

Section 1: Background on Digital Assets and Blockchain Technology

The first Section provides context by giving a high-level primer on blockchain
technology and digital assets in two parts. Section 1.1 explains the mechanics of blockchain and
various applications of the technology. Section 1.2 distinguishes between digital assets (under
the term’s narrower meaning) and digitized assets, different categories of digital and digitized
assets, and how they function within a blockchain.

Blockchain Technology. Although the rise of blockchain (and related technology)
occurred seemingly overnight, the technology’s roots date back at least several decades. In 1976,
two Stanford University authors published a paper on cryptography discussing the concept of a
mutual distributed ledger (albeit not using that particular term)\(^5\)—the same concept that
underpins today’s blockchain distributed ledger technology. A 1991 white paper expanded upon

\(^5\) Whitfield Diffie and Martin E. Hellman, *New Directions in Cryptography*, 22 IEEE TRANSACTIONS ON INFO.
‘mathematical systems’ for solving two kinds of security problems: privacy and authentication.” *Id.* at 645.
that concept to explore “computationally practical procedures for digital time-stamping of . . .
documents so that it is infeasible for a user either to back-date or forward-date his document,
even with the collusion of a time-stamping service.” Nearly three decades later, technological
progress rendered these theoretical concepts a reality, giving rise to the modern blockchain.

Although blockchains differ in terms of configurations and users, one of the most popular
and widely known uses of blockchain technology, bitcoin, made its debut in 2009. Blockchain
technology requires the employment of complex calculations and powerful, expensive
computers. Bitcoin provided an attractive entry point for new blockchain users, rewarding them
with something of value (bitcoins) for participating in the blockchain process, thereby offsetting
(and in some instances surpassing) costs associated with running the computers necessary to
maintain the technology.

As the virtual currency market continues to mature and evolve, additional uses for
blockchain technology have been contemplated, including:

- financial services and investment services (e.g., payment processing and money
  transfers; equity trading; energy futures trading and compliance);
- monitoring supply chains and tracking products, including food products;
- cybersecurity (e.g., creating digital IDs through which users can authenticate and
  control their digital identities);
- copyright and royalty protection;
- digital voting;

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7 See Jon Martindale, What is a blockchain?, DIGITAL TRENDS (last updated May 16, 2020),
https://www.digitaltrends.com/computing/what-is-a-blockchain/.

8 Id.

9 See id.
• products to enable compliance in various legal contexts (e.g., real estate, land, and auto title transfers; tax regulation and compliance; medical recordkeeping; wills or inheritances);

• a blockchain registry of smart contracts to verify, facilitate, or enforce worker contracts; and

• products that secure access to belongings (e.g., using blockchain to grant service technicians access to a house, or a mechanic access to a car, to perform repairs).\(^{10}\)

As Section 1.2 explains in greater detail, the varying applications of blockchain tokens are critical to the increasing variations of uses for digital and digitized assets, such as smart contracts.

As much as blockchain technology presents new opportunities to revolutionize various legal and business processes, the technology raises novel concerns regarding security, technological shortcomings, fraud, and confidentiality. These concerns, at least in part, have prompted regulators to attempt to better understand the digital asset market.

**Digital and Digitized Assets.** “Digital assets” and “digitized assets” are electronic records that are represented on an electronic ledger, including blockchain. Like blockchain technology, digital and digitized assets on a blockchain, also called “blockchain tokens,” have varying uses, including as a means of payment for goods and services, a key to get access to an application, an asset with a particular claim on the issuer, or a combination of multiple uses. None of these applications is explicitly defined by statute or regulation in the United States or other jurisdictions (with certain exceptions addressed below). The absence of uniform definitions creates obstacles for regulators in establishing what obligations should apply to the applications,

as well as to market participants, such as virtual currency businesses or traditional businesses that offer blockchain tokens or virtual currency exchanges that convert and trade virtual currencies.

2020 Updates to Section 1. 2020 updates to Section 1.1 include further discussion of the processes underlying the verification of blockchain transactions and the rapid development of cryptocurrencies backed by fiat currencies (stablecoins), which FINMA recently recognized as a fourth general category of tokens, as detailed in Section 1.2. Updates to Section 1.2 also include an added discussion of the growth of the decentralized finance movement (DeFi) and the increasing number of state central banks exploring the creation of virtual currencies, known as Central Bank Digital Currencies (CBDCs)—digital representations of a sovereign currency issued by a central bank or other mandatory authority.

Section 2: Commodity Exchange Act and CFTC Regulation

The second Section provides an overview of the CEA provisions that may apply to digital assets and derivatives based on digital assets. The discussion focuses on virtual currencies and the CFTC’s efforts to regulate or police those markets, and the issues raised by the CFTC’s actions.

CFTC Regulation of Derivatives. Following an Introduction in Section 2.1, Section 2.2 summarizes the various derivatives products covered by the CEA, along with the CFTC’s authority to regulate certain retail commodity transactions. It discusses how the CFTC’s authority may extend to derivatives or retail transactions based on digital assets, in particular virtual currencies. The CFTC also has anti-fraud policing authority over cash commodity markets, but (putting aside “in scope” retail transactions) it does not have the authority to adopt regulations governing cash commodity markets. Determining whether the CEA will apply to derivatives or retail transactions involving digital assets hinges in large part on whether the
digital asset is a “commodity” as defined in the CEA, and also on whether, if it is a covered “commodity,” the digital asset could be sub-classified as a security.

**CFTC Regulation of Virtual Currencies.** Section 2.3 summarizes the CFTC’s potential authority over virtual currencies or other digital assets as “commodities,” and provides an explanation of the CEA’s commodity definition (which covers items one would not expect under a common understanding of the term), the definition’s potentially broad reach, and interpretative questions raised under the definition since the CFTC first formally asserted in 2015 that virtual currencies are commodities within its oversight. The CFTC’s assertion of authority over virtual currencies largely has been in the context of enforcement actions, where the CFTC generally seeks to combat fraud and manipulation. 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” under the CEA, and on whether it is a security or a non-security commodity.

The CFTC’s assertion that all virtual currencies are “commodities” over which it has anti-fraud authority (which presupposes that they are not securities) has faced challenges by defendants in civil enforcement cases. Some of those challenges raise significant questions about the scope of the CFTC’s authority over virtual currencies, as discussed in Section 2.3. Section 2.3 also discusses litigation over the meaning of the “actual delivery” requirement in the exclusion from the CEA provision imposing regulation on certain margined, leveraged, or financed retail commodity transactions.

**Allocation of Jurisdiction between the CFTC and SEC.** Putting aside whether a particular virtual currency (or other digital asset) is a security or a non-security commodity, it is useful to understand how federal law allocates jurisdiction between the CFTC and SEC over
securities-based derivatives and hybrid securities with derivatives elements. Section 2.4 provides an overview of the current jurisdictional allocation between the two agencies.

2020 Updates to Section 2. Updates to Section 2 include discussion of the CFTC’s 2020 guidance concerning “actual delivery” of digital assets (Section 2.2) and recent case law updates addressing the actual delivery issue (Section 2.3), as well as recent cases involving questions of whether a particular digital asset falls within the CEA’s definition of “commodity” (Section 2.3).

Section 3: Federal Securities Regulation: Securities Act and Exchange Act

The third Section summarizes the application of federal securities laws and SEC regulations to digital assets. Section 3.1 analyzes whether the current definition of “security” in the Securities Act and Exchange Act may apply to digital assets. Section 3.2 discusses the regulatory implications for digital assets that are determined to be securities under the Securities Act and the Exchange Act.

Application of the Security Definition. Under the Securities Act and the Exchange Act, the SEC has statutory authority to regulate “securities” to protect investors from improper conduct (e.g., manipulation, fraud, theft). Thus, similar to the CFTC’s jurisdiction over “commodities,” the SEC’s statutory authority to regulate digital assets relies on a determination that those assets fall within the definition of “security.” Also similar to the CFTC context, the definition of “security” covers a broad range of instruments, and also includes the catch-all term “investment contract.” Because the Securities Act and the Exchange Act do not explicitly contemplate the treatment of digital assets and virtual currencies, whether a digital asset will fall within the scope of securities regulations often will depend on whether it is determined to be an “investment contract.” As Section 3.1 explains, in assessing whether an instrument is an “investment contract,” and, therefore, a “security,” the SEC primarily applies a four-part test the Supreme Court set out in SEC v. Howey—(1) an investment of money; (2) in a common
enterprise; (3) with a reasonable expectation of profits; and (4) the expectation of profits is based upon the entrepreneurial or managerial efforts of others. Applying the Howey test necessarily invites questions as to how the particular characteristics of various digital assets fall within each element, as addressed below.

**Securities Act and Exchange Act Compliance.** Because certain digital assets are likely to be classified as “securities,” Section 3.2 outlines the regulatory obligations that would apply to the digital assets, and any applicable exemptions for parties transacting in digital assets. For example, the Securities Act, which generally addresses initial offerings of securities, requires issuers of securities to register the securities with the SEC or establish that the securities are exempt from registration. If none of the available exemptions apply to a securities offering, the Securities Act requires issuers to provide disclosures regarding both the security and the issuing entity as part of the registration process. The SEC has anti-fraud authority over both exempt and non-exempt securities.

Section 3.2 also outlines the regulatory obligations set out in the Exchange Act, which establishes the regulatory regime for the secondary securities market. Specifically, the Exchange Act regulates financial intermediaries such as broker-dealers, exchanges, transfer agents, and clearing agencies. Financial intermediaries that perform any of these activities in the digital asset context may be subject to regulation under the Exchange Act. Depending on the activities of the entity, compliance with the Exchange Act may include obligations such as registration, capital requirements, reporting, disclosures, and filings of forms and policies with the SEC for approval.

**2020 Updates to Section 3.** Updates to Section 3.1 include discussion of three major developments in the wake of the DAO Report that help to clarify the SEC’s views of the application of federal securities laws to digital assets, including (1) the SEC staff’s publication of
a Digital Asset Framework, which describes how certain features make a digital asset more or less likely to qualify as a security; (2) the SEC’s issuance of its first digital asset-related no-action letters; and (3) further developments in two SEC enforcement actions targeting significant digital asset projects (Kik Interactive and Telegram). Section 3.2 updates include discussion of the SEC’s recent allowance of several issuers to offer digital assets that fit within the legal framework for securities offerings and the implications that recent decisions in SEC enforcement cases have on such offerings; recent SEC actions against entities acting as unregistered broker-dealers in the course of their involvement in ICOs and token offerings; and the SEC’s stance on recent market participants’ attempts to offer trading platforms for digital assets.

Section 4: Federal Securities Regulation: Investment Company Act and Investment Advisers Act

Section 4 covers regulatory implications under two other federal securities statutes, the ICA and IAA, in Sections 4.1 and 4.2, respectively.

Investment Company Act Compliance. Regulatory requirements under the ICA ultimately may apply to digital assets as the market continues to attract vehicles that invest in digital assets. Entities that are “investment companies” under the ICA are required to register with the SEC and also register their shares for sale under the Securities Act, unless an exemption is available. Investment companies also are subject to extensive regulation under the ICA. Section 4.1 outlines the bases on which an issuer of digital assets or a digital asset fund would have to register as an investment company under the ICA and the associated regulatory implications. As is the case with the Securities Act and the Exchange Act, applying the ICA regulatory regime to digital assets raises interpretative questions. For example, a person is an investment company if it is an “issuer” of a “security” and either holds itself out as investing primarily in securities or invests a certain percentage of its assets in securities. While the Securities Act and the Exchange Act define these terms similarly, the definition of “security” for
purposes of determining whether the issuer’s investments trigger investment company status can be broader than the Securities Act and Exchange Act definition of “security.” Section 4.1 also includes a discussion of issues that can arise if conventional investment companies, such as mutual funds and ETFs, invest in digital assets.

**Investment Advisers Act Compliance.** Persons providing advice with respect to digital assets may be “investment advisers” who are subject to regulation and potential registration requirements under the IAA or comparable provisions of state law, depending on whether the digital assets are considered securities for this purpose. Section 4.2 explains who might be regulated as investment advisers under the IAA and the regulatory implications for such persons. Similar to the ICA, applying the IAA to digital assets involves interpretative questions, including whether a person engages in the business of “advising” others regarding a “security.” The definition of a “security” under the IAA is identical to the definition under the ICA.

**2020 Updates to Section 4.** Updates to Section 4.1 include discussion of a recent digital asset fund’s registration under the ICA; added discussion of potential structures of digital asset funds that may and may not be subject to the ICA (including as illustrated in Exhibit A to Section 4); and added discussion of responses to, and recent developments in the wake of, the SEC staff’s Cryptocurrency Funds Letter, which sought information and insight on a number of significant investor protection issues relating to fund offerings to retail investors. Updates to Section 4.2 include discussion of the SEC’s 2019 letter seeking industry and public comment on application of the custody rule to digital assets, as well as subsequent issuance of staff guidance on the custody of digital asset securities under the rules applicable to broker-dealers.

**Section 5: Potential Jurisdictional Overlap between the CFTC and the SEC**

While various federal and state regulators have issued guidance regarding digital assets, in particular with respect to virtual currencies, the question of whether, and to what extent,
digital assets may be subject to the regulatory regimes of both the CFTC and SEC is of particular importance. Following an Introduction, Section 5.2 discusses the legal and policy analysis, including the intersection of securities and non-security commodities transactions. Section 5.3 provides an overview of problematic issues with the current CFTC and SEC statutory schemes. Section 5.4 provides some explanation of how jurisdictional debates between the two agencies have been resolved in the past, as that may provide helpful precedent for how to resolve issues around digital assets. Section 5.5 describes the process for cooperation mandated as part of the Dodd-Frank Act as a mechanism for seeking clarification on which agency has jurisdiction over novel products. Section 5.6 then examines potential tools to establish jurisdictional policies without new legislation, including each agency’s exemptive authority and the Dodd-Frank prescribed process for cooperation.

2020 Updates to Section 5. Updates to Section 5.2 include discussion of recent 2019 and 2020 case law developments in certain CFTC enforcement actions involving digital assets. Updates to Section 5.3 include discussion of SEC Commissioner Hester M. Peirce’s recommendation that the SEC establish a safe harbor that would afford network developers a three-year grace exemption from the registration provisions of the federal securities laws, provided that certain conditions are met; recent CFTC statements regarding trading of certain cryptocurrency derivatives in U.S. markets and potential deference to the SEC’s jurisdiction where the SEC views a transaction as a security under the Howey test; recent legislative proposals to resolve the jurisdictional uncertainty between the SEC and CFTC; and discussion of recent parallel SEC and CFTC enforcement actions.

Section 6: FinCEN Regulation

The sixth Section summarizes FinCEN’s regulation of virtual currencies through its authority to regulate “financial institutions” under the Bank Secrecy Act (BSA), which focuses
on combating persons and entities that engage in money laundering or terrorism financing.

Section 6.1 summarizes the scope of FinCEN’s regulatory authority under the BSA. The term “financial institution” under the BSA extends to entities including Money Services Businesses (MSBs). FinCEN has extended its authority to certain virtual currency businesses that it determined fall within the broad MSB definition.

Sections 6.2, 6.3, and 6.4 detail the regulatory implications of falling within FinCEN’s jurisdiction. For example, if a virtual currency business is deemed to be a MSB, it would incur compliance obligations such as registering with FinCEN, submitting to examinations by the IRS, and establishing an AML program. As Section 6.5 explains, like the SEC and CFTC, FinCEN has taken steps to regulate the virtual currency market, including enforcement actions against virtual currency market participants under its BSA authority.

2020 Updates to Section 6. Updates to Section 6.1 include discussion of FinCEN’s May 2019 guidance applying to common business models involving virtual currencies, and updates to Sections 6.2, 6.3, and 6.4 include discussion of the regulatory implications of that guidance and new developments regarding the Travel Rule’s application to virtual asset service providers. Updates to Section 6.5 include discussion of recent enforcement actions, including FinCEN’s first assessment of civil money penalties against a peer-to-peer virtual currency exchanger.

Section 7: International Regulation of Digital Assets and Blockchain Technology

The seventh Section summarizes international regulations, directives, and guidance regarding virtual currency and other digital asset markets. Sections 7.1 and 7.2 detail European efforts initiated at both the EU level, including through EU legislation and ESMA guidance and statements, and the individual country level, including through legislation and guidance provided by national regulators. Section 7.3 summarizes approaches to virtual currency taken by regulators in Asia and Australia. Section 7.4 outlines guidance on virtual currencies provided by
international bodies such as IOSCO. Collectively, Section 7 describes a spectrum of approaches ranging from regulators who are skeptical of the benefits of virtual currencies to those who welcome and encourage the markets’ development.

**European Initiatives.** As Section 7.1 explains, the characteristics of digital assets created and used in Europe determine whether—and to what extent—certain EU compliance obligations apply to those assets. MiFID II obligations will be triggered where digital assets are considered to fall within the MiFID II definition of “financial instrument,” which includes, among other items, transferable securities, money-market instruments, units in collective investment undertakings, and certain options, futures, forward rate agreements, and swaps. Like the definitions of “security” and “commodity” in the United States, the financial instrument definition does not specifically enumerate digital assets or virtual currencies, so European authorities must determine whether the assets have characteristics sufficiently similar to the enumerated categories.

Additionally, EMIR risk mitigation requirements may apply to certain cleared and non-centrally cleared OTC derivatives transactions. Because EMIR requires that certain OTC derivatives transactions clear through a CCP, blockchain technologies that may be used to clear derivatives transactions covered by EMIR may need to comply with these requirements. To the extent EMIR requirements extend to OTC derivatives not cleared by CCPs, they also may impact blockchain technology used in connection with those derivatives.

Other obligations may apply to certain types of market participants as well. For example, the European Parliament and EU Council have amended the governing AML legislation specifically to cover cryptocurrency exchanges and custodial wallet providers.
As Section 7.2 outlines, regulators in the United Kingdom, Switzerland, France, Germany, Austria, Slovenia, and Malta have taken active steps to evaluate the evolving virtual currency market, examine how digital assets and blockchain technology may fall within existing regulations and directives, and in some instances implement new laws, regulations, or other initiatives. As described below, regulators in these countries have taken varying approaches, demonstrating the differing policy perspectives regarding the operation of virtual currency markets.

**Asian and Australian Regulations.** Unlike Europe, Asia has no larger regional body tasked with setting regulatory agendas. Accordingly, jurisdictional issues raised by the virtual currency markets are particularized to each individual country. Section 7.3 focuses on approaches taken by national governments in a number of Asian countries, including Japan, South Korea, Singapore, and China; it also addresses Australia’s regulation of the virtual currency markets, as well as differences among these approaches.

The regulatory postures fall within two broader categories. First, Japan, South Korea, and Australia have taken proactive steps to regulate their cryptocurrency markets and thus have dynamic and increasingly nuanced regulatory regimes. These jurisdictions have embraced cryptocurrency and afforded it legal protection but, to varying degrees, have sought to regulate the inherent risks that cryptocurrency products pose to consumers, financial markets, the private sector, and payment systems. Of the jurisdictions in this category, Japan has the deepest history with cryptocurrencies and likely the most robust long-term infrastructure within which cryptocurrency providers and consumers can operate. South Korea similarly has sought to develop a strong regulatory regime that embraces the economic and innovative potential of cryptocurrencies while mitigating risks. Finally, Australia has recently begun to regulate its
otherwise generally open market and has done so largely to limit cryptocurrencies as a vehicle for financial crimes.

Second, Singapore and China have developed less nuanced regulatory regimes designed to create a clear and consistent approach. Singapore generally has embraced cryptocurrencies and sought to create a permissive environment for their operation. Consistent with that operating principle, Singapore appears to lightly regulate cryptocurrencies, and when it does regulate them, appears to do so in accordance with preexisting regulation. Conversely, China largely has rejected the private cryptocurrency industry (although notably, it has not rejected virtual currencies or blockchain technology more broadly). As a result, China has taken a consistently restrictive posture towards cryptocurrency, and effectively has banned vital elements of the cryptocurrency industry in its jurisdiction.

As Section 7.3 explains, the approaches taken by regulators in Asia with respect to regulating foreign virtual currency market participants differ as well, but generally address two larger questions of (1) whether foreign entities will be permitted to participate in the respective markets and, (2) if so, how those entities should be regulated.

**Global Guidance.** As the virtual currency markets continue to expand, international organizations that are tasked with setting global standards for the regulation of industries related to banking, securities, or other financial markets have created initiatives to assess the virtual currency markets. Among those organizations are the following:

- The BIS, which is owned by 60 central banks worldwide and, among other initiatives, publishes research analyses and international banking and financial statistics in support of international policymaking. The BIS also hosts a number of committees, including the BCBS and the CPMI. The BCBS is a committee responsible for setting
global standards for the prudential regulation of banks as well as creating a forum to enable cooperation regarding banking regulatory matters. The CPMI is a committee that sets global standards in the areas of payment, clearing, settlement, and related arrangements. The CPMI is tasked with monitoring developments in these subject areas and, like the BCBS, serves as a forum for central bank cooperation in related oversight, policy, and operational matters;

- IOSCO, an international body composed of national securities regulators that develops and promotes adherence to internationally recognized standards for securities regulation;

- FATF, an inter-governmental body established to set standards for preventing money laundering, terrorist financing, and other related threats to the integrity of the international financial system; and

- The FSB, an international body that coordinates national financial authorities and international organizations in their efforts to develop regulatory policies and monitors and makes recommendations about the global financial system.

None of these international bodies has proposed to broadly restrict the virtual currency market; however, they have offered a spectrum of opinions, with some organizations expressing more concern regarding the risks posed by the virtual currency markets than others. Nevertheless, as Section 7.4 details, these international bodies have highlighted potential benefits that the virtual currency markets may provide and, in doing so, favored continued observation of the development of the market.

**2020 Updates to Section 7.** Updates to Section 7 include discussion of various developments impacting digital assets across Europe, Asia, Australia, and globally. In Europe,
these include the EU’s recent approval of the Sixth Anti-Money-Laundering Directive; the European Central Bank’s consideration of developing a digital currency; developments arising from the UK’s withdrawal from the EU and UK regulators’ issuance of new guidance in 2019 and 2020 detailing their regulatory oversight of digital assets; Switzerland’s release of new stablecoin guidelines and creation of new AML regulations affecting digital assets; France’s new regulatory regime for digital assets and 2020 test of a CBDC; and Germany’s and Austria’s formal incorporation of the Fifth Anti-Money-Laundering Directive into their regulatory regimes. In Asia and Australia, these include Japan’s official certification of a self-regulatory organization in the digital asset sphere, passage of new laws relating to cryptocurrency transactions, which reflect a softening approach towards cryptocurrencies, and consideration of creating a CBDC; South Korea’s passage of a reform bill providing a comprehensive framework for the regulation of digital assets and crypto exchanges, and launch of a CBDC testing program; Australia’s introduction of a gold-backed digital asset; Singapore’s codification of the Payment Services Act, which imposes certain licensure and other requirements on digital payment token services providers; and recent statements from China’s leaders endorsing blockchain technology and China’s commencement of testing a CBDC. Globally, these include IOSCO’s further examination of cryptoasset platforms and recent reports and statements by FATF and G20, among others, relating to stablecoins and other digital assets.

Section 8: State Law Considerations

Section 8 identifies key state regulators that also have asserted authority over virtual currency businesses. Section 8.1 summarizes the New York DFS regulations of virtual currency businesses and the requirement that those businesses register for a “BitLicense.” Section 8.2 summarizes an exemption from BitLicense regulations for virtual currency businesses that are chartered under New York Banking Law. Section 8.3 discusses the recent adoption of a virtual
currency token listing framework under DFS guidance. Section 8.4 outlines an initiative started by New York regulators to gather additional information from major virtual currency businesses. Section 8.5 summarizes the efforts of other states in regulating the issuance of virtual currencies or tokens through ICOs.

**BitLicense Requirements and Exemptions.** Generally, virtual currency businesses are subject to the New York BitLicense regulations only if (1) the business involves a “virtual currency,” as that term is defined by the DFS regulations; (2) the business is engaged in a “virtual currency business activity;” and (3) no available exemptions apply. “Virtual currency” is defined broadly to include any type of digital assets, with a few exceptions such as digital units that are used on gaming platforms or as part of a customer rewards program. The DFS regulations also define what constitutes “virtual currency business activity” to include a number of activities such as storing, holding, or maintaining custody of virtual currency on behalf of others, issuing virtual currency, or buying and selling virtual currency.

Unlike the federal regulatory schemes, which were not created with virtual currency businesses in mind, the DFS BitLicense regime specifically addresses the existing virtual currency markets. The significant compliance requirements can be costly. Thus, a threshold question for a business subject to the BitLicense requirements is whether it qualifies for an exemption from the requirements. The BitLicense requirements do not apply to businesses that are using virtual currency solely for the purchase of goods and services or for investment purposes or that are chartered under New York Banking Law. As Section 8.2 explains, with respect to the latter exemption, while there are certain differences between compliance obligations set out by the New York Banking Law and the BitLicense requirements, complying
with the alternative regime does not provide exemptive relief from the primary BitLicense requirements.

*Other State Regulation.* State regulators have asserted jurisdiction over virtual currency businesses primarily in the context of money transmitter regulations, which apply to issuers of virtual currencies, and ICO regulations. With respect to money transmitter regulations, state regulators have attempted to balance their regulatory interests with a need for coordination to prevent unnecessary regulatory burdens. Specifically, the states have proposed, but not yet enacted, a uniform regulation for virtual currency businesses that could apply to each state. As Section 8.5 will explain, state regulators have taken a more varied approach to ICOs under existing securities laws. Additionally, the Appendix to this paper provides a 50-state survey of virtual currency regulations (as of October 8, 2020) that identifies what legislative or regulatory steps, if any, a state has taken with respect to the licensing or regulation of the virtual currency market.

**2020 Updates to Section 8.** Updates to Section 8 include discussion of a 2020 DFS proposal regarding conditional BitLicenses in Section 8.1; a new Section 8.3 discussing New York’s adoption of a virtual currency token listing and self-certification framework under DFS guidance; and discussion of various state legislatures’ introduction of the Uniform Supplemental Commercial Law for the Uniform Regulation of Virtual Currency Business Act, as detailed in Section 8.5. The Appendix to this paper also has been updated to reflect recent state legislative and regulatory developments regarding licensing or regulation of virtual currency markets.
SECTION 1. BACKGROUND ON DIGITAL ASSETS AND BLOCKCHAIN TECHNOLOGY*

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2020 UPDATES TO SECTION 1

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1. **Blockchain Technology**

   (a) **What Is “Blockchain?”**

   Blockchain is a shared, immutable chronological record of transactions, frequently referred to as a digital ledger, and a type of distributed ledger technology. Blockchain technology “makes it possible to create a digital ledger of transactions and share it among a distributed network of computers. It uses cryptography to allow each participant on the network to manipulate the ledger in a secure way without the need for a central authority.”

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*The authors of Section 1 wish to thank Petal P. Walker and Twane Harris of WilmerHale for their substantial contributions to this Section.*

the chain represents a set of transactional records, which the “chain” component in turn links together via a “hash” function\textsuperscript{12} that distills an original piece of information into a code that is recognizable and archived on the blockchain ledger.\textsuperscript{13}

The working concept behind the decentralized digital ledger is that it eliminates the need for a trusted third-party intermediary or central authority, such as a bank or government, to verify the transactions.\textsuperscript{14} Instead, blockchain network participants themselves collectively verify transactions through a procedure referred to as a consensus algorithm, which determines when all blockchain network participants agree on the validity of the transactions. The original and still most widely used consensus algorithm is Proof of Work (commonly abbreviated as “PoW”). Under this consensus algorithm, when blockchain network participants announce transactions to the network, certain participants (referred to as “miners”) validate the transactions by competing among themselves to find the solution to increasingly more complex mathematical puzzles. They present solutions on a trial-and-error basis until one finds the correct number and communicates it to the network. When a majority of network participants agree that one miner has solved the problem, a consensus is achieved. For this work, the miner receives a reward in the form of transaction fees, and the block of transactions is added to the distributed ledger, where it becomes an immutable part of the blockchain.\textsuperscript{15} As a result of the high energy costs associated with PoW and related issues, other types of consensus algorithms have been developed. One

\textsuperscript{12} See Martindale, supra note 7.


\textsuperscript{14} See Martindale, supra note 7.

major variation is Proof of Stake (commonly abbreviated as “PoS”). While PoW miners use electricity to perform computations to mine blocks, PoS “validators” stake cryptocurrency to “attest” or “validate” blocks. Validators make themselves available to be randomly selected to propose a block; other validators then “attest” that they have seen the block; and when a sufficient number of attestations for the block has been collected, the block is added to the blockchain. Validators receive rewards for proposing blocks, as well as for making attestations, and are subject to penalties for failure to perform validations or malicious behavior, including potentially losing up to the whole amount of their stake. A number of other consensus algorithms exist, and there is a trend of integrating several consensus algorithms in a particular application rather than relying on a single consensus algorithm.

Two types of blockchains exist: permissionless and permissioned chains. As the name suggests, permissionless chains allow anyone to participate, without vetting, whereas consortia or administrators evaluate and determine each entity’s proposed participation in a permissioned chain. In both instances, blockchains use “smart contracts”—contracts that are coded to automatically execute contractual obligations (e.g., direct payments, or impose penalties if certain conditions are not satisfied) via the blockchain without manual intervention.

Unlike the central authority model (in which a single, trusted authority like a bank maintains a master copy of a ledger), all blockchain participants maintain identical copies of the

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18 *Id.*
same ledger. Every time a new block is created, information related to the transaction, including a time stamp and the hash number of the previous block, is included. Blockchain advocates believe this technology renders the blockchain system less vulnerable to fraud.\textsuperscript{19} Tampering with a ledger maintained, monitored, and verified by multiple participants across the globe is conceived to be significantly more difficult than falsifying a ledger maintained by a single bank—perhaps by hacking into the bank’s recordkeeping system, for example. In addition, attempts to tamper with the blockchain are perceived to be immediately apparent, because the new hash associated with the proposed transaction will not match prior hashes in the chain, and the transaction thus should not be approved.\textsuperscript{20}

(b) Cryptocurrency Trading Platforms and Points of Intersection with Fiat Currencies

Although some blockchain advocates suggest that cryptocurrencies may one day render fiat currencies obsolete, at present, the two are linked. Bitcoin, for example, may be purchased on exchanges or directly from others in the marketplace using fiat currency (transferred, \textit{e.g.}, via credit or debit card payments, or wire transfer) or other cryptocurrencies.\textsuperscript{21}

Transacting in bitcoin (and similar cryptocurrencies) typically requires setting up a “wallet” to store the digital coins, such as an online wallet (which can be provided as part of an exchange platform or via an independent provider), a desktop wallet, a mobile wallet, or an

\textsuperscript{19} \textit{See infra} Section 1.1(c).

\textsuperscript{20} \textit{The Trust Machine}, \textit{supra} note 13. A hacker essentially would need to hack the entire blockchain, which would be extremely cumbersome to decipher.

\textsuperscript{21} \textit{How Can I Buy Bitcoin?}, COINDESK (last updated July 8, 2020), https://www.coindesk.com/information/how-can-i-buy-bitcoins/. Although this discussion references Bitcoin, we use Bitcoin by way of example only; similar processes are applicable to other blockchain technologies and cryptocurrencies, though the types of processes of course differ for different blockchains and cryptocurrencies.
offline wallet (such as a hardware device or paper wallet).22 A wallet, in whatever form, keeps the keys (a string of characters) and/or passwords for the cryptocurrency safe. Losing these means losing access to the cryptocurrency.23

Hundreds of cryptocurrency exchanges currently are operating globally and will buy and sell cryptocurrency on behalf of users, though individual user access may be limited, depending on geographical area.24 Given KYC and AML regulations, many exchanges require proof of identity for account setup, which can include a photo ID and proof of address.25

Most exchanges charge fees and accept payment via credit card or bank transfer, and some also accept PayPal transfers.26 Once the exchange receives payment (for the bitcoin purchase and any applicable fees), it will purchase the bitcoin on the user’s behalf and automatically deposit the coin into the user’s wallet on the exchange.27 The user then may transfer the bitcoin to a different off-exchange wallet if desired.28

Bitcoins also may be transacted off-exchange. Certain online platforms are available to assist bitcoin users in finding other individuals willing to exchange bitcoins for cash, or retail outlets at which cash may be exchanged for bitcoins.29 Some bank branches also permit

22 Id. A paper wallet is an offline wallet—usually a “cold storage” device that does not make contact with the internet—typically printed on paper or plastic. It includes a public and private key printed together. See id.

23 Id.

24 Id. These exchanges vary in terms of liquidity and security. See infra Section 7.

25 Id.

26 Id.

27 Id.

28 Id.

29 Id.
individuals to make cash deposits in exchange for bitcoins.\textsuperscript{30} In addition, much like traditional cash ATMs, Bitcoin ATMs enable users to deposit cash in exchange for bitcoins (which in turn are deposited in the user’s wallet and recorded on the blockchain after a cash deposit to the ATM).\textsuperscript{31} In each instance of purchase or sale, once the transaction is verified (by miners), the bitcoin transaction will be recorded on the blockchain.

Apart from the blockchain transactions themselves, miners of cryptocurrency networks generally do not measure the income they receive in terms of bitcoin (or other applicable cryptocurrency). Instead, they value their income in terms of fiat currency, converting their bitcoins (or other cryptocurrency) into the local fiat currency in the physical location of their mining operation.\textsuperscript{32} This is in part because fiat currencies typically are “stable and liquid,” whereas the values of bitcoin and other cryptocurrencies can be volatile.\textsuperscript{33}

This price volatility has led to the rapid development of cryptocurrencies that are backed by fiat currencies (referred to as “stablecoins”).\textsuperscript{34} In addition to the rise of stablecoins as trading assets, banks have been working toward the use of stablecoins as new payment methods for digitized money transfers and payments.\textsuperscript{35} For example, the Utility Settlement Coin is a proposal by Fnality International (a consortium of 15 large financial institutions),\textsuperscript{36} which aims to provide

\textsuperscript{30} Id.
\textsuperscript{31} Id.
\textsuperscript{33} Id.
\textsuperscript{34} See infra Section 1.2(b)(4).
\textsuperscript{36} The consortium includes Banco Santander, BNY Mellon, Barclays, CIBC, Commerzbank, Credit Suisse, ING, KBC Group, Lloyds Banking Group, Mizuho Financial Group, MUFG Bank, Nasdaq, Sumitomo Mitsui Banking
digital tokens called USC in local currencies, each token representing a par value claim on a pool of fiat currency reserves held at an account at the central bank in its jurisdiction. To make a payment, a participant would first submit fiat currency in exchange for USC tokens at par value. USC payments would then be conducted over a blockchain-based ledger.\textsuperscript{37} Another example is the JPM Coin, a proposal by JPMorgan Chase, which would enable instantaneous transfer of U.S. dollar payments between institutional clients. Each JPM Coin would be a liability of JPMorgan, and the value of each coin would be USD 1.\textsuperscript{38} Many central banks, too, have been considering issuing their own digital currencies, some of which may rely on distributed ledger technology for verification.\textsuperscript{39} Thus, as this discussion shows, the relationship between fiat currency and cryptocurrency is fluid, and blockchain transactions frequently intersect with fund transfer systems for fiat currencies.

(c) Security Issues Associated with Blockchain

Because all participants have copies of the existing blockchain and transaction history, changing or removing a transaction from the ledger is difficult.\textsuperscript{40} Advocates of the technology suggest that this feature makes blockchain significantly less susceptible to fraud risk.\textsuperscript{41}

\begin{footnotesize}

\textsuperscript{38} Signet and Wells Fargo Digital Cash are similar proposals by other large commercial banks. \textit{Id}.


\textsuperscript{40} See Norton, \textit{supra} note 11.

\textsuperscript{41} See \textit{id}.
\end{footnotesize}
addition, it has been argued that blockchain provides advantages over traditional centralized data storage systems in that blockchain is resilient to single point of failure and insider attacks; users are given a single pseudonymous address that protects their identities; and the use of smart contracts can provide users the autonomy to share their data flexibly.\(^{42}\) That said, blockchain is not altogether immune to fraud, and it is subject to a number of security (and other) risks.

Risks associated with blockchain depend in part upon whether the chain is permissioned or permissionless. In the permissionless context, anyone can participate as a validator, so long as they meet the network’s technological requirements. No other entity checks, such as KYC, are performed, so anyone acquiring the cryptocurrency traded on the blockchain may transact with any other entity on the blockchain.\(^{43}\) This increases risks of money laundering and theft from a user’s account.\(^{44}\) In addition, permissionless blockchains pose privacy and scalability risks.\(^{45}\) In the permissioned context, these risks can be mitigated through monitoring by the administrator or consortium.\(^{46}\)


\(^{43}\) BLOCKCHAIN RISK MANAGEMENT, supra note 17, at 4.


\(^{45}\) “Scalability” risks include risks associated with recording every transaction in the chain, which in turn may present security concerns.

\(^{46}\) BLOCKCHAIN RISK MANAGEMENT, supra note 17, at 4.
Both types of blockchains involve the use of smart contracts, which can be vulnerable to cyberattack and technology failures.\(^47\) Specifically, smart contracts rely on data from outside entities called “oracles,” which feed data to the network. Oracles, in turn, may be subject to malicious attacks aimed at corrupting data transmitted to the blockchain.\(^48\)

Although blockchain technology provides transaction security (by protecting data stored in the blockchain ledger against tampering), it does not provide individual wallet or account security. Accordingly, individual wallets and accounts remain susceptible to risks like account takeover (for example, when bad actors steal private keys), which in turn can render digital assets irretrievably lost.\(^49\) In addition, a malicious actor theoretically could take over more than 50% of network participant nodes, which in turn creates cybersecurity risks and threats to the larger blockchain.\(^50\) Such takeovers, which are commonly referred to as “51% attacks,” resulted in losses of approximately $1.1 million on the Ethereum Classic blockchain in January 2019 and $18 million on the Bitcoin Gold blockchain in May 2018.\(^51\)

Blockchain technology also includes risks associated with data confidentiality. All blockchain participants may view the transactions in the ledger, and although transactions may be stored in a format that does not reveal personal details, network participants always will have

\(^{47}\) Id.

\(^{48}\) Id. at 7.

\(^{49}\) Id. at 5–6.

\(^{50}\) Id. at 5.

access to some of the metadata, which in turn can reveal information about the type of activity and volume associated with the activity.52

2. Digital Assets

(a) Digital and Digitized Asset Definitions

A “digital asset” is an electronic record in which an individual has a right or interest. The term does not include an underlying asset or liability unless the asset or liability is itself an electronic record.53 In the words of SEC Director William Hinman, “the digital asset itself is simply code.”54 Digital assets are distinguished from physical assets because the digital asset itself does not exist in physical form. For example, a bitcoin is a digital asset because it is an electronic record that is created and stored exclusively on the Bitcoin blockchain.55

A “digitized asset” is an asset (which may be a security or a physical asset), the ownership of which is represented in an electronic record.56 An example of a digitized asset would be an electronic record of the ownership of real estate stored on a digital ledger. The ledger may include an electronic record that contains all of the rights associated with ownership, although the asset itself—the real estate—exists apart from the electronic record. Utilizing the

52 BLOCKCHAIN RISK MANAGEMENT, supra note 17, at 6.


55 The “wallets” in which parties keep their bitcoins do not physically possess the bitcoin. Wallets maintain a party’s private key data in a location that usually is encrypted. See How to Store Your Bitcoin, COINADES (last updated July 8, 2020), https://www.coindesk.com/learn/bitcoin-101/how-to-store-your-bitcoins.

electronic record to record the ownership of the asset on the ledger makes the electronic record a digitized asset.

Digital and digitized assets are represented on an electronic ledger that is not necessarily a blockchain. Digital and digitized assets on a blockchain are commonly referred to as “blockchain tokens.” A blockchain token is “a digital token created on a blockchain as part of a decentralized software protocol.”

(b) Digital and Digitized Asset Classifications

Digital assets can take many different forms, which implicate the jurisdictions of different regulators and regulatory regimes. In the United States, the different categories of applications have not been codified by federal statute or regulatory rulemaking.

In February of 2018, FINMA set out its guidelines for ICOs, which included tokens defined by the intended underlying economic function of the token. FINMA then published a supplement to these guidelines in September of 2019, which included a new category of token. This Section of the White Paper incorporates the FINMA token definitions for its analysis. It also, though, focuses primarily on U.S. law, so in many cases the conclusions reached will differ from those of FINMA when FINMA makes jurisdictional classifications of token applications under Swiss law. The FINMA definitions refer to blockchain tokens, although conceptually the


definitions may be equally applied to digital and digitized assets that are not transacted on a blockchain.

FINMA divides tokens into (1) Payment Tokens, (2) Utility Tokens, (3) Asset Tokens, and (4) Stablecoins. Some tokens fall under multiple token categories, and some tokens may be used in ways that were not intended at inception.

(1) Payment Tokens

“Payment [T]okens (synonymous with cryptocurrencies) are tokens which are intended to be used, now or in the future, as a means of payment for acquiring goods or services or as a means of money or value transfer. Cryptocurrencies give rise to no claims on their issuer.”

Bitcoin is the most widely used Payment Token. A bitcoin holder does not have a claim on any asset, foundation, or company. The value of a bitcoin is a function of the ability of the holder to trade the bitcoin for goods, services, other tokens, or fiat currency. The Bitcoin Foundation’s vision for Bitcoin is as a “globally accepted method of exchanging and storing value which will operate without the need for third parties.” Bitcoin is accepted by some merchants in exchange for goods and services, although the vast majority of bitcoin transactions to date have been speculative.

(2) Utility Tokens

“Utility [T]okens are tokens which are intended to provide access digitally to an

60 FINMA GUIDELINES, supra note 58, at 3.


application or service by means of blockchain-based infrastructure.\footnote{FINMA GUIDELINES, supra note 58, at 3.}

The Ethereum blockchain is a network upon which a host of applications can be developed. As of this writing, there are approximately 3,734 decentralized applications on the Ethereum blockchain.\footnote{DApp Statistics, STATE OF DAPPS (last visited Oct. 8, 2020), https://www.stateofthedapps.com/stats.} In order to transfer a token from one node on the Ethereum blockchain to another, a transaction must include the cryptocurrency “Ether,” in addition to the token being transferred between the parties to the transaction. This additional ether is paid as an incentive to the node, which validates the new block by recording the transaction on the Ethereum blockchain, and is often referred to as “gas.”\footnote{For a discussion of nodes, see Ameer Rosic, What are Ethereum Nodes and Sharding?, BLOCKGEeks (last visited Feb. 26, 2019), https://blockgeeks.com/guides/what-are-ethereum-nodes-and-sharding/.} A transaction with insufficient gas to incentivize validators to validate the transaction will not be recorded on the blockchain, which means that ether is necessary for a party to access the Ethereum blockchain. When used as gas, ether is functioning as a utility token. Ether also has been used as a speculative store of value.

(3) Asset Tokens

“Asset [T]okens represent assets such as a debt or equity claim on the issuer. Asset tokens promise, for example, a share in future company earnings or future capital flows. In terms of their economic function, therefore, these tokens are analogous to equities, bonds or derivatives. Tokens which enable physical assets to be traded on the blockchain also fall into this category.”\footnote{FINMA GUIDELINES, supra note 58, at 3.} Asset Tokens can be digital or digitized assets.

Under the FINMA definition, Asset Tokens that represent intangible assets are digital assets because they exist purely on the computer system. Asset Tokens that enable physical
assets to be traded on the blockchain are digital representations of physical assets; therefore, they are *digitized* assets and not digital assets.

An example of a digital Asset Token is a token that entitles the holder to the smart contract initiated payout from an escrow account upon the occurrence of an event. A letter of credit that is paid to the token holder upon the default of a debtor would be a digital Asset Token.

An example of a digitized Asset Token is the RMG coin offered by the Royal Mint Bullion Company and traded on the blockchain.67 The holder of one RMG token is entitled to 1g of gold stored in the Royal Mint’s vault. RMG holders have full title to their gold at all times and may request physical delivery of their gold from The Royal Mint.68

(4) **Stablecoins**

Stablecoins are tokens whose value “is frequently linked to an underlying asset.”69 They aim to “increase price stability” by minimizing “the price volatility typical of currently available payment tokens.”70 “This, in turn, should increase market acceptance, in particular for payment purposes.”71 Many Stablecoins “confer a contractual claim against the issuer on the underlying assets (so-called redemption claim) or confer direct ownership rights.”72

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70 *Id.*

71 *Id.*

72 *Id.* at 2.
The value of Stablecoins is most commonly linked to a specific fiat currency like the U.S. dollar or the euro.\(^\text{73}\) The predominant market leader is Tether, which is a fiat collateralized Stablecoin called tether that is backed by the U.S. dollar in a 1:1 ratio.\(^\text{74}\) The number of tethers in circulation are 100% backed by Tether’s reserves.\(^\text{75}\) However, Stablecoins also can be backed by commodities like precious metals, other cryptocurrencies, or not backed by anything.\(^\text{76}\) For example, Tether launched a Stablecoin backed by physical gold, where the value of one tether gold “represents ownership of one troy fine ounce of physical gold on a specific gold bar.”\(^\text{77}\)

(5) **Hybrid Tokens**

In some cases a digital asset may fit multiple definitions, such as a utility token that is necessary for the right to access a blockchain network but that also is used as a general means of payment or exchange for goods that are outside of the network. As an example, ether functions as a Utility Token when used as gas and as a Payment Token when exchanged for goods.

(c) **Digital and Digitized Asset Applications**

The core innovation of blockchain technology—the trading of assets between peers with no trusted intermediary—has applications beyond virtual currency and can be applied to advance traditional industries as well as spawn new ones. Applications include (1) smart contract transactions, and (2) peer-to-peer trading of digital and digitized assets.


\(^\text{75}\) For more information, see TETHER (last visited Aug. 1, 2020), https://tether.to/.

\(^\text{76}\) See Batabyal, supra note 74.

(1) Smart Contract Transactions

A smart contract is “a set of coded instructions that execute automatically, without human involvement, when particular conditions are met. The fully automated nature of execution provides for self-enforcing automated trustworthiness with no counterparty risk of non-performance.”

By automating the performance of contractual obligations, parties are able to perform with greater speed and certainty. Smart contracts are seen to mitigate the risk of counterparty failure because the code will execute as written without any intervention by the parties. By placing their trust in the code, the parties assume the risk that the code has been written in a manner that accurately expresses their intentions, with the further risk of uncertainty as to who is accountable, or alternatively they have created mechanisms outside of the automated nature of the smart contract to allow for intervention if defects in the code are discovered. Although it is possible to have entire agreements executed solely using code, in present practice, smart contracts typically leave the resolution of certain issues outside of the automated smart contract.

Smart contracts function efficiently when there is a predefined range of outcomes that can be objectively identified. In its smart contract primer, CFTC staff offered self-executing insurance, transportation rentals, and credit default swaps as potential smart contract use cases. In these examples, an objectively determined event must occur: the occurrence of an insurable event, receipt of funds to rent a bike, and a debtor default, respectively. The occurrence of the


80 Id. at 13–15.
objectively determined event induces the coded smart contract response, the payment of escrowed funds in the insurance and credit default swap examples, or the unlocking of a bike in the transportation rental example.81

(2) **Peer-to-Peer Microgrid Trading of Digital and Digitized Assets**

Microgrids are newly constructed electrical grids which, in some cases, are not connected to the main electrical grid and may be geographically isolated from the main grid, or in other cases can be integrated into the existing grid.82 In blockchain enabled microgrid projects, energy producers, colloquially called “prosumers,” with a rooftop solar array or an interest in an off-site renewable energy project, are able to track and transfer electricity to their neighbors who are on the same microgrid.83 The electricity is represented via a blockchain token, which can be tracked and transferred via a smart contract, such that if a prosumer’s solar array generates more energy than it needs, the token is sold to a different customer on the grid that has not produced as much energy as it needs. The transactions themselves can be automated so that smart meters buy and sell the energy through automated smart contract transactions. The methods used for transacting energy over a microgrid can be applied to other peer-to-peer trading applications in which transactions are automated via smart contracts.

(d) **Process for Issuing, Selling, and Trading Virtual Currency**

The process used to create or issue a virtual currency has varied over time. The idea for bitcoin, widely recognized as the first virtual currency, was discussed in a white paper that was

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81 LabCFTC also offered a wealth of additional smart contract application examples, including supply chain management, trade clearing and settlement, and data reporting and recordkeeping. Id at 18.


83 LO3 Energy is running a blockchain enabled microgrid pilot in Brooklyn. BROOKLYN MICROGRID (last visited Feb. 27, 2019), https://www.brooklyn.energy/.
posted to a cryptography mailing list in 2008. The first bitcoin specification and proof of concept was published in 2009. By 2013, the price of one bitcoin had exceeded $1,000. Capitalizing on the success of bitcoin, other virtual currencies were created, and ICOs emerged as a way to raise money to fund early stage ventures. To complete an ICO, an offeror generally issued a white paper describing the virtual currency, its uses or advantages, and its value proposition. The white paper typically would be published and publicly available on the offeror’s website and would help facilitate the sale and distribution of the virtual currency to institutional and retail investors. Forbes reported that ICOs raised nearly $6 billion in 2017.

On July 25, 2017, the SEC issued the DAO Report, which makes clear that many virtual currencies fall within the definition of a security under the Howey test. In order to offer or sell securities in the United States, they must be registered or qualify for an exemption. Since the DAO Report, the SEC has engaged in numerous enforcement actions and offered public guidance to issuers in determining whether their virtual currency is actually a security.

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86 Adam Bergman, This Is How ICOs Can Save the Financial Services Industry, FORBES (June 14, 2018, 10:22 AM), https://www.forbes.com/sites/greatspeculations/2018/06/14/this-is-how-icos-can-save-the-financial-services-industry/#448af0f364aa.


After an ICO, additional quantities of a virtual currency can be created by miners that operate open-source software and solve complex mathematical problems to validate and log transactions on the publicly distributed ledger created using funds from the ICO. Virtual currencies also can be acquired or used in commerce as a medium of exchange (provided, of course, that both parties to a transaction are willing to use the digital asset as a means of payment) or purchased or sold through privately negotiated transactions or virtual currency exchanges.

Virtual currency exchanges provide a mechanism for converting U.S. dollars and other traditional currencies into virtual currencies. These exchanges list currency pairs such as BTC/USD (bitcoin denominated in U.S. dollars) and ETH/USD (ether denominated in U.S. dollars) and even cryptocurrency pairs like ETH/BTC (ether denominated in bitcoin). As of August 31, 2020, the website cryptocoindicators.info indexed 270 virtual currency exchanges and indicated that over 60 of these exchanges had been used to execute a virtual currency transaction within the past 24 hours. Prominent U.S.-based virtual currency exchanges include: bitFlyer USA, Inc.; Bitstamp USA Inc.; Bittrex, Inc.; Circle Internet Financial Limited (Poloniex LLC); Coinbase, Inc. (GDAX); Gemini Trust Company; itBit Trust Company; and Payward, Inc. (Kraken).

(1) Transferring Virtual Currencies

Virtual currencies may be traded over “centralized” exchanges or “decentralized” exchanges (as described below). For both centralized and decentralized exchanges, counterparty credit concerns theoretically are mitigated because properly drafted smart contract code will not

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allow for a party to perform on its transaction obligations without ensuring that the counterparty has the assets needed to concurrently perform on its reciprocal transaction obligations.

Centralized virtual currency exchanges hold custody of customer assets and operate order books that allow customers to purchase or sell digital assets at posted rates. Centralized exchanges typically purchase virtual currencies for their own account on the public ledger and allocate them to customers through internal bookkeeping entries while maintaining exclusive control of the private keys. Under this structure, centralized exchanges collect large amounts of customer funds for the purpose of buying and holding virtual currencies on behalf of their customers with limited regulatory oversight. In transactions between parties using a centralized exchange, the exchange holds the tokens on the parties’ behalf.\(^{91}\) Such settlement is said to occur outside the blockchain (\textit{i.e.}, “off-chain”). By maintaining order books and custody of customer assets, centralized virtual currency exchanges provide similar services to those of centralized exchanges of more traditional commodities and securities. Coinbase, Kraken, and Binance are examples of centralized virtual currency exchanges.

Decentralized exchanges are relatively new and provide a platform that allows users to transact directly with each other. The feature that is most characteristic of all platforms labeled “DEXs” is allowing users to maintain custody of their digital assets before and after transactions. Users can trade tokens from and to their own personal wallet address on the Ethereum (or other) blockchains.\(^{92}\)


\(^{92}\) See \textit{id}.
As opposed to the centralized exchange keeping an order book, decentralized exchanges frequently will follow one of two approaches for discovery and matching open trading interests. One involves a peer-to-peer system through which buyers and sellers find one another and communicate directly to negotiate transaction details. The other involves a smart contract deployed on the blockchain, which specifies order details and the trade execution process.93

Once the buyer and seller have agreed to terms, the transaction is submitted to the blockchain via the smart contract, and the token transfer is recorded on the blockchain. Legal possession and ownership of the tokens generally passes once the transaction is validated, recorded on the blockchain, and the buyer has control over the tokens, though this can vary by jurisdiction, and delays attributable to network congestion may occur. Users may seek faster validation if they agree to pay a higher gas fee to miners, which in turn increases the miners’ incentives to validate the transaction.94 Parties also may utilize this transaction mechanism to transfer virtual currency with no involvement from an exchange of any type.

Decentralized exchanges provide the software platforms whereby virtual currency buyers and sellers locate one another and provide infrastructure, which facilitates the transfer of the virtual currency; however, the receipt and custody of the virtual currency is entrusted to the user. Examples of decentralized exchanges include IDEX, Airswap, and Paradex.

In June of 2020, the ratio of decentralized-to-centralized exchange volume reached 1% for the first time.95 The increasing popularity of decentralized exchanges may be attributed to the

93 See generally id.


growth of the decentralized finance movement, commonly referred to as “DeFi.” By relying on permissionless platforms and smart contracts, DeFi projects aim to reduce friction in financial transactions by reducing transaction costs, eliminating the need for intermediaries, and enabling interoperability.\(^\text{96}\) DeFi applications allow individuals across the world to enter into secured loans and leveraged positions or to tokenize and trade assets—all without the need of a bank or central authority. The majority of current DeFi platforms have been built as decentralized applications on Ethereum, including examples such as MakerDAO, Synthetix, Compound, and Uniswap.\(^\text{97}\) While the DeFi market still faces regulatory uncertainty, DeFi applications continue to grow rapidly, and assets committed to DeFi smart contracts first exceeded $1 billion in February of 2020 and by August 2020 exceeded $6 billion.\(^\text{98}\)

(2) Virtual Currency Pricing

At issuance, the pricing terms of a particular virtual currency generally are set forth in the white paper or relevant offering document. An investor that purchases a virtual currency through an ICO may be able to use venture capital valuation methodologies to discern the price or value of a particular offering.

In the secondary market, the price of a virtual currency is based on the agreement of the parties to a transaction and their perception of the virtual currency’s value. Some have argued


that the intrinsic value of a virtual currency can be derived from the cost of mining the virtual currency.\textsuperscript{99} In addition, certain virtual currencies may be used or redeemed for another product or service, in which case the price or value of such product or service could influence the price of the virtual currency. Many virtual currencies are susceptible to changes in sentiment and highly volatile, and this attribute has spurred the development of Stablecoins tied to the value of a fiat currency or other asset.\textsuperscript{100}

Several financial service companies have launched virtual currency indices or market data services. For example, CME Group has established a Bitcoin Real-Time Index,\textsuperscript{101} and Intercontinental Exchange offers a cryptocurrency data feed.\textsuperscript{102}

(3) Virtual Currency Market Participants

Issuers of virtual currency may be distinguished by their level of decentralization. Bitcoin, widely regarded as the most decentralized cryptocurrency, arguably lacks any person or group of people who can be identified as an issuer or otherwise as a responsible party. Instead, the Bitcoin protocol developed by Satoshi defined how miners can create new bitcoins by performing specific calculations.\textsuperscript{103} These miners generally are not thought of as true “issuers,” as they do not have the ability to control the creation and distribution of new bitcoins; rather, they receive bitcoins as a reward for performing work for the network. Other forms of virtual


\textsuperscript{100} See FINMA SUPPLEMENT, supra note 59, at 1.


\textsuperscript{103} See NAKAMOTO, supra note 84.
currency, such as tokens, may be considered to have issuers as that term is commonly understood.

In addition to private issuers, an increasing number of state central banks are exploring the creation of virtual currencies. A survey by the Bank for International Settlements in 2019 indicated that over 80% of central bank respondents were engaged in some form of Central Bank Digital Currency (CBDC) project. CBDCs are “digital representations of a sovereign currency issued by and as a liability of a jurisdiction’s central bank or other monetary authority.” While DeFi projects reduce the need for banks to act as intermediaries in financial transactions, CBDC projects represent central banks’ efforts to maintain their oversight function in the financial market by offering the efficiency of digital tokens with the stability of traditional fiat currency and institutional accountability. These central bank initiatives seek to integrate virtual currencies into the retail economy, potentially expanding the pool of individuals and entities engaging with digital assets.

Buyers of virtual currencies traditionally have been individuals who are speculating on the value of virtual currency with their own money. The first non-retail buyers of virtual currencies typically were businesses that purchased virtual currencies for operations, such as cryptocurrency exchanges, payment providers, and similar businesses. Over time, buyers of virtual currency have become more institutionalized. As more sophisticated investors have begun to enter the space in recent years, there has been rapid growth in hedge funds and venture funds that are focused on cryptocurrencies. Autonomous Research LLP reports that there are 780

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105 Id. at 9.
crypto funds with $10 to $15 billion in assets under management. However, individual investors have been key drivers of virtual currencies, with Coinbase, the primary exchange in the United States, reporting more than 35 million users on its platform.

(e) Unique Digital Asset Features

A fork is a split in the blockchain of a digital asset where two separate blockchains with a shared history are created. Forks can result from updates to the software that change the rules that determine whether or not a blockchain transaction is valid. If only some, but not all, users accept the updated rules, then a fork may occur. One version of the software may then accept one blockchain as the valid history while the other version accepts the other blockchain as the valid history.

The causes of forks may vary. Sometimes, the changes to the rules that trigger a fork are changes that are introduced during the normal process of updating software. If the changes are widely accepted, generally the updated blockchain will win and only one chain will survive.

Other times, a fork may be triggered by a conscious decision by some participants in the network to change the rules in a manner that is not accepted by all participants in the network. For example, some forks have occurred because users have had a difference of opinion regarding the future of the network. This kind of fork can result in the existence of two separate digital assets.


A well-known example of a fork is the split of Bitcoin Cash from Bitcoin. Prior to the Bitcoin Cash fork, some Bitcoin users advocated for an upgrade to the Bitcoin rules that would permit larger blocks to be accepted by the network. Many other Bitcoin users resisted this upgrade, believing that larger block sizes would make it more difficult to maintain a decentralized network. Ultimately, a group of users believing in the need for larger blocks decided to launch the Bitcoin Cash software and fork away from the Bitcoin network to pursue a blockchain with larger blocks.
SECTION 2. COMMODITY EXCHANGE ACT AND CFTC REGULATION

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1. Introduction

The CEA is a federal statute that focuses on regulating transactions and markets in derivatives, i.e., contracts whose value derives from the value of a referenced underlying “commodity.” Congress determined it is in the public interest to regulate derivatives markets, with an initial emphasis on exchange markets for futures on agricultural commodities, because derivatives markets are closely related to the cash markets for the underlying commodities and thus can have implications for the cash markets. Derivatives are used by many businesses to manage price or other risks associated with their activities. Businesses also may price commercial merchandizing or other transactions by reference to the prices discovered in
centralized derivatives markets, when those prices are considered reliable projections of future market value. The hedging and price discovery benefits that centralized derivatives markets provide are deemed to be in the public interest,\textsuperscript{109} and much of the CEA framework is intended to protect the derivatives markets and related cash markets against manipulation, unwarranted price distortions, and, for derivatives on tangible commodities that settle by delivery at expiration, congestion in deliverable supplies of the underlying commodities.

The CEA grants the CFTC regulatory authority over certain categories of derivatives transactions, as well as over certain leveraged off-exchange retail transactions regardless of whether the transactions are derivatives. The scope of the CFTC’s jurisdiction depends, in part, on whether the derivative or other transaction involves a “commodity.” The CEA also vests the Commission with enforcement authority (but not rulemaking authority) with respect to fraud and manipulation involving cash market trading of commodities.

Notably, the CEA definition of “commodity” is broader than one might expect based on a common understanding of the term. Although there are significant issues surrounding the scope and interpretation of what the CEA definition encompasses, the definition is understood to cover securities, foreign currencies, and other financial assets, and is not limited to tangible (physical) commodities.

The CEA makes distinctions based on the type or classification of a commodity, which are relevant because the commodity classification can lead to different regulatory treatment under the statute. For example, CEA provisions allocate jurisdiction over derivatives that are based on a security or group or index of securities (or any interest therein or based on the value

\textsuperscript{109} See 7 U.S.C. § 5. Over time, Congress expanded the public interest justification for regulating derivatives markets, to recognize the public interest benefits of market self-regulation and to protect financial integrity of transactions, protect against systemic risk, and protect market participants from fraud and abusive sales practices.
thereof) between the CFTC and the SEC or jointly to the two agencies. As another example, the CEA provisions regulating off-exchange retail transactions differ based on whether the commodity is a foreign currency or another type of non-security commodity. Classification as an exempt commodity (non-agricultural commodities considered non-financial in nature) or excluded commodity (considered financial in nature) is relevant to whether transactions may qualify for exclusion from futures or swaps regulation as forward contracts.

Thus, threshold questions for determining whether and how the CEA could apply to a digital or digitized asset, and transactions in the asset, include (1) whether the asset is a “commodity,” as defined in the CEA, and (2) if so, how the asset is classified—in particular, whether it is a security. A digitized asset that represents a record of title to an underlying asset, e.g., a token representing ownership of gold, is simply a form of electronic title document, where it is the classification of the underlying asset that is relevant. Digital assets where the token itself is the asset may be more challenging to classify as a security or non-security commodity, if the digital asset is (or aspires to be) a virtual currency or has some other type of utility function, but also may serve an initial capital raising purpose or have other characteristics associated with securities.

This Section focuses on a particular type of digital asset, virtual currencies, because the CFTC to date has asserted jurisdiction primarily over virtual currencies among digital assets. At the same time, the same principles that the CFTC applies to virtual currencies likely will apply to other digital assets.¹¹⁰

¹¹⁰ See, e.g., CFTC, A CFTC PRIMER ON VIRTUAL CURRENCIES (2017), https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf [hereinafter PRIMER ON VIRTUAL CURRENCIES] (“There is no inconsistency between the SEC’s analysis and the CFTC’s determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.”).
The CFTC has asserted jurisdiction over virtual currency transactions in a variety of contexts, beginning with a settlement order entered between the CFTC and Coinflip, Inc. in 2015. The CFTC based its assertion of jurisdiction on its position that virtual currencies are “commodities,” as that term is defined in the CEA, 7 U.S.C. § 1 et seq. The CFTC’s position regarding its statutory authority over transactions involving virtual currencies has remained consistent in public statements made by CFTC Commissioners, a CFTC interpretation of the


112 Id. at 77,855 (“Bitcoin and other virtual currencies are encompassed in the [commodity] definition and properly defined as commodities.”).

113 In December 2014, then-Chairman Timothy Massad considered whether the CFTC had regulatory authority over virtual currencies in congressional testimony before the Senate Committee on Agriculture, Nutrition, and Forestry. There, Massad explained:

The CFTC’s jurisdiction with respect to virtual currencies will depend on the facts and circumstances pertaining to any particular activity in question. While the CFTC does not have policies and procedures specific to virtual currencies like bitcoin, the agency’s authority extends to futures and swaps contracts in any commodity. The CEA defines the term commodity very broadly so that in addition to traditional agricultural commodities, metals, and energy, the CFTC has oversight of derivatives contracts related to Treasury securities, interest rate indices, stock market indices, currencies, electricity, and heating degree days, to name just a few underlying products. Derivative contracts based on a virtual currency represent one area within our responsibility.


Notably, in a keynote address on March 7, 2018, CFTC Commissioner Brian Quintenz not only asserted the agency’s jurisdiction over digital asset derivatives, but also stated his support for an “independent, self-regulating body” for spot virtual currency transactions. Quintenz added that a self-regulatory organization for virtual currencies could “create uniform standards . . . reduce the possibility of regulatory arbitrage, and avoid duplicative regulation,” which would address the concern of multiple federal and state regulators (including the CFTC) having jurisdiction over spot virtual currency transactions. See Brian Quintenz, Comm’r, CFTC, Keynote Address by Commissioner Brian Quintenz before the DC Blockchain Summit (Mar. 7, 2018), https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz8.
“actual delivery” exception to regulation of leveraged retail commodity transactions,\textsuperscript{114} CFTC staff guidance,\textsuperscript{115} and enforcement actions in both administrative and civil cases.\textsuperscript{116} In May 2018, CFTC staff published guidance restating that “bitcoin and other virtual currencies are properly defined as commodities”\textsuperscript{117}—an interpretation that a federal court accepted just months earlier.\textsuperscript{118} The CFTC also launched LabCFTC in May 2017, which is designed to promote FinTech innovation in the markets under CFTC jurisdiction by providing a space for market participants to engage with the CFTC and potentially influence its future guidance and policy decisions over virtual currencies.\textsuperscript{119}

\textsuperscript{114} See Retail Commodity Transactions Involving Certain Digital Assets, 85 Fed. Reg. 37,734 (June 24, 2020) (final interpretative guidance) (interpreting 17 C.F.R. pt. 1) [hereinafter Actual Delivery Guidance]; see also infra Section 2.2(c).

\textsuperscript{115} See, e.g., CFTC, CFTC BACKGROUNDER ON OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS (2018), https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency


\textsuperscript{117} CFTC Staff Advisory No. 18-14, Advisory with respect to Virtual Currency Derivative Product Listings (May 21, 2018), https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/2018-05/18-14_0.pdf. In the advisory, CFTC staff clarified its priorities and expectations with respect to new virtual currency products to be listed on a designated contract market (DCM) or swap execution facility (SEF), or cleared by a derivatives clearing organization (DCO). The advisory is intended to aid these entities in “effectively and efficiently” complying with their statutory and self-regulatory responsibilities. In light of the “significant risks associated with virtual currency markets,” CFTC staff highlighted five key areas that require heightened attention when listing a new virtual currency contract on a SEF or DCM or clearing it through a DCO: (i) enhanced market surveillance, (ii) coordination with CFTC staff, (iii) large trader reporting, (iv) outreach to stakeholders, and (v) DCO risk management.

\textsuperscript{118} See McDonnell I, 287 F. Supp. 3d at 213.

\textsuperscript{119} 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. See PRIMER ON VIRTUAL CURRENCIES, supra note 110. In November 2018, LabCFTC issued a primer on smart contracts, which is intended to help explain smart contract technology and related risks and challenges. See SMART CONTRACT PRIMER, supra note 79. One month later, LabCFTC published a request for public comments on cryptoasset mechanics and markets to help
Nevertheless, without express statutory authority over digital assets such as virtual
currency, the CFTC’s ability to regulate the virtual currency market necessarily depends on
whether the particular virtual currency falls within the bounds of the CFTC’s existing
jurisdiction under the CEA. In particular, much of the CFTC’s statutory authority hinges on the
involvement of a “commodity.”\(^{120}\) Given the CFTC’s longstanding interpretation that virtual
currencies are commodities (implicitly, of the non-security type), many of the allegations in the
CFTC’s civil cases understandably are based on CEA provisions relating to the CFTC’s
jurisdiction over commodities.\(^{121}\) Therefore, the question of whether virtual currencies are
“commodities” is critical to the CFTC’s larger efforts to regulate virtual currencies and, in
particular, to prohibit fraud and manipulation.

If a particular virtual currency is a commodity under the CEA definition, another
important jurisdictional question is triggered: whether it also is a security. Although the CFTC
has jurisdiction over certain segments of the securities-based derivatives markets, the SEC, not

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\(^{120}\) The CFTC may have authority over a non-commodity virtual currency to the extent it is the subject of a swap.
The CEA defines “swap” in a manner that is not limited to contracts based on a commodity. Some of the provisions
of the swap definition expressly list many items in addition to “commodities” (see 7 U.S.C. §§ 1a(47)(A)(i), (iii)),
and others do not reference “commodities” at all (see id. §§ 1a(47)(A)(ii), (iv)).

\(^{121}\) See Coinflip, Comm. Fut. L. Rep. (CCH) ¶ 33,538, at 77,855 (CEA section 4c(b), which restricts “any transaction
involving any commodity which is . . . an ‘option’”); BFXNA Inc., Comm. Fut. L. Rep. (CCH) ¶ 33,766, at 79,389–
90 (CEA section 2(c)(2)(D), which governs “any agreement, contract, or transaction in any commodity that is
entered into with . . . a non-eligible contract participant”); McDonnell I, 287 F. Supp. 3d at 231; Complaint at 16,
Blueprint, Inc., No. 17-7181 (S.D.N.Y. Sept. 21, 2017) (CEA section 6(c)(1), which prohibits manipulative schemes
and fraud “in connection [with any] contract of sale of any commodity in interstate commerce”); Complaint at 3,
CFTC v. Kantor, No. 18-cv-2247 (E.D.N.Y. Apr. 16, 2018) (CEA section 2(e), which prohibits off-exchange retail
transactions in swaps; CEA section 4d(a)(1), which prohibits soliciting or accepting orders, and accepting money,
for commodity options or swap transactions without registration as a futures commission merchant). While the
defendants in the initial administrative enforcement actions brought by the CFTC did not challenge the CFTC’s
interpretation of the commodity definition, defendants in the pending civil actions are litigating whether the relevant
virtual currency is a commodity. See infra Section 2.3(e)(ii).
the CFTC, is responsible for oversight and regulation of the cash securities markets. The CFTC’s assertion of jurisdiction over virtual currency cash markets presupposes that virtual currencies are not securities.

The Sections that follow explain the CFTC’s regulatory authority over derivatives markets and certain retail transactions; the history and scope of, and interpretive issues under, the CEA’s commodity definition; an examination of the CFTC’s classification of virtual currencies as commodities over which it has jurisdiction; and allocation of jurisdiction between the CFTC and SEC.

2. **Classification of Transactions under the CEA**

   The CEA regulates many (but not all) types of derivatives transactions, along with certain retail transactions that are not necessarily derivatives. The CEA imposes requirements on organized markets and clearing systems, industry professionals, and market participants with respect to different classifications of transactions, with further distinctions based on the nature of the underlying interest. The CEA approach is piecemeal, in that it prescribes separate requirements with respect to (i) contracts for the sale of commodities for future delivery (futures contracts);\(^{122}\) (ii) options on commodities;\(^{123}\) (iii) options on futures contracts;\(^{124}\) (iv) swaps;\(^{125}\) (v) over-the-counter (OTC) transactions with retail customers involving foreign currencies;\(^{126}\)

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\(^{122}\) 7 U.S.C. § 2(a)(1). In addition to the categories identified in the text, the CEA has special provisions for regulating long-term contracts involving precious metals, referred to as “leverage contracts,” but those contracts do not trade today and are not relevant for the analysis in this White Paper. The leverage contract provisions are set out in CEA section 19, 7 U.S.C. § 23.

\(^{123}\) Id. § 6c(b).

\(^{124}\) Id. § 2(a)(1).

\(^{125}\) Id.

\(^{126}\) Id. §§ 2(c)(2)(A)–(C).
and (vi) transactions in commodities that are not foreign currencies or securities with retail customers that are entered into or offered on a margined, leveraged or financed basis, unless the transaction fits within an exemption.\textsuperscript{127}

Under this structure, the term “commodity” is one element that defines the CEA’s reach over transactions and markets. Futures are defined by reference to commodities.\textsuperscript{128} The term “commodity” also is used in the CEA’s swap definition, but in sequence with other descriptive terms for permissible underlying interests. Thus, the commodity definition is relevant for purposes of understanding the broad scope of the swap definition, but arguably does not act as a limiting definitional element.

This Section explains the contours of CFTC jurisdiction over derivatives and retail transactions, and how that jurisdiction could apply to transactions involving virtual currencies. It also describes commercial forward and spot contracts that are outside the scope of CFTC regulation (but not necessarily outside the scope of its anti-fraud and anti-manipulation authority).

\textbf{(a) Classifications of Regulated Transactions}

A derivative is a contract whose value derives from the value of an underlying interest, such as a physical commodity, an interest rate, the economic or financial consequences of the occurrence of an event, or a security. Derivatives may take a variety of forms, and may require settlement by delivery (if held to expiration or, in the case of an option, upon exercise) of the underlying interest (which may occur via transfer of title) or by a cash payment. The following is

\textsuperscript{127} \textit{Id.} § 2(c)(2)(D).

\textsuperscript{128} Conversely, as explained in Section 2.3(b) below, whether something is classified as a commodity for CEA purposes may depend on whether it is the subject of futures trading.
a high-level summary of the definitions for the different types of derivatives covered by the CEA.

**Futures.** The CEA does not contain a definition for the terms “futures contract” or “futures.” The definitional elements are found in the CEA’s grant of jurisdiction to the CFTC to regulate futures under CEA section 2(a)(1). Under that provision, futures contracts are “contracts of sale of a commodity for future delivery.” The CEA does define the term “future delivery” or, more accurately, what the term does not mean, for the purpose of excluding from regulation as futures commercial merchandizing contracts for deferred delivery of a commodity.

**Swaps.** The term “swap” is defined in CEA section 1a(47) and CFTC Rule 1.3. The definition is broad and covers many types of derivative structures, specifically:

- Puts, calls, caps, floors, collars, or similar options on the value of one or more interest rates or other rates, currencies, commodities, securities (but options on securities also are excluded from the definition), instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind;

- Contracts for any purchase, sale, payment, or delivery (other than payment of a dividend on an equity security) that are dependent upon the occurrence, nonoccurrence, or extent of occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (i.e., event contracts or binary options);

- Executory contracts for the fixed or contingent exchange of one or more payments based on the value or level of one or more interest rates, other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including contracts that become commonly known as one of an enumerated list of contracts such as interest rate swaps, currency swaps, agricultural swaps, or energy swaps;

- Contracts that are or in the future become commonly known to the trade as swaps;
Security-based swap agreements that meet the definition of “swap agreement” under Section 206A of Gramm-Leach-Bliley Act,\textsuperscript{129} a material term of which is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein; or

Any combination or permutation of the foregoing types of contracts, including any option thereon.

The definition also contains some exclusions. Notably, security-based swaps, options on securities or a group or index of securities, and forwards on securities where the transactions are intended to be physically settled are not swaps.

	extbf{Options}. The term “option” is defined as a contract that is “of the character of, or . . . commonly known to the trade as, an ‘option’, ‘privilege’, ‘indemnity’, ‘bid’, ‘offer’, ‘put’, ‘call’, ‘advance guaranty’, or ‘decline guaranty.’”\textsuperscript{130} The interest underlying an option could be a commodity or another derivative, such as a futures contract or a swap. Under a typical option, the holder, or buyer, pays a premium for the right to require the counterparty, often called the “writer,” to sell a commodity or other underlying interest to the option holder at a fixed strike price, in the case of a call option, or to purchase the commodity or other underlying interest from the option holder at a fixed strike price, in the case of a put option. In either case, the option holder has an “exercise right” to decide whether to require its counterparty to buy or sell the underlying interest. That right, depending upon the contract terms, may be exercisable at any time through the term of the option, during a narrowly defined time period at expiration or under other terms. An option on a commodity may be structured to require settlement by payment of cash for the difference between the strike price and current market price, in lieu of an actual sale and delivery of the commodity between the parties.

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\textsuperscript{129} 15 U.S.C. § 78c note.
\textsuperscript{130} 7 U.S.C. § 1a(36).
\end{flushleft}
(b) Primary Differences in CEA Regulation of the Different Types of Derivatives

Futures and Options on Futures. Futures and options on futures are grouped together for the same general regulatory treatment. Futures and options on futures legally may be traded only on or subject to the rules of a futures exchange. The exchange must be registered with the CFTC as a DCM or, if the exchange is located outside the United States and has market participants located in the United States, it may operate under the CEA regime as an FBOT. Transactions in futures and options on futures must be centrally cleared by a derivatives clearing house. If the clearing house is clearing transactions in futures or options on futures that are listed on a DCM, the clearing house must be registered with the CFTC as a DCO. The CEA does not impose any restriction on who may trade on a DCM or FBOT.

Absent an exemption, a person that provides market participants with access to the exchanges and to their associated clearing houses must register with the CFTC as an FCM, whereas a person that assists market participants in arranging futures or options on futures transactions but does not act as a clearing intermediary may instead register with the CFTC as an IB. A person that provides trading advice to others with respect to the advisability of trading futures or options on futures generally must, absent an exemption, register with the CFTC as a CTA, and a person that forms and operates pooled investment vehicles that invest in such products generally must, absent an exemption, register with the CFTC as a CPO.

Transactions in futures and options on futures are not reported to a data repository. Information on the transactions is captured by the exchanges and clearing houses.

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131 See 17 C.F.R. pt. 33 (rules that the CFTC adopted pursuant to its plenary authority over options involving commodities, and that apply to options on futures).
Swaps. In contrast, swaps are not subject to an exchange-trading requirement, and not all swaps must be submitted to central clearing. The CFTC has authority to designate certain types of swaps for mandatory clearing, in which case the transactions must (absent an exemption) be centrally cleared, and also may have to be executed on a trading facility that is registered with the CFTC as a SEF or DCM. For swaps that have not been designated for mandatory clearing, counterparties may enter into transactions directly on a bilateral (i.e., OTC) basis, or may voluntarily enter into transactions on a SEF or DCM if such a market is available. They also may voluntarily clear the transactions if a DCO is available that clears the type of swap.

To legally trade swaps on a SEF or bilaterally, a person must meet the definition of ECP set out in CEA section 1a(18) and CFTC Rule 1.3. If a person is not an ECP, the person generally is considered to be “retail.” A person is not required to be an ECP to enter into swaps on a DCM.

For cleared swaps transactions, a person that provides clearing access to swaps counterparties must be registered as an FCM. Firms that assist counterparties in arranging swap transactions but that do not act as clearing intermediaries may do so pursuant to IB registration. A person that provides trading advice to others with respect to the advisability of trading swaps generally must, absent an exemption, register with the CFTC as a CTA, and a person that forms and operates pooled investment vehicles that invest in such products generally must, absent an exemption, register with the CFTC as a CPO.

Persons that hold themselves out as dealers or regularly enter into swaps with counterparties for their own account may have to register with the CFTC as swap dealers. Persons with substantial swap exposures may have to register with the CFTC as major swap participants.
Swap transactions must be reported to an SDR. This is the case regardless of whether the transaction is submitted to clearing.\textsuperscript{132}

\textbf{Commodity Options.} The CEA grants the CFTC plenary authority to adopt rules regulating commodity options in CEA section 4c.\textsuperscript{133} That authority does not extend to options on a security or a group or index of securities or any interest therein or based on the value thereof.\textsuperscript{134} Commodity options also are covered by the statutory swap definition described above, and instead may be regulated under the swaps regime. The CFTC has determined to regulate commodity options under the same general rules that apply to swaps, with the exception of options on non-financial commodities under the “Trade Options Exemption.”\textsuperscript{135}

\begin{itemize}
\item[(c)] \textbf{Special Provisions for Regulating Retail Transactions under the CEA}
\end{itemize}

\textbf{Retail Forex.} The CEA contains special provisions in section 2(c)(2)(B) that permit and regulate OTC trading of foreign currency futures and options on futures by retail customers, \textit{i.e.},

\begin{itemize}
\item[(i)] If a transaction is submitted to and accepted for clearing, the resulting termination of the original transaction also must be reported to the SDR, and the DCO must report the novated trades replacing the original trade to an SDR.
\item[(ii)] 7 U.S.C. § 6c(b).
\item[(iii)] See \textit{id.}, § 2(a)(1)(C)(i)(I). The provision states that the CEA does not apply to options on securities or on any group or index of securities, or any interest therein or based on the value thereof. Such options also are excluded from the “swap” definition in CEA section 1a(47). Such options are included in the definitions of “security” in the Exchange Act and the Securities Act and are regulated by the SEC.
\item[(iv)] As defined in CFTC Rule 32.3, a trade option is a commodity option that:
\begin{itemize}
\item[(i)] If exercised, must be settled physically, resulting in the sale and delivery of an exempt or agricultural commodity; and
\item[(ii)] Is entered into between (A) an offeree (buyer) that (i) is a producer, processor, or commercial user of, or merchant handling the commodity or the products or by-products of the commodity (\textit{i.e.}, it is a “commercial participant”) and (ii) is entering into the transaction solely for purposes related to its business as such, and (B) an offeror (seller) that is either a commercial participant entering into the transaction solely for purposes related to its business or an eligible contract participant as defined in the CEA and CFTC Rule 1.3.
\end{itemize}
\end{itemize}

CFTC Rule 32.3 excludes trade options from classification as swaps and imposes substitute “light touch” regulation on the parties to such transactions.
by persons that are not ECPs as that term is defined in CEA section 1a(18) and CFTC Rule 1.3. It also contains comparable provisions in CEA section 2(c)(2)(C) that regulate trading by retail customers of any type of agreement, contract, or transaction in foreign currency, regardless of whether it could be classified as a future or a swap, if done on a leveraged, margined, or financed basis. The statutory provisions limit the persons permitted to engage in such trading with retail customers, certain of which are persons that are registered with the CFTC, such as an FCM or retail foreign exchange dealer.\footnote{The retail forex activities of other permissible counterparties may be regulated by other federal regulators. For example, firms registered with the SEC as broker-dealers are permitted to trade retail forex, but only as permitted and regulated by the SEC. The SEC currently prohibits broker-dealers from trading retail forex, with the effect that firms that are dually registered as broker-dealers and as FCMs are prohibited from that activity.} They also authorize the CFTC to adopt rules for registering persons that act in the capacity of an IB, CTA, or CPO with respect to retail forex. The CFTC Part 5 Rules govern the retail forex activities of such persons registered with the CFTC.

Notably, the ECP definitions in CEA section 1a(18) and CFTC Rule 1.3 place a high bar for individuals to qualify, with the consequence that many individuals will be considered retail. For an individual to be considered an ECP, he or she must have amounts invested on a discretionary basis in excess of $10 million or in excess of $5 million if the individual is entering into transactions to manage risk associated with assets owned or liabilities incurred, or reasonably likely to be owned or incurred, by such individual.

\textit{Retail Commodity Transactions}. CEA section 2(c)(2)(D) provides that agreements, contracts, or transactions in commodities—other than foreign currencies or securities—entered into by or offered to retail customers (non-ECPs) on a leveraged, margined, or financed basis must be regulated as or “as if” they are futures, unless covered by an exemption. As explained above, many customers who are individuals will be retail. Among other things, the “as if futures”
requirement arguably means that a non-exempt transaction may be executed only on or subject to the rules of a CFTC-regulated exchange, and persons providing services in connection with non-exempt transactions may be covered by one of the CEA’s registration categories for professionals (FCM, IB, CTA, or CPO).

The CFTC has taken the position that tokens that may serve as a means of payment for goods or services as “virtual” currencies are not the same as currencies, and thus that bilateral retail transactions in virtual currencies may not occur under the rubric of the CEA’s retail forex framework and instead are subject to the retail commodity transaction provisions. That is significant because retail forex transactions are not subject to the same restrictions that apply to margined, leveraged, or financed sales of commodities subject to CEA section 2(c)(2)(D).

As a threshold matter, the retail commodity provisions apply only when a party to the transaction is retail, i.e., not an ECP. A second element must be present for a particular commodity sale transaction to be regulated under CEA section 2(c)(2)(D) as well: the seller must offer or execute the transaction on a leveraged or margined basis, or the transaction must be financed either directly by the seller or by a third party acting in concert with the seller. If not, then CEA section 2(c)(2)(D) is inapplicable, notwithstanding that the buyer is retail.

If both elements are present in a transaction (retail buyer; leveraged, margined, or financed transaction), there are two important exceptions under which the transaction nonetheless could occur off of a CFTC-regulated exchange (and without triggering potential FCM or other professional registration requirements).

The first exception, which receives the most attention, covers a transaction in a contract for the sale of a commodity that results in “actual delivery” of the commodity within 28 days. The CFTC has been wrestling for years with its interpretation of the term “actual delivery.” In
August 2013, the CFTC issued a final interpretation of “actual delivery” in the context of CEA section 2(c)(2)(D) that generally focused on physical (tangible) commodities (the “2013 Guidance”). The 2013 Guidance emphasized that whether actual delivery is accomplished turns on a “functional approach” that considers facts beyond the language used by parties to the transaction. In that regard, the 2013 Guidance included a list of factors the CFTC will consider in determining whether a transaction has resulted in actual delivery. For example, actual delivery occurs if there is a transfer of title and possession of the commodity to the buyer or a depository acting on the buyer’s behalf. In contrast, mere book entries and certain instances where a purchase is “rolled, offset, or otherwise netted with another transaction or settled in cash” do not constitute actual delivery.

In recent years, the CFTC has focused on whether certain retail transactions in virtual currencies call for “actual delivery” and therefore are not required to be traded on regulated exchanges. The need to clarify the meaning of actual delivery in virtual currency transactions became more pronounced in 2016, when the CFTC brought its first enforcement action against a trading platform that offered retail commodity transactions in virtual currency without registering with the CFTC. In its settlement order against Bitfinex, the CFTC took the position that delivery of bitcoin purchased with borrowed funds to a private, omnibus settlement wallet where the coins were held for the benefit of the buyer but also as collateral for the loan did not constitute actual delivery, because the buyer did not have any rights to access or use the

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138 Id. at 52,429.

purchased bitcoin until released by Bitfinex following satisfaction of the loan. The CFTC noted that Bitfinex’s “accounting for individual customer interests in the bitcoin held in the omnibus settlement wallet in its own database was insufficient to constitute ‘actual delivery,’” following its position in the 2013 Guidance that “book entry” purporting to show delivery is insufficient.

In March 2020, the CFTC addressed the uncertainty surrounding the concept of “actual delivery” in the context of digital asset transactions by issuing an interpretation (the “Actual Delivery Guidance”). More than two years earlier, in December 2017, the CFTC had issued a proposed interpretation on the same subject. Consistent with the principles established in the 2013 Guidance and the litigation position taken against Bitfinex, the Actual Delivery Guidance explains that, in interpreting the term “actual delivery” for purposes of retail commodity transactions, the CFTC will employ a functional approach and examine how the transaction is marketed, managed, and performed, instead of relying solely on language used by the parties.

Under the Actual Delivery Guidance, actual delivery occurs in retail virtual currency transactions when:

- a customer secures (i) possession and control of the entire quantity of the commodity, whether it was purchased on margin, or using leverage, or any other financing arrangement, and (ii) the ability to use the entire quantity of the commodity freely in commerce (away from any particular execution venue) no later than 28 days from the date of the transaction and at all times thereafter; and

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140 See id. at 79,390.


142 See Actual Delivery Guidance, 85 Fed. Reg. 37,734. The Actual Delivery Guidance became effective on June 24, 2020, three months after its adoption.

• the offeror and counterparty seller (including any of their respective affiliates or other persons acting in concert with the offeror or counterparty seller on a similar basis) do not retain any interest in, legal right, or control over any of the commodity purchased on margin, leverage, or other financing arrangement at the expiration of 28 days from the date of the transaction.\textsuperscript{144}

The Actual Delivery Guidance provides further direction on “actual delivery” of virtual currency through illustrative examples. Some notable aspects of these examples include the following:

• Actual delivery will have occurred if, within 28 days of entering into a transaction, the virtual currency’s public distributed ledger reflects the transfer of the entire quantity of the purchased virtual currency to the purchaser’s blockchain address.

• Actual delivery will not have occurred if, within 28 days of entering into a transaction, the transaction is rolled, offset against, netted out, or settled in cash or virtual currency.

• When a transaction involves a depository that acts on behalf of the purchaser, three conditions must be met for actual delivery: (i) the offeror or seller has delivered the entire quantity of the virtual currency purchased into the possession of the depository; (ii) the purchaser has secured full control over the virtual currency; and (iii) the virtual currency delivered to the depository must be free of liens or other interests or legal rights of the offeror or seller 28 days after the transaction.

• A book entry made by the offeror or counterparty seller purporting to show delivery will not by itself establish actual delivery; instead, the entire quantity of the virtual currency purchased must have been delivered to the customer.\textsuperscript{145}

The second exception from having to treat a contract for the sale of a commodity as or “as if” it were a futures contracts applies when (i) the contract creates an enforceable delivery obligation between the seller and the buyer, and (ii) the seller and the buyer have the ability to deliver and accept delivery of the commodity in connection with their respective lines of business. To date, the CFTC has declined to provide any interpretive guidance on this exception.

\textsuperscript{144} Actual Delivery Guidance, 78 Fed. Reg. at 37,742–43.

\textsuperscript{145} Id. at 37,743–44.
The focus on the commercial nature of the parties and the transaction suggests that this exception is a counterpart to the forward contract exclusions discussed below that exclude commercial merchandizing transactions from regulation as futures or swaps.

(d) Commercial Forward Contracts and Spot Contracts

The CFTC is not authorized under the CEA to adopt rules regulating trading in the cash markets for physical (or non-financial) commodities, known as forward or spot contracts or transactions, and the SEC, not the CFTC, regulates initial offerings of securities and secondary market trading of securities. The CFTC, though, does have certain authority to monitor the cash market activities of users of the derivatives markets, combined with authority to impose recordkeeping requirements on such persons relating to their cash market activities. The CFTC also has authority to require hedgers to file certain reports regarding their cash market positions and commercial operations.

Notably, the CEA makes it unlawful to manipulate or to attempt to manipulate the prices of any commodity, and vests the CFTC with authority to take enforcement action against any person that engages in such conduct. The CEA also classifies manipulation and attempted manipulation as criminal felonies, which may be prosecuted by the U.S. Department of Justice.

Commercial Forward Transactions. A forward contract is a commercial merchandizing contract between commercial parties where delivery of a non-financial commodity (such as an agricultural, energy, or metal commodity) is deferred for commercial reasons, the parties intend to make or take delivery of the commodity, and delivery routinely occurs. Forward contracts are excluded from regulation as futures pursuant to CEA section 2(a), in conjunction with section 1a(27), which provides that the term “future delivery” used in section 2(a) does not include “any sale of any cash commodity for deferred shipment or delivery.” The exclusion is
not limited to forward contracts for non-financial commodities by its terms, but it historically has been applied to, and interpreted in the context of, sales of physical or tangible commodities.

The CEA swap definition expressly excludes forward contracts on “non-financial commodities” (and on securities), provided the parties intend to physically settle the transactions, with the consequence that such contracts are excluded from regulation as swaps. When the CFTC adopted its swap product definition rules in August 2012, it stated that it would interpret the forward contract exclusion from the futures and swap definitions in a consistent manner.146

**Spot Contracts.** Spot contracts are commercial contracts for the sale of a commodity for delivery within two days, or such other short timeframes consistent with applicable market convention, under which the commodity is typically delivered. Spot contracts generally are outside the regulatory ambit of the CEA (apart from the anti-fraud and anti-manipulation provisions or potential application of the retail forex or retail commodity transaction provisions described above).

(e) **CFTC Registration Requirements for Virtual Currency Market Participants**

Market participants that are dealing in, or providing services related to, derivatives on a virtual currency may be required to register with the CFTC. The CEA establishes different registration categories based on a participant’s activities. The chart below summarizes the CEA registration categories.147

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146 See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,207, 48,227–28 (Aug. 13, 2012) [hereinafter Swap Definition Rule]. When it adopted the swap product definition rules, the CFTC also provided extensive interpretive guidance for determining whether contracts on non-financial commodities should be classified as excluded forward contracts. The analysis is fact intensive, based on the specific circumstances.

147 The registration requirements in this chart presume that the virtual currencies are not securities. If the virtual currency is a security, a market participant may have to register with the SEC or, in some cases, with both the CFTC and the SEC (for example, if the derivative is a futures contract on a virtual currency that is a security).
<table>
<thead>
<tr>
<th>Registration Category</th>
<th>Registration Requirement</th>
</tr>
</thead>
</table>
| Swap Dealer (SD)              | An entity that either (i) holds itself out as a dealer in swaps on virtual currencies; (ii) makes a market in swaps on virtual currencies for its own account in the ordinary course of business; or (iv) engages in activities causing it to be commonly known as a dealer or market maker in swaps on virtual currencies, must register with the CFTC and become a member of the NFA, unless certain exceptions apply. For instance, a dealer is not required to register with the CFTC if the gross notional value of its swap dealing trades, combined with those of its affiliates, over the prior 12 months is below $8 billion.  
148 7 U.S.C. § 1a(49); 17 C.F.R. § 1.3. |
| Major Swap Participant (MSP)  | An entity that is not an SD but maintains a position in swaps on virtual currencies that is substantial enough that the entity’s default could have adverse effects on the financial stability of the U.S. banking system is required to register with the CFTC and become an NFA member.  
149 7 U.S.C. § 1a(33); 17 C.F.R. § 1.3. |
| Futures Commission Merchant (FCM) | An entity that (i) “engages in soliciting or accepting orders for” futures or swaps on virtual currencies, options on futures on virtual currencies, retail off-exchange foreign exchange contracts, or swaps on virtual currencies; and (ii) in connection with those activities, accepts any money, securities, or property, or extends credit in lieu thereof to margin, guarantee, or secure the resulting trades must register with the CFTC and become an NFA member, unless an exemption applies.  
150 7 U.S.C. § 1a(28); 17 C.F.R. § 1.3. |
| Introducing Broker (IB)       | An entity that “engages in soliciting or accepting orders for” futures or swaps on virtual currencies but does not accept any money, securities, or property from customers, or extend credit in lieu thereof, to margin, guarantee, or secure the resulting trades must register with the CFTC and become an NFA member, unless an exemption applies.  
151 7 U.S.C. § 1a(31); 17 C.F.R. § 1.3. |
| Commodity Pool Operator (CPO)  | An entity that operates a commodity pool (i.e., “any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests”), or an investment trust, syndicate, or other pooled investment vehicle that invests in derivatives on virtual currencies, must register with the CFTC and become an NFA member, unless certain exemptions apply.  
152 7 U.S.C. § 1a(11); 17 C.F.R. § 1.3. |
<table>
<thead>
<tr>
<th>Registration Category</th>
<th>Registration Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodity Trading Advisor</td>
<td>An entity that advises others on trading in futures, swaps, and other derivatives on virtual currencies for compensation or profit must register with the CFTC and become an NFA member, unless certain exemptions apply. 153</td>
</tr>
<tr>
<td>(CTA)</td>
<td></td>
</tr>
<tr>
<td>Associated Person (AP)</td>
<td>An individual who solicits customers or supervises others who solicit customers on behalf of any of the registered entities above (other than SDs or MSPs) must register with the CFTC and become a member of the NFA. APs of SDs or MSPs are subject to a fitness screening. 154</td>
</tr>
</tbody>
</table>

Any person registered in one of the foregoing capacities (with the exception of an AP of a swap dealer) also must become a member of the NFA. 155 NFA is a self-regulatory organization for industry professionals, created in 1976 pursuant to statutory authority. 156 It is registered with the CFTC as a “registered futures association” and is subject to CFTC oversight. Members of NFA are bound by NFA’s rules, and subject to NFA’s self-regulatory oversight and disciplinary authority. 157

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153 7 U.S.C. § 1a(12); 17 C.F.R. § 1.3.
154 7 U.S.C. § 1a(4); 17 C.F.R. §§ 1.3, 5.1(h)(2).
155 See 17 C.F.R. §§ 3.2, 3.12. CFTC Rule 170.17, 17 C.F.R. § 170.17, provides a narrow exception to the NFA membership requirement to a person that is registered as a CTA if the person meets the criteria in CFTC Rule 4.14(a)(9), which provides that the CTA does not “[d]irect[] client accounts” or “[p]rovid[e] commodity trading advice based on, or tailored to, the commodity interest or cash market positions or other circumstances or characteristics of particular clients.” 17 C.F.R. § 4.14(a)(9). Individuals who are “principals” of a registered firm also are subject to fitness screening by NFA. As defined in CFTC Rule 3.1(a), 17 C.F.R. § 3.1(a), the term covers individuals who are in a position to exercise a controlling influence over activities of the firm that are subject to CFTC regulation, such as a board member, president, chief executive officer, chief operating officer, chief financial officer, or head of a business division engaged in CFTC-regulated activities. It also covers individuals who (directly or indirectly) have a 10% or more financial or ownership interest in any class of the firm’s voting securities, or have contributed 10% or more of the firm’s capital.
157 NFA’s oversight can extend to the activities of members relating to digital assets. In that regard, NFA adopted an interpretative notice that took effect on October 31, 2018, which imposes disclosure obligations on FCMs, IBs, CTAs, and CPOs regarding virtual currency derivative and underlying or spot virtual currencies.
3. **The CFTC’s Treatment of Virtual Currencies as Commodities**

   (a) **The CEA “Commodity” Definition**

   As the structure of the CEA illustrates, determining whether the CFTC has jurisdiction over transactions involving virtual currencies in large part turns on whether they fall within the CEA’s commodity definition, which defines the CEA’s reach over transactions and markets. The commodity definition includes two categories, one narrow and one that potentially is 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).  

   The definition—which has not been amended since 2010—understandably does not expressly reference virtual currencies. The legislative history behind the commodity definition, however, provides insight as to whether the definition should be interpreted to contemplate including virtual currencies. The second, broad category of the commodity definition was added to the CEA in 1974, to grant the newly created CFTC expansive authority over futures markets. By establishing a far more open-ended definition of “commodity,” Congress provided the CFTC substantial latitude to determine the scope of its authority through its interpretation of the flexible category. However, as illustrated by the CFTC’s recent attempts to combat alleged fraud in the virtual currency markets, the CFTC’s assertion of expansive authority over non-derivative markets generates interpretative issues as market participants seek clarity regarding the bounds of the CFTC’s authority.

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158 7 U.S.C. § 1a(9).

(b) Evolution of the CEA “Commodity” Definition

Until 1974, Congress specified the bounds of commodity futures regulation through the narrow commodity definition, and expanded it over time on a commodity-by-commodity basis to regulate additional markets that Congress determined warranted regulation. Congress first enacted the Grain Futures Act in 1922\textsuperscript{160} to regulate futures trading in “grain,” which was defined by the Act to mean “wheat, corn, oats, barley, rye, flax, and sorghum.”\textsuperscript{161} In 1936, Congress replaced the Grain Futures Act with the CEA to address limitations from the use of the “grain” definition.\textsuperscript{162} Congress replaced the term “grain” with “commodity” in an effort to make the CEA more generally applicable to any additional item that Congress later determined should be subject to futures regulation.\textsuperscript{163} The CEA also expanded the list of commodities (and, therefore, the Commodity Exchange Authority’s jurisdiction) to include cotton, rice, mill feeds, butter, eggs, and Solanum tuberosum (Irish potatoes).\textsuperscript{164}

Over the years, Congress expanded the coverage of the CEA by amending the commodity definition to add specified commodities such as “fats and oils . . . cottonseed meal, cottonseed, peanuts, soybeans, and soybean meal” and “frozen concentrated orange juice.”\textsuperscript{165} Before

\begin{footnotes}
\item[163] \textit{Regulation of Grain Exchanges: Hearing Before the H. Comm. on Agric.}, 73rd Cong. 11 (1934) (statement of J.M. Mehl, Assistant Chief Grain Futures Admin., U.S. Dep’t of Agric.); \textit{see also} H.R. REP. NO. 1522, at 2 (1934).
\end{footnotes}
Congress established the CFTC, however, the commodity definition covered enumerated agricultural commodities only.

The 1974 amendments reflected a notable departure from Congress’s traditional approach as the new definition of “commodity” not only retained the list of agricultural commodities but added a category of goods, articles, services, rights, and interests that contemplated the CFTC’s exercise of jurisdiction over additional commodities without congressional action.

The current commodity definition maintains the revised structure set by Congress in 1974:

The term “commodity” means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions (as provided by section 13-1 of this title) and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.  

The breadth of the commodity definition is evidenced by the fact that Congress has carved out only onions and movie box office receipts from the commodity definition, in 1974 and 2010, respectively.

The expanded commodity definition, while granting the CFTC expansive authority over the commodity futures markets, invites questions on the limits to the CFTC’s jurisdiction. This issue is most apparent in the context of novel products involving underlying interests that do not resemble the commodities enumerated in the statutory definition. Under the more expansive

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166 7 U.S.C. § 1a(9).

167 Dodd-Frank Act, supra note 159, § 721(a), 124 Stat. at 1659.
commodity definition, each novel product over which the CFTC exercises authority raises the question of whether the agency is extending its jurisdiction farther than Congress intended. This question is particularly relevant in circumstances where the CFTC is not exercising its authority in the futures or swaps markets, over which the CFTC’s jurisdiction is plenary and clear, but rather in the spot or cash markets, where the CFTC’s authority is limited to anti-fraud and anti-manipulation enforcement, or pursuant to its authority to regulate certain retail commodity transactions.

(c) **Interpretative Issue Raised by the Commodity Definition: Does a Virtual Currency Require the Existence of Overlying Futures Contracts to Be Deemed a Commodity?**

As virtual currencies are not any of the enumerated agricultural commodities, whether the CFTC has jurisdiction over transactions in virtual currencies depends (with limited exception\(^{169}\)) on whether they fall within any of the categories in the second portion of the definition—“goods and articles . . . [or] all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.” One interpretative question related to the treatment of virtual currencies under this portion of the commodity definition is whether a futures contract on a virtual currency must already exist for such virtual currency to be considered a “commodity.”

There are different ways to read the second category of the commodity definition. The first, and narrowest, approach to understanding this phrase is that only goods, articles, services, rights, and interests on which a futures contract exists are “commodities” under the CEA. This reading necessarily makes the existence of futures trading on a commodity a prerequisite for the CFTC to assert its authority over something as a commodity. Accordingly, although the CEA


\(^{169}\) As explained above, CEA regulation of swaps is not limited to swaps on commodities.
definition contemplates futures contracts that are “in the future dealt in,” a commodity would not be deemed to be a “commodity” for purposes of the CEA definition until it was the subject of a futures contract.\textsuperscript{170}

A variation of this reading is that the futures trading element qualifies only “services, rights, and interests,” and not “goods and articles.” If this interpretation applies, it is then necessary to determine whether a virtual currency is a good or article. If so, futures trading is not a prerequisite to classifying the virtual currency as a commodity, but if it instead is a service, right, or interest, the futures trading element is relevant.

Under a broad reading, the commodity definition encapsulates all goods, articles, services, rights, and interests on which a futures contract exists, as well as any other commodity that could be the subject of futures trading in the future.\textsuperscript{171} Under this interpretation, the CFTC would have jurisdiction over a commodity so long as it is possible that the commodity could be the subject of a futures contract and would not necessarily require a futures market to exist prior to the CFTC asserting its jurisdiction over that commodity.

Finally, the middle-ground approach is that there needs to be an overlying futures contract, but not necessarily on the precise item, as long as there is a futures contract on another item that belongs to the same category of commodity. As explained further below in Section 2.3(e)(ii), the court in \textit{CFTC v. My Big Coin Pay}\textsuperscript{172} took this stance and held that the CFTC has enforcement jurisdiction over MBC, a virtual currency that had no overlying futures contract.

\textsuperscript{170} The definition’s “in the future” language could be read by reference to the definition’s establishment in 1974, such that Congress intended that the CFTC’s jurisdiction not be limited by the futures contracts already in existence at that time but rather would extend to any commodity over which a futures contract was established thereafter.


contract, because futures contracts did exist for bitcoin, and MBC and bitcoin belonged to the same category of commodity.

Evaluating each interpretative approach through the lens of the legislative history of the commodity definition offers some additional insight, though not a clear answer as to how this condition should be understood. All four possible readings of the definition seemingly would be consistent with Congress’s intent in 1974 to end its longstanding approach to specifying the bounds of commodity regulation through enumerating the commodities over which agency jurisdiction could be exercised. Even under the narrowest reading of the commodity definition, the interest underlying any futures trading that developed after 1974 would be included in the definition, thereby avoiding an outcome where expanding the CFTC’s authority depends on congressional action.

The narrowest approach, however, would limit the CFTC’s jurisdiction by tying the CFTC’s authority directly to commodities that already are encompassed by futures trading. This outcome seemingly raises a concern similar to that which influenced Congress’s first legislative approach, because the CFTC’s authority would again depend on congressional action to combat fraud and manipulation with respect to a commodity that was not yet subject to a futures contract. On the other hand, the original public interest justification for regulating futures markets is based on the interrelationship between futures markets and underlying cash markets, suggesting the narrowest approach is consistent with congressional intent.

Under the expansive reading of the definition, the CFTC would not be subject to this limitation, as it would be able to regulate an emerging commodity so long as a futures market for that commodity conceivably could develop. However, the expansive reading may create as many problems as it solves. Under this reading, the CFTC’s anti-fraud and anti-manipulation authority
could be read to capture *any* good, article, service, right, or interest, including those that do not necessarily have any connection to the futures markets.\(^{173}\)

The middle-ground approach avoids the untenable implications of the expansive reading, but still begs the question of what items would be deemed to belong to the same “category” of commodity and thus subject to the CFTC’s jurisdiction. That question could become more salient in the regulation of virtual currencies as different virtual currencies develop distinct characteristics. For example, virtual currencies may possess all or some of the characteristics of payment tokens, utility tokens, asset tokens, and hybrid tokens, and the virtual currencies’ characteristics may even evolve over time.

How these interpretative issues are resolved is important to the question of whether virtual currencies are subject to the CFTC’s jurisdiction under the CEA. Only one virtual currency, bitcoin, currently is the subject of exchange-listed futures trading.\(^{174}\)

(d) Another Interpretative Question: If Virtual Currencies Are Commodities, What Type of Commodity Are They?

The CEA makes distinctions based on the type or classification of a commodity. It refers in various provisions to securities, foreign currencies, non-financial commodities, agricultural commodities, excluded commodities, and exempt commodities, and includes definitions of the latter two classifications.

\(^{173}\) Press Release, Bart Chilton, Comm’r, CFTC, Statement on MDEX Application Regarding Box Office Receipt Contracts (June 14, 2010), https://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement061410.

\(^{174}\) Futures generally are subject to an exchange-trading requirement. Thus, listing on a futures exchange is not an element of the futures contract definition, but a consequence that follows from classification of a contract as a futures contract. To the extent that futures trading is permitted to occur outside the exchange-trading requirement or occurs in disregard of that requirement, such trading also could provide a basis under the narrow interpretation for classifying the interests underlying such trading as commodities.
Classification of a virtual currency as a security or non-security is important, because the CEA and federal securities laws allocate jurisdiction over securities-related derivatives between (or jointly to) the CFTC and SEC, as explained more fully below. Thus, there is potential for conflicting assertions of jurisdiction over transactions in virtual currencies if the CFTC and SEC take different positions on whether a particular virtual currency is a security.

If a virtual currency is a non-security commodity, another important distinction is whether it could be considered a foreign currency. As explained above, the CFTC takes the position that virtual currencies are not currencies, with the consequence that retail transactions involving virtual currencies could not operate under the more favorable CEA framework governing retail forex, and instead must be considered under the more restrictive provisions applicable to retail commodity transactions.

If virtual currencies are not considered to be foreign currencies, that also means that physical delivery swaps involving virtual currencies are outside the scope of the Treasury Department’s determination to exclude deliverable foreign exchange forwards and foreign exchange swaps from the CEA’s definition of “swap.” Transactions that are covered by the Treasury Department’s determination would not be subject to swap regulations except for swap data reporting and business conduct standards applicable to swap dealers.175

The distinction between excluded commodities and exempt commodities also is relevant to the extent that it is a proxy for distinguishing financial commodities from non-financial commodities. The term “excluded commodity,” added to the CEA by Congress in 2000,176


means:

(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;

(ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is—

(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or

(II) based solely on one or more commodities that have no cash market;

(iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or

(iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is—

(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and

(II) associated with a financial, commercial, or economic consequence. 177

The term “exempt commodity” means “a commodity that is not an excluded commodity or an agricultural commodity.” 178 This definition thus is a catchall category that includes energy interests and precious metals. Exempt commodities and agricultural commodities together generally cover commodities that are considered non-financial.

The regulatory implications of the excluded versus exempt commodity characterization are most notable where market participants are transacting in forwards or swaps based on virtual currencies. If virtual currencies are considered to be excluded commodities, the forward contract exclusions discussed above probably are not available, because the exclusion from the “swap”

177 7 U.S.C. § 1a(19).
178 Id. § 1a(20).
definition is by its terms limited to non-financial commodities, and the exclusion from the futures definition typically is read to apply to non-financial commodities.

The CFTC’s Trade Option Exemption, which excludes qualifying options from regulation as swaps, by its terms is limited to options on exempt or agricultural commodities, and thus would be unavailable for options on virtual currencies if the virtual currency is classified as an excluded commodity.\footnote{17 C.F.R. § 32.3(a). Entities that qualify for the Trade Option Exemption still must comply with certain CFTC rules, such as certain of the Part 23 rules for Swap Dealers and Major Swap Participants and the capital and margin requirements for Swap Dealers and Major Swap Participants. See id. § 32.3(c).} Virtual currencies defy easy categorization because of their diverse characteristics and evolving uses. In the simplest reading, the term virtual currency necessarily includes the term “currency,” which suggests that virtual currencies can be used as a means of payment and, as such, should be treated like a currency for regulatory purposes.\footnote{Indeed, bitcoin, the leading virtual currency today, already is being used as a means of payment in some cases. See, e.g., Kenneth Rapoza, Goldman Sachs Caves: Bitcoin Is Money, FORBES (Jan.10, 2018, 11:15 AM), https://www.forbes.com/sites/kenrapoza/2018/01/10/goldman-sachs-caves-bitcoin-is-money/.} The CFTC nonetheless has declined to treat virtual currencies the same as currencies. Bitcoin and other virtual currencies also arguably share characteristics with precious metals, which historically have been treated as exempt commodities, due to individuals’ belief in their intrinsic use and value. Virtual currencies exist in limited supply, often are capable of delivery, and are capital goods used to produce other goods and services.\footnote{Houman B. Shadab, Regulating Bitcoin and Block Chain Derivatives, Written Statement to the CFTC Global Markets Advisory Committee 5 (Oct. 9, 2014), https://www.cftc.gov/sites/default/files/idc/groups/public/@aboutcftc/documents/file/gmac_100914_bitcoin.pdf.} The CFTC has not yet definitively resolved the question of whether virtual currency is an excluded or exempt commodity.

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When asserting that virtual currencies are commodities, though, the CFTC’s statements to date suggest that it considers virtual currencies to be exempt commodities. For example, in *Coinflip*, the CFTC stated that “Bitcoin and other virtual currencies are distinct from ‘real’ currencies, which are the coin and paper money of the United States or another country that are designated as legal tender, circulate, and are customarily used and accepted as a medium of exchange in the country of issuance.”\(^{182}\) Further, the CFTC seemingly suggested that virtual currencies are exempt commodities by considering whether the bitcoin options at issue in *Coinflip* were offered pursuant to the Trade Option Exemption under CFTC Rule 32.3.\(^{183}\) This apparent approach is consistent with public statements made by CFTC and SEC leadership contrasting virtual currencies with traditional currencies.\(^{184}\)

In the consent order that the CFTC later entered into with Bitfinex, the CFTC similarly signaled that it may view virtual currencies as exempt, not excluded, commodities. The CFTC there referred to CEA section 2(c)(2)(D) when reasoning that the margined virtual currency transactions that were offered by Bitfinex did not qualify for an exception from CFTC jurisdiction over retail commodity transactions.\(^{185}\) CEA section 2(c)(2)(D) is a provision that applies to retail commodity transactions, rather than the analogous retail foreign exchange transaction exception. By evaluating the legality of Bitfinex’s virtual currency transactions by

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183 *Id.* at 77,856 & n.5.

184 Jay Clayton & J. Christopher Giancarlo, *Regulators are Looking at Cryptocurrency*, WALL ST. J. (Jan. 24, 2018, 6:26 PM), https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363 (“But cryptocurrencies lack a fundamental characteristic of traditional currencies, namely sovereign backing. They also lack other hallmarks of traditional currencies, such as governance standards, accountability and oversight, and regular and reliable reporting of trading and related financial data. Significantly, cryptocurrencies are now being promoted, pursued and traded as investment assets, with their purported utility as an efficient medium of exchange being a distant secondary characteristic.”).

reference to the retail commodity provision rather than its retail foreign currency counterpart, the
CFTC signaled that it may view virtual currency as an exempt commodity.

The CFTC made clear that its interpretation would apply to retail commodity transactions
and would not apply to retail foreign currency transactions covered by CEA section 2(c)(2)(C) in
its subsequent proposed interpretation and request for comment regarding how the “actual
delivery” exception would apply to virtual currencies.\textsuperscript{186} The CFTC explained that it considered
virtual currencies to be “like many other intangible commodities that the Commission has
recognized over the course of its existence (\textit{e.g.}, renewable energy credits and emission
allowances, certain indices, and certain debt instruments, among others). Indeed, since their
inception, virtual currency structures were proposed as digital alternatives to gold and other
precious metals.”\textsuperscript{187}

Although the principal attributes of virtual currencies are important in determining how
to categorize them under the CEA, it also will be important for the CFTC to consider how any
future determination compares to statements it already has made or actions it already has taken.
For example, if the CFTC determined that virtual currencies are excluded commodities because
of their use as a medium of exchange and payment, such a determination would seem consistent
with the CFTC’s prior conclusion that excluded commodities “generally are financial,” whereas
“exempt and agricultural commodities by their nature generally are nonfinancial.”\textsuperscript{188}

\textsuperscript{186} See Proposed Actual Delivery Guidance.

\textsuperscript{187} Id. at 60,337–38 (footnote omitted) (citing Swap Definition Rule) (discussing application of the swap forward
exclusion to intangible commodities)).

\textsuperscript{188} Swap Definition Rule, 77 Fed. Reg. at 48,232; see also CFTC, Excluded Commodity, CFTC GLOSSARY (last
(“Excluded Commodity: In general, the Commodity Exchange Act defines an excluded commodity as: any financial
instrument such as a security, currency, interest rate, debt instrument, or credit rating; any economic or commercial
other hand, the CFTC would be tasked with reconciling its decision to put virtual currencies in the same “excluded” category as fiat currencies with prior CFTC statements (some of which we have described above), as well as current positions of agencies such as the IRS and FinCEN, \(^{189}\) which found virtual currencies to be dissimilar to fiat currencies, irrespective of their potential use as a payment medium. \(^{190}\) The CFTC also would need to distinguish the main characteristics of virtual currency from other exempt commodities that similarly have intrinsic value in order to avoid calling into question whether other exempt commodities may fall within the excluded commodity category. Conversely, if the CFTC were to categorize virtual currencies as exempt commodities, it would need to go through a similar exercise. Further complicating the CFTC’s task is the development of new types of virtual currencies that may operate like a traditional currency, such as “stablecoins” whose prices are tied to a fiat currency.

It is against this backdrop of the commodity definition—and the outstanding questions related to the scope and content of the definition—that the CFTC asserted its jurisdiction over virtual currencies. As the discussion below explains, having definitively determined that virtual currencies are commodities (implicitly as non-securities), the CFTC faces numerous challenges regarding its regulatory approach to them.


\(^{190}\) CFTC Staff Advisory No. 18-14, at 2 (May 21, 2018), https://www.cftc.gov/sites/default/files/idc/groups/public/%40lreltgeneral/documents/letter/2018-05/18-14_0.pdf (“The Commission interprets the term ‘virtual currency’ broadly, to encompass any digital representation of value that functions as a medium of exchange and any other digital unit of account used as a form of currency.”).
(e) The CFTC’s Asserted Jurisdiction over Virtual Currencies as Commodities

Key regulatory consequences flow from the CFTC’s determination that bitcoin and other virtual currencies are commodities, and of a type that are not securities. First, the CFTC possesses anti-fraud and anti-manipulation authority over such commodities in interstate commerce, so to the extent the CFTC finds fraud or manipulation occurring in connection with virtual currencies, it can take enforcement action. Second, the CFTC has full regulatory authority over derivatives on virtual currencies that are not securities, such as futures contracts. We discuss below the basis for the CFTC’s critical determination that virtual currencies are commodities, challenges to that determination, and the responsive actions taken by the Commission.

i. Basis for the CFTC’s View That Virtual Currencies Are Commodities

The CFTC initially articulated its position that virtual currencies are commodities through administrative proceedings. However, in each of those matters, the CFTC did not provide many, if any, supporting points to explain its reasoning or criteria for determining that virtual currencies were commodities. As explained below in Section 2.3(e)(ii), it was not until defendants challenged the CFTC’s asserted jurisdiction in civil actions that the CFTC came forward with a more substantial explanation for its authority over virtual currencies.

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.191 The CFTC based that conclusion on two factors: (i) the statutory definition of commodity includes “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in,” and

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(ii) the definition of a commodity is “broad.” However, the consent order provides no additional, more specific explanation as to why bitcoin and virtual currencies fall within the “services, rights, and interests” commodity definition category. Under the terms of the order, Coinflip agreed to cease and desist from its conduct but was not required to pay a civil monetary penalty—a relatively rare occurrence in a CFTC enforcement action. Perhaps the CFTC refrained from imposing a civil monetary penalty because this was a “first of its kind” case—the CFTC’s first step in providing notice to the market of its assertion of enforcement authority over virtual currencies.

A week after the Coinflip settlement, the CFTC settled with TeraExchange, LLC, a registered SEF, regarding allegations that the SEF failed to prevent wash trading by publicizing the execution of non-deliverable forward contracts based on the value of the U.S. dollar and bitcoin without disclosing that the trades were prearranged. The CFTC relied on its initial determination in Coinflip, stating in a footnote of its order: “Bitcoin is a commodity under Section 1a of the Act . . . and is therefore subject as a commodity to applicable provisions of the Act and Regulations.” The order provided no further explanation or reasoning.

In June 2016, the CFTC settled with an online platform, Bitfinex, regarding allegations that Bitfinex engaged in illegal, off-exchange retail commodity transactions without registering as an FCM. Bitfinex engaged in different activities than the defendants in the first two enforcement actions. Unlike the platforms in the first two settlement orders, which involved

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192 Id. (quoting 7 U.S.C. § 1a(9); citing Bd. of Trade of City of Chi. v. SEC, 677 F.2d 1137, 1142 (7th Cir. 1982)).


194 Id. at 77,894 n.3.

derivatives on virtual currencies, Bitfinex offered leveraged trading in virtual currencies, primarily bitcoin. Nevertheless, the CFTC—here too, relying simply on its previous Coinflip and TeraExchange orders—emphasized that “Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.” According to the CFTC, Bitfinex’s platform constituted unlawful futures trading because it did not occur on a registered exchange. Also, because Bitfinex directly accepted customer funds and trading orders, it allegedly should have registered with the CFTC as an FCM, but did not.

In September 2017, more than one year after the Bitfinex case, the CFTC filed its first virtual currency-related action in federal district court against Gelfman Blueprint, Inc. and its CEO, Nicholas Gelfman. The CFTC charged the defendants with one count of engaging in fraud by a deceptive device or contrivance, in violation of CEA section 6(c)(1) and CFTC Rule 180.1, by making written misrepresentations to their customers, failing to disclose material information to them, and misappropriating their funds. The CFTC again asserted that virtual currencies are commodities, adhering to its initial position from administrative cases but similarly without much reasoning. In its complaint, the CFTC alleged in one sentence that “Bitcoin and other virtual currencies are encompassed in the definition of ‘commodity’ under section 1a(9) of the

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196 Id. at 77,855. The CFTC repeated its statements from Coinflip that the statutory definition of commodity includes “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in,” and that the definition of a commodity is broad.

197 See 7 U.S.C. § 2(c)(2)(D)(iii) (leveraged trading of commodities that does not meet the actual delivery exception will be treated as if the trading is of futures, which must occur on a registered exchange under CEA section 4(a)).

Commodity Exchange Act . . .”199 In footnote 1 of the complaint, the CFTC defined “virtual currency” the same way it had done in the Coinflip order.200

On October 12, 2017, Mr. Gelfman, acting pro se, filed a response to the CFTC’s complaint. In the response, he asserted that the CFTC lacks jurisdiction because “[b]itcoin and other virtual currencies are not commodities under Section 1a(9) of the Act.”201 This answer was filed prior to the launch of two different exchange-traded bitcoin futures contracts in December 2017. On October 1, 2018, Mr. Gelfman’s argument was rendered moot, and the case was terminated, by the filing of a Consent Order for Permanent Injunction.202 In the “Findings of Fact” section of the Order, bitcoin was described as “a commodity in interstate commerce.”203 The “Conclusions of Law” section of the Order stated that “[v]irtual currencies such as [b]itcoin are encompassed in the definition of ‘commodity’ under Section 1a(9) of the Act, 7 U.S.C. § 1a(9) (2012).”204 In addition to an injunction against committing future violations of the CEA, the Order directed Mr. Gelfman to pay $492,064.53 in restitution and a civil monetary penalty of $177,501.

Two federal courts have offered an analysis regarding how virtual currencies should be treated under the commodity definition. In CFTC v. McDonnell,205 the CFTC alleged that the

199 Id. at ¶ 12.

200 Id. at ¶ 12 n.1.


202 Consent Order for Permanent Injunction, Civil Monetary Penalty, and Other Equitable Relief Against Defendant Nicholas Gelfman, Gelfman, No. 1:17-cv-07181 (S.D.N.Y. Oct. 2, 2018), ECF No. 33.

203 Id. at 5.

204 Id. at 9.

205 McDonnell I, 287 F. Supp. 3d at 213.
defendants purportedly solicited customers to provide advice on trading virtual currencies, but instead misappropriated the funds and provided no advice. Mr. McDonnell, who also was not represented by counsel, did not expressly assert that virtual currencies were not commodities, but took the position that the CFTC “possessed no enforcement jurisdiction” to bring its complaint against him. The CFTC interpreted Mr. McDonnell’s argument that the CFTC lacked “enforcement jurisdiction” as “suggesting that the Commission’s anti-fraud enforcement authority under Section 6(c)(1) of the [CEA] and Regulation 180.1 does not reach the virtual currency-related scheme alleged.” In a pretrial ruling, the court rejected Mr. McDonnell’s argument, explaining that the CFTC can regulate virtual currencies as commodities because (i) they are “‘goods’ exchanged in a market for a uniform quality and value;” (ii) they “fall well-within the common definition of ‘commodity,’” and (iii) they meet the CEA’s definition of commodities as “‘all other goods and articles . . . in which contracts for future delivery are presently or in the future dealt in.’”

Following a bench trial, the court ruled in favor of the CFTC and against Mr. McDonnell. Citing its earlier ruling, the court concluded that “[v]irtual currency may be regulated by the CFTC as a commodity” and that the CFTC’s “broad statutory authority . . . and regulatory authority . . . extends [sic] to fraud or manipulation in the virtual currency derivatives

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206 Id. at 229–30.
207 Defendant’s Memorandum in Support of Motion to Dismiss at 2, CFTC v. McDonnell, No. 18-cv-00361 (E.D.N.Y. Feb. 15, 2018), ECF No. 18-2.
208 Plaintiff’s Memorandum in Opposition to Defendant’s Motion to Dismiss at 6, CFTC v. McDonnell, No. 18-cv-00361 (E.D.N.Y. Feb. 26, 2018), ECF No. 20.
209 McDonnell I, 287 F. Supp. 3d at 228 (alteration in original) (quoting 7 U.S.C. § 1a(9)).
market and its underlying spot market.” Later in the opinion, the court commented that Bitcoin and Litecoin are virtual currencies and are commodities in interstate commerce. In addition to an injunction against committing future violations of the CEA, the Order directed Mr. McDonnell to pay $290,429.29 in restitution and a civil monetary penalty of $871,287.87. Mr. McDonnell did not appeal the order, and the case has concluded.

The positions summarized above provide some support for the ultimate conclusion that virtual currencies are commodities but do not resolve many interpretative questions relating to the CFTC’s jurisdiction over virtual currencies. For example, although the *McDonnell* court agreed with the CFTC’s position, it did not rely on the same grounds that the agency previously had stated. The CFTC previously asserted in its administrative settlements that virtual currencies fall within the definition of commodity under the CEA as part of “all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.” Thus, there is an outstanding question regarding which of the “goods, articles, services, rights, and interests” categories apply to virtual currencies. Further, while the *McDonnell* court concluded that virtual currencies fall within the commodity definition, the court’s reasoning stops short of addressing whether a virtual currency already must be subject to a futures contract in order to be a commodity. Resolving these issues will be critical in determining how far the CFTC may go in exercising its authority over virtual currencies.

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211 Id. at 651.
212 Id. at 723.
213 Id. at 727–28.
214 7 U.S.C. § 1a(9).
ii. Challenges to the CFTC’s Position That Virtual Currencies Are Commodities

While the CFTC thus far has successfully asserted that virtual currencies are commodities under the CEA, the issue is far from settled. For example, the *Gelfman* defendants argued that virtual currencies are not commodities because, among other reasons, Congress has not categorized bitcoin and other virtual currencies as such, and various agencies other than the CFTC also have asserted jurisdiction over virtual currencies.\textsuperscript{215} Although the *Gelfman* court did not rule on that issue because the case was settled, the *McDonnell* court offers a plausible rebuttal to this challenge, stating that “[u]ntil Congress clarifies the matter, the CFTC has concurrent authority, along with other state and federal administrative agencies, and civil and criminal courts, over dealings in virtual currency.”\textsuperscript{216}

A second challenge focuses on the interpretive ambiguities in the commodity definition under the CEA. “Commodity,” as defined by the CEA, includes all goods, articles, services, rights, and interests “in which contracts for future delivery are presently or in the future dealt in.” Even under the narrowest reading discussed above, this definition covers bitcoin because it is currently the subject of futures trading on the CME and Cboe Futures Exchange. It remains unclear, however, whether the same is true for other virtual currencies for which no futures trading currently exists. As noted in Section 2.3(c) above, the commodity definition can be read in competing ways: the first interpretation would require the existence of an overlying futures contract for the CFTC to have jurisdiction over a particular virtual currency as a commodity; the second interpretation would only require the possibility that the virtual currency would be the

\textsuperscript{215} Answer, *supra* note 201, at 13.

\textsuperscript{216} *McDonnell I*, 287 F. Supp. 3d at 217.
subject of a futures contract in the future; and a third, middle-ground interpretation would require that a futures contract exist on one of the virtual currencies as a category of commodity. The outcome of this interpretation carries significance, as the CFTC’s authority over virtual currencies under the first interpretation would be far less clear unless and until other virtual currencies become subject to futures contracts.

The defendants in *CFTC v. My Big Coin Pay* urged the court to take the first approach and dismiss the case for lack of CFTC jurisdiction.\(^{217}\) The case involves MBC, a virtual currency that is not bitcoin and has no overlying futures contract. The defendants argued that “[p]er the plain language of the CEA, intangible ‘services, rights and interests’ are only included in the CEA’s definition of the term ‘commodity’ if there are futures contracts traded on them.”\(^{218}\) Because no futures contracts are traded on MBC, the defendants argued, it is not a commodity, and the CFTC has no authority to bring the action.\(^{219}\)

Not surprisingly, the CFTC has supported the adoption of the second interpretive approach. In its administrative proceedings, the CFTC consistently has stated that “[b]itcoin and other virtual currencies” are properly defined as commodities—even though no future contracts existed on bitcoin or any other virtual currency when it first made that determination in

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\(^{219}\) *Id.* at 6.
In *My Big Coin Pay*, the CFTC provided additional justifications for that position.

First, the Commission avoided the interpretive ambiguities and argued that MBC is a commodity regardless of whether there are futures contracts on it because it is a “good” or an “article” (a position first taken by the *McDonnell* court, not the CFTC). The Commission reasoned that the modifier “presently or in the future dealt in” applies “as a matter of syntax, punctuation, and grammar” only to “services, rights, and interests” in the definition of commodity. The CFTC’s argument potentially carries far-reaching consequences. If the CFTC is correct, then it can regulate cash markets for any goods or articles regardless of whether those markets are, or ever could be, connected to a futures market. Congress, however, amended the CEA to add both the goods and articles and the services, rights, and interests clauses at the same time it added the modifier regarding futures contracts. That timeline, when combined with the delineation of CFTC jurisdiction under CEA section 2(a)(1) over futures contracts and the public interest justification for regulating futures markets, suggests that Congress did not intend to give the CFTC authority over commodities that would have no connection to a futures market.

Second, in the alternative, the CFTC argued that, even if the modifying clause applied to goods and articles as well, MBC and other virtual currencies are commodities because “futures contracts on the functionally similar virtual currency [b]itcoin currently are ‘dealt in.’” The

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221 Plaintiffs’ Opposition to Defendants’ Motion to Dismiss at 8–9, *CFTC v. My Big Coin Pay, Inc.*, No. 1:18-cv-10077 (D. Mass. filed May 18, 2018), ECF No. 70 (citing *Barnhart v. Thomas*, 540 U.S. 20, 21 (2003), for the grammatical rule of the last antecedent under which a limiting clause is read to modify only the phrase it immediately follows).


223 Plaintiffs’ Opposition to Defendants’ Motion to Dismiss, *supra* note 221, at 10–11.
Commission reasoned that “Congress defined commodities under the Act categorically, not by type, grade, quality, brand, producer, manufacturer, or form,” and the Commission therefore has authority to regulate virtual currencies as a category of commodities given that bitcoin futures are being traded. The Commission also relied on United States v. Valencia, which rejected the argument that “West Coast gas” was not a commodity under the CEA because there was no futures contract for “West Coast gas.” The court explained that “West Coast gas” was still a commodity because “natural gas, for delivery on the West Coast or otherwise, is a commodity” in general, natural gas is “fungible,” and “there is no evidence that West Coast gas could not in the future be traded on a futures exchange.”

While not cited by the Commission, the Fifth Circuit in United States v. Brooks similarly rejected the argument that only natural gas traded at Henry Hub is a commodity under the CEA because only natural gas traded at Henry Hub underlies the natural gas futures contracts traded on NYMEX. The court instead held that natural gas generally is a commodity regardless of its location, because “the actual nature of the ‘good’ does not change.”

On September 26, 2018, the My Big Coin Pay court rejected the defendant’s argument made in its motion to dismiss, ruling that at least at the pleading stage of the case, the CFTC had alleged sufficient facts for the case to move forward. In so ruling, the court took the middle-

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224 Id. at 9.
226 Id. at *8 & n.13.
228 Id. at 695.
ground interpretive approach to the commodity definition and held that it was sufficient at the pleading stage of the case for the complaint to allege that My Big Coin is a virtual currency and that there is futures trading in a virtual currency, namely bitcoin.\textsuperscript{230} The court characterized the CFTC’s argument in this way: “Pointing to the existence of [b]itcoin futures contracts, it argues that contracts for future delivery . . . are ‘dealt in’ and that My Big Coin, as a virtual currency, is therefore a commodity.”\textsuperscript{231} The court then ruled that the text of the CEA supported the CFTC’s argument. The court observed that the CEA defines the term “commodity” generally and categorically, and “not by type, grade, quality, brand, producer, manufacturer, or form,” agreeing with the CFTC’s position that “Congress’[s] approach to defining ‘commodity’ signals an intent that courts focus on categories—not specific items—when determining whether the ‘dealt in’ requirement is met.”\textsuperscript{232} Citing the \textit{Brooks} and \textit{Valencia} cases, the court ruled that, “[t]aken together, these decisions align with plaintiff’s argument that the CEA only requires the existence of futures trading within a certain class (\textit{e.g.}, ‘natural gas’) in order for all items within that class (\textit{e.g.}, ‘West Coast’ natural gas) to be considered commodities.”\textsuperscript{233} In his answer to the amended complaint, filed approximately six weeks after the denial of the motion to dismiss, defendant Randall Crater raised the following affirmative defense: “My Big Coin is not sufficiently related to [b]itcoin, the only virtual currency on which futures contracts are traded, to conclude that My Big Coin is a good, article, service, right or interest on which contracts for future delivery are

\textsuperscript{230} \textit{Id}.

\textsuperscript{231} \textit{Id.} at 496–97.

\textsuperscript{232} \textit{Id.} at 497.

\textsuperscript{233} \textit{Id.} at 498.
dealt in, and, therefore, My Big Coin is not a ‘commodity’ as defined in the Commodity Exchange Act.”

On February 26, 2019, a federal grand jury in the U.S. District Court for the District of Massachusetts returned an indictment charging Randall Crater with wire fraud and money laundering in connection with his marketing and sale of My Big Coin. The indictment alleges that Mr. Crater made misrepresentations to investors and misappropriated their money, but does not refer to or depend on My Big Coin’s status as a commodity under the CEA. The word “commodity” does not appear in the indictment. Nine days after the indictment, the U.S. Department of Justice filed an unopposed motion to intervene in the CFTC’s case and to stay discovery. The court granted the motion the next day, and no substantive motions were filed or rulings made for one year.

On March 9, 2020, the defendants filed in the CFTC case a motion to amend or reissue the court’s September 26, 2018 order denying their motion to dismiss, and to certify the order for interlocutory appeal. In the memorandum of law in support of the motion, the defendants identified the issue they wished to raise on appeal as “[w]hether a good or article, other than an enumerated agricultural product, or a service, right or interest, on which no futures contracts are

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238 Defendant Randall Crater’s and Relief Defendants’ Notice of Motion to Amend the Court’s Order Denying the Defendants’ Motion to Dismiss to Certify the Order for Interlocutory Appeal, CFTC v. My Big Coin Pay, Inc. et al., No. 1:18-cv-10077 (D. Mass. filed Mar. 9, 2019), ECF No. 154.
traded, is a ‘commodity’ as that term is defined in the Commodity Exchange Act (‘CEA’)?”

The CFTC opposed the motion, and the court denied the motion on October 29, 2020. Because the CFTC case remains stayed while the criminal case is pending, and no trial date has been set in the criminal case, it is not certain when or whether the CFTC case will provide an answer to the question above.

While instructive, these cases do not resolve the interpretive ambiguities in the commodity definition. At best, they suggest that, where there are enough similarities among components of a general commodity category and one component underlies a futures contract, the CFTC may properly regulate all of those components as commodities. That, in turn, raises the question of how similar virtual currencies must be before they may be grouped together as functional equivalents of bitcoin and thus fall under the commodity definition. As explained in Section 2.3(d) above and Section 2.4 below, virtual currencies may defy easy categorization and each may have unique features that render the analogy to natural gas at different locations inapposite.

(f) The CFTC’s Exercise of Anti-Fraud and Anti-Manipulation Authority over Virtual Currencies as Commodities

The CFTC is not authorized under the CEA to adopt rules regulating trading in the cash markets for commodities, known as forward or “spot” contracts or transactions. As a result, many virtual currency trading platforms operate outside of the CFTC’s jurisdiction. Although

239 Memorandum of Law in Support of Defendant Randall Crater’s and Relief Defendants’ Motion to Amend the Court’s Order Denying the Defendants’ Motion to Dismiss to Certify the Order for Interlocutory Appeal at 1, CFTC v. My Big Coin Pay, Inc. et al., No. 1:18-cv-10077, at 1 (D. Mass. filed Mar. 9, 2019), ECF No. 155.


241 Giancarlo HUA Statement, supra note 2. In his testimony, Giancarlo clarified the CFTC’s jurisdiction over virtual currencies: while these assets are “commodities” under the CEA, current law does not provide any U.S. federal regulator with regulatory oversight authority over spot virtual currency platforms operating in the United States or abroad. However, the CFTC does have enforcement authority to investigate through subpoena and other
spot commodity markets are not directly subject to broader CEA compliance requirements such as registration, reporting, and recordkeeping,\textsuperscript{242} the CFTC has authority under CEA section 6(c)(1)\textsuperscript{243} and CFTC Rule 180.1 to punish fraudulent practices and manipulation related to the commodities traded in those spaces.

CFTC Rule 180.1 states, in part:

Prohibition on the employment, or attempted employment, of manipulative and deceptive devices.

(a) It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly:

1. Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;

2. Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;

3. Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person; or,

4. Deliver or cause to be delivered, or attempt to deliver or cause to be delivered, for transmission through the mails or interstate commerce, by any means of investigatory powers and, as appropriate, conduct civil enforcement actions against fraud and manipulation in virtual currency derivatives markets and in underlying virtual currency spot markets. \textit{Id.} Giancarlo stated that in contrast to the spot markets, the CFTC does have comprehensive regulatory oversight over derivatives on virtual currencies traded in the United States, including registration requirements and a host of requirements for trading and market surveillance, reporting and recordkeeping, business conduct standards, capital requirements, and platform and system safeguards.

\textsuperscript{242} The CFTC, though, does have certain authority to monitor the cash market activities of users of the derivatives markets, combined with authority to impose recordkeeping requirements on such persons relating to their cash market activities. \textit{See, e.g.}, 17 C.F.R. § 1.31.

\textsuperscript{243} 7 U.S.C. § 9(1) (“(1) Prohibition against manipulation. It shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate by not later than 1 year after July 21, 2010, provided no rule or regulation promulgated by the Commission shall require any person to disclose to another person nonpublic information that may be material to the market price, rate, or level of the commodity transaction, except as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect.”).
communication whatsoever, a false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate. Notwithstanding the foregoing, no violation of this subsection shall exist where the person mistakenly transmits, in good faith, false or misleading or inaccurate information to a price reporting service.244

The CFTC’s authority under CEA section 6(c)(1) and Rule 180.1 is similar to the SEC’s anti-fraud authority under Exchange Act section 10(b)245 and SEC Rule 10b-5.246 One difference, however, is that the provisions in the CEA and CFTC Rule 180.1 do not restrict prohibited activities to those that are in themselves tied to a transaction.247 CEA section 6(c)(1) and CFTC Rule 180.1 reach “all manipulative or deceptive conduct in connection with the purchase, sale, solicitation, execution, pendency, or termination of any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity.”248

244 17 C.F.R. § 180.1(a).

245 15 U.S.C. § 78j (“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” (footnote omitted)).

246 17 C.F.R. § 240.10b-5 (“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”).

247 See Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,399 n.6 (Jul. 14, 2011) (to be codified at 17 C.F.R. pt. 180) [hereinafter CFTC Manipulation Rule] (“Differences between the wording of Exchange Act section 10(b) and CEA section 6(c)(1) include, but are not limited to, the express prohibition of the ‘attempt to use’ any ‘manipulative or deceptive device or contrivance’ in CEA section 6(c)(1), and the absence of a ‘purchase or sale’ requirement in CEA section 6(c)(1).”).

248 CFTC Manipulation Rule, 76 Fed. Reg. at 41,401 (“The Commission declines to adopt the request of certain commenters to interpret CEA section 6(c)(1) as merely extending the Commission’s existing anti-fraud and anti-
Nevertheless, the CFTC acknowledged some limits on its authority when finalizing CFTC Rule 180.1.249 The preamble to the rulemaking responded to commentators’ concerns that the language in the rule was so broad that it gave the CFTC limitless authority by offering examples of activities that would not be considered to be “in connection with” any swap, contract of sale of any commodity, or futures contract and, therefore, outside of the scope of the CFTC’s jurisdiction.250 The preamble further stated that the CFTC expected its authority “to cover transactions related to the futures or swaps markets, or prices of commodities in interstate commerce, or where the fraud or manipulation has the potential to affect cash commodity, futures, or swaps markets or participants in these markets.”251 On this point, the preamble concluded, “[t]his application of the final Rule respects the jurisdiction that Congress conferred upon the Commission.”252

Recent CFTC civil cases highlight the potential issues raised when the CFTC seeks to exercise its anti-fraud and anti-manipulation authority in the context of virtual currencies and against the backdrop of its prior statements that its enforcement authority is tied to the CFTC’s overall jurisdiction under the CEA. In CFTC v. Monex, for example, a federal judge in the manipulation authority to cover swaps. Such an interpretation would be inconsistent with the language of CEA section 6(c)(1), as amended by section 753 of the Dodd-Frank Act.”).

249 Id. at 41,405–06.

250 See, e.g., id. (“In this regard, the Commission finds the Supreme Court’s decision in [SEC v. Zandford, 535 U.S. 813 (2002)] interpreting SEC Rule 10b-5’s ‘in connection with’ language particularly instructive. In its opinion, the Court gave the following example to highlight the limits of SEC Rule 10b-5 applicability: If * * * a broker embezzles cash from a client’s account or takes advantage of the fiduciary relationship to induce his client into a fraudulent real estate transaction, then the fraud would not include the requisite connection to a purchase or sale of securities. Likewise, if the broker told his client he was stealing the client’s assets, that breach of fiduciary duty might be in connection with a sale of securities, but it would not involve a deceptive device or fraud.” (second alteration in original) (footnote omitted) (citation omitted)).

251 Id. at 41,401.

252 Id.
Central District of California held that the CFTC may exercise its enforcement authority under CEA section 6(c)(1) only when it can show both manipulative and deceptive conduct, even though “the plain language of § 6(c)(1) suggests that Congress intended to prohibit either manipulative or deceptive conduct.”253 There, the defendants argued that CEA section 6(c)(1) confers the CFTC anti-fraud jurisdiction only where a particular commodity transaction manipulates or potentially manipulates the derivatives market.254 The Ninth Circuit subsequently reversed the district court, rejecting Monex’s argument that “stand-alone fraud claims—without allegations of manipulation—fail as a matter of law.”255

In McDonnell, the court similarly disagreed with the Monex district court decision and allowed the CFTC’s case under CEA section 6(c)(1) to continue based solely on allegations of deceptive conduct. The McDonnell court, after “fully consider[ing] Monex,” held that CEA section 6(c)(1) “gives the CFTC standing to exercise its enforcement power over the fraudulent schemes alleged in the complaint.”256 In several cases, the CFTC is pursuing alleged virtual currency frauds under CEA section 6(c)(1) and CFTC Rule 180.1,257 and the Ninth Circuit’s reversal of the district court’s decision in Monex suggests that the CFTC likely will bring these types of cases based on allegations of fraud alone, even absent proof of manipulation.

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254 Id. at 1184–85.

255 Monex, 931 F.3d at 969.


257 See, e.g., McDonnell; Gelfman; and My Big Coin Pay, supra note 121.
Similar to the defendants in *Monex*, the defendants in *My Big Coin Pay* argued that the CFTC could not rely on its anti-fraud and anti-manipulation authority because the legislative intent behind CEA section 6(c)(1) and the CFTC’s own explanation of CFTC Rule 180.1 did not contemplate permitting the CFTC to punish individuals and entities for general fraud where there is no evidence of market manipulation. Unlike in previous cases, the CFTC stated in its complaint that the prohibited activity was a misrepresentation about the virtual currency, MBC, itself and how MBC could be used by the consumer. The defendants’ argument in *My Big Coin Pay* mirrors some arguments made by others that the CFTC’s interpretation of its Rule 180.1 authority is more expansive in the context of virtual currencies than it has been in the past because it reaches beyond fraud or manipulation related to derivatives markets.

Notwithstanding these challenges, the CFTC declared a continuing interest in policing virtual currency market participants that fall within the bounds of CFTC jurisdiction. Notably,

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258 Defendants’ Memorandum in Support of Motion to Dismiss, *supra* note 218, at 16 (“The CFTC stated that the fears commenters had expressed in response to the Notice of Proposed Rulemaking that ‘the word “commodity” in proposed Rule 180.1 “indicates that the rule will apply to virtually every commercial transaction in the economy” are misplaced.’” (quoting CFTC Manipulation Rule, 76 Fed. Reg. at 41,401)).

259 *Id.* at 15 (“The legislative history shows that these provisions were meant to combat fraudulent market manipulations—not the kind of garden variety sales puffery that the Amended Complaint alleges.”).

260 Complaint, *supra* note 217, at ¶ 60.

261 *See* Geoffrey F. Aronow, *Is The CFTC Becoming The National Fraud Police? The CFTC Goes All In On Policing Fraud In Virtual Currencies*, 38 NO. 3 FUTURES & DERIVATIVES L. REP. NL 1, at 9 (Mar. 2018) (“If the CFTC is, indeed, committed to policing fraud in the sale of virtual currency wherever the Commission may find it (with the exception of where the SEC may be able to act), the question becomes, how far is the CFTC now prepared to go in asserting broad authority to police fraud in the sale of commodities in interstate commerce?”).

the CFTC and SEC Enforcement Directors released a joint statement regarding their respective enforcement programs:

When market participants engage in fraud under the guise of offering digital instruments—whether characterized as virtual currencies, coins, tokens, or the like—the SEC and the CFTC will look beyond form, examine the substance of the activity and prosecute violations of the federal securities and commodities laws. The Divisions of Enforcement for the SEC and CFTC will continue to address violations and to bring actions to stop and prevent fraud in the offer and sale of digital instruments.  

This statement aligns with the CFTC’s position in its civil enforcement actions in 2018 as well as public statements made by CFTC Commissioners and staff that reiterated the CFTC’s commitment to punishing bad actors in the virtual currencies markets.

(g) The CFTC’s Exercise of Jurisdiction over Virtual Currencies as Retail Commodity Transactions

Classification of virtual currencies as commodities (of a type other than a currency or security) has implications for margined, leveraged, or financed transactions in virtual currencies under the retail commodity provisions of CEA section 2(c)(2)(D). As explained above in Section 2.2(c), a transaction that is within the scope of the provision is treated as or “as if” it is a futures contract, but it may be excluded from that regulatory consequence if the transaction

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264 See, e.g., Brian Quintenz, Comm’r, CFTC, Remarks before the Eurofi High Level Seminar 2018 (Apr. 26, 2018), https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz11 (“From my perspective as a CFTC Commissioner, I think the area with the greatest need for enhanced regulatory certainty and oversight is the spot market. In that regard, the CFTC has undertaken an educational campaign to provide customers with information about cryptocurrencies and to warn about potential fraud in these markets. The CFTC’s Division of Enforcement has aggressively targeted deception and manipulation to ensure that innocent customers are not exploited by fraudsters. And with respect to jurisdictional considerations, the CFTC has been, and continues to be, in close communication with the SEC.”).

results in “actual delivery” of the commodity within 28 days. The meaning of “actual delivery” is open to debate.

In its enforcement action against Bitfinex, the CFTC took the position (consistent with its 2013 interpretation) that delivery of bitcoin purchased with borrowed funds to a private wallet where the coins were held for the benefit of the buyer but also as collateral for the loan did not constitute actual delivery, because the buyer did not have any rights to access or use the purchased bitcoin until released by Bitfinex following satisfaction of the loan. Because the transactions did not fall within the actual delivery exclusion, the CFTC determined that Bitfinex executed illegal, off-exchange transactions and also violated the CEA by acting as an unregistered FCM.

Although the CFTC faced a potential roadblock to its interpretation of the term “actual delivery” when a federal district court rejected the CFTC’s position in the precious metals context in May 2018, the Ninth Circuit sided with the CFTC and overturned that decision in July 2019. In its case against Monex Credit Company, the CFTC alleged that the defendants violated, among others, CEA sections 4(a) and 4d by offering precious metals off-exchange on a leveraged basis without registering with the Commission as an FCM. The defendants required that customers trading on a leveraged basis (“Atlas customers”) deposit funds to serve as margin for their open trading positions. The defendants also could change the margin requirements at any time in their sole discretion, and could liquidate customers’ trading positions without notice in certain cases. Under the account agreement between the defendants and Atlas customers,

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267 Monex, 311 F. Supp. 3d at 1173.

268 Id. at 1176–77.
customers with open trading positions did not take physical delivery of the metals. Instead, the metals were stored in third-party depositories, subject to contracts between the defendants and the depositories. The customers could get physical possession of the metal only if they made full payment, requested actual delivery of specific physical metals, and had the defendants ship the metals to them.\textsuperscript{269}

Relying on the Eleventh Circuit’s 2014 decision in \textit{CFTC v. Hunter Wise Commodities},\textsuperscript{270} the CFTC argued that the actual delivery exception to its jurisdiction did not apply because “‘actual delivery’ only occurs once there has been a transfer of possession of and control over the purchased commodities.”\textsuperscript{271} In the CFTC’s view, the purported delivery in the defendants’ leveraged transactions was a “sham” because customer positions could be “liquidated any time and in [the defendants’] sole discretion, without notice to customers,” which “deprive[d] customers of all control and authority over any metals that underlie their trading positions.”\textsuperscript{272} The Monex court disagreed, finding that adopting the CFTC’s view would “eliminate the Actual Delivery Exception from the CEA” because all leveraged retail transactions of fungible commodities would involve at least some of the same alleged practices by the defendants.\textsuperscript{273} The court held that the defendants’ practice of delivering precious metals to third-party depositories within 28 days of their purchase by retail customers on margin fell within the actual delivery exception to the CFTC’s authority.

\begin{flushleft}
\textsuperscript{269} \textit{Id.} at 1177–78.
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\textsuperscript{270} \textit{CFTC v. Hunter Wise Commodities, LLC}, 749 F.3d 967 (11th Cir. 2014).
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\textsuperscript{271} \textit{Monex}, 311 F. Supp. 3d at 1180 (citation omitted).
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\textsuperscript{272} \textit{Id.} at 1181 (citation omitted).
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\textsuperscript{273} \textit{Id.}
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The Ninth Circuit reversed, holding that “actual delivery requires at least some meaningful degree of possession or control by the customer.” According to the Ninth Circuit, actual delivery does not occur when the commodity is in the broker’s chosen depository, never changes hands, and is subject to the broker’s exclusive control, and the customer has no “substantial, non-contingent interests.” The court further noted that, even if the CEA provisions on actual delivery were ambiguous, it “would find the CFTC’s [2013 Guidance] persuasive.” Applying the guidance, the court concluded that Monex’s arrangement with an independent depository for holding metals purchased on margin was “merely a book entry” that “amounts to sham delivery, not actual delivery.”

4. Allocation of Jurisdiction over Transactions between the CFTC and SEC

As noted above, the CEA “commodity” definition covers securities. Rather than exclude securities from the definition, Congress has allocated jurisdiction between the CFTC and SEC over derivatives based on securities or on a group or index of securities (or an interest therein or based on the value thereof), based in part on distinctions between exempted securities (as defined in the Exchange Act) and non-exempted securities, and narrow-based or broad-based indices of non-exempted securities. As a result, derivatives on a virtual currency or other digital asset that is a “security” also nevertheless may be subject to CFTC jurisdiction, but the scope of the CFTC’s jurisdiction is more constrained than with respect to non-security commodities.

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274 Monex, 931 F.3d at 974.
275 Id.
276 Id. at 975.
277 Id.
Securities where one or more payment components (e.g., interest payments on a debt security) are linked in whole or in part to the value of a non-security commodity also raise issues of jurisdictional overlap, if the embedded commodity terms could be classified as a futures contract or another type of derivative on the commodity. The issuers of such hybrid instrument securities can control the design of the instruments to qualify for an exemption from CEA regulation under either a statutory exemption provided in CEA section 2(f) or an exemption provided in the CFTC’s Part 34 Rules. If the embedded terms relate to the value of a virtual currency, and the virtual currency is a non-security commodity, the issuer will have to qualify for one of the exemptions if it wants to avoid complicated issues of how (if even possible) to comply with CEA requirements, on top of federal securities laws requirements for initial offerings and secondary market trading of securities.

The security/non-security distinction also is important more generally for determining which agency has authority over the cash market trading activities in a digital asset. The SEC, not the CFTC, is responsible for protecting cash securities markets against fraud and manipulation. Thus, beyond determining whether a digital asset is within the scope of the CEA’s commodity definition, it is important to know whether the asset is a security or a non-security commodity.

The CEA and federal securities laws have been amended over the years since 1974 to address areas of competing or potentially competing jurisdictional claims between the CFTC and SEC. The two agencies also on occasion have jointly resolved jurisdictional issues, and some of those agreements have been captured in the statutory amendments, notably the terms of the Shad-Johnson Accord adopted in 1983. The table at the end of this Section summarizes the

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278 The Shad-Johnson Accord was added to the CEA as part of the Futures Trading Act of 1982, which was enacted in January 1983. It incorporated into the CEA (and the federal securities laws) the terms of an agreement reached
current allocation of jurisdiction between the two agencies over trading in derivatives and in the
assets underlying the derivatives.

The allocation scheme means, among other things, that if a virtual currency or other
digital or digitized asset is a non-security commodity, DCMs (and FBOTs) may list futures and
options on futures contracts on the token as a contract solely regulated in the normal course by
the CFTC. If it is a security, though, then a futures exchange may list futures or options on
futures on the token or virtual currency only as a “security futures product” under rules jointly
developed and enforced by the CFTC and SEC.

Persons also may trade options on the token or virtual currency as a CFTC-regulated
transaction. Transactions in options on a virtual currency that is a security, however, would be
regulated by the SEC alone as securities.

Also, if a digital asset is a non-security commodity, then certain CEA and CFTC
restrictions may apply to leveraged, margined, or financed transactions in the commodity, under
the retail commodity provisions in CEA section 2(c)(2)(D), described above, but those
provisions do not apply if the asset is a security.

Congress’s allocation of jurisdiction to the CFTC and SEC described in the table below
presupposes that the interest underlying a derivative is something that can fit neatly into either
the security or the non-security commodity box. Bitcoin’s status as a non-security commodity
seems well-settled, based on the emergence of CFTC-regulated markets for bitcoin-based

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between the respective Chairmen of the SEC and CFTC as to which agency would have jurisdiction over securities-
related futures and options. Under the accord, the CFTC was given jurisdiction over futures and options on futures
on exempted securities and broad-based indices of securities, and the SEC was given jurisdiction over options on all
securities and all stock indices. Futures and options on futures on individual securities (other than exempted
securities) and on narrow-based indices of securities (other than exempted securities) were banned, but that was
intended to be temporary until the two agencies could agree on how to allocate jurisdiction. Congress tired of
waiting for the CFTC and SEC to reach agreement and lifted the ban in 2000.
derivatives, regulated as futures and not security futures, or as swaps and not as security-based swaps, without any challenge from the SEC.

There can be uncertainty, though, on how to classify other virtual currencies, or other types of digital assets. Section 3 includes an analysis of whether the definition of “security” in the federal securities laws could apply to digital assets. Section 5 discusses the jurisdictional overlap issues and challenges created by uncertainty as to whether a digital asset is properly classified as a security or a non-security commodity.
Table: Allocation of Jurisdiction between the CFTC and SEC

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<thead>
<tr>
<th>Futures and Options on Futures</th>
<th>SEC</th>
<th>CFTC-SEC Jointly</th>
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<tr>
<td>Futures and options on futures on non-security commodities. Futures and options on futures on:</td>
<td>Futures or options on futures on the following, regulated as security futures products:</td>
<td>Futures or options on futures on the following, regulated as security futures products:</td>
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<tr>
<td>• A broad-based index of securities.</td>
<td>• Any security other than an exempted security(\mathrm{v}) or foreign government debt security enumerated in SEC Rule 3a12-8.</td>
<td>Futures or options on futures on the following, regulated as security futures products:</td>
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<tr>
<td>• An exempted security as defined in Exchange Act section 3(a)(12).(\mathrm{i})</td>
<td>• Any narrow-based index of securities other than exempted securities.(\mathrm{v})</td>
<td>Futures or options on futures on the following, regulated as security futures products:</td>
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<tr>
<td>A foreign government debt security enumerated in SEC Rule 3a12-8.(\mathrm{iii})</td>
<td>Futures on exchange-traded funds (ETFs) that passively hold non-security commodities such as gold, energy commodities, or foreign currencies are regulated as security futures products, but there is an issue whether the CFTC alone should have jurisdiction over these products as futures. The CFTC issued exemptions permitting futures on commodity-based ETFs to trade as security futures products instead of treating them as futures on non-security commodities that it alone would regulate.(\mathrm{vi})</td>
<td>Futures on exchange-traded funds (ETFs) that passively hold non-security commodities such as gold, energy commodities, or foreign currencies are regulated as security futures products, but there is an issue whether the CFTC alone should have jurisdiction over such products as options based</td>
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Options

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<th>Options on non-security commodities—may be regulated as swaps or as trade options.(\mathrm{viii})</th>
<th>Options on: (\mathrm{viii})</th>
<th>Options on exchange-traded funds (ETFs) that passively hold non-security commodities such as gold, energy commodities, or foreign currencies are regulated as options on securities, but there is an issue whether the CFTC has jurisdiction over such products as options based</th>
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<tr>
<td>• Securities, without distinction between exempted or non-exempted.</td>
<td>• Any group or index of securities, without distinction between broad or narrow-based or exempted or non-exempted securities, or any interest therein or based on the value thereof.</td>
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<td>on the value of the underlying commodity. The CFTC has issued exemptions permitting such derivatives to trade on national securities exchanges, regulated as options on securities.\textsuperscript{ix} Options on foreign currencies when listed on a national-securities exchange (otherwise regulated by the CFTC).\textsuperscript{x}</td>
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**Swaps / Security-Based Swaps**

Swaps based on a non-security commodity, including options on a non-security-commodity

Swaps based on:
- A broad-based index of securities\textsuperscript{iv} or
- An exempted security as defined in Exchange Act section 3(a)(12).\textsuperscript{xii}

Options on securities or an index of securities are excluded from the swap definition and are regulated by the SEC.

Security-based swaps, i.e., swaps based on:
- Any security other than an exempted security or foreign government debt security enumerated in SEC Rule 3a12-8 or
- Any narrow-based securities index.

Mixed swaps, i.e., security-based swaps with a component based on the value of one or more interest rates or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or narrow-based security index), or the occurrence, nonoccurrence, or the extent of occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence not related to a single company or issuer.\textsuperscript{xiii}

**Hybrid Securities**

If the conditions for the exclusion in CEA section 2(f) or the CFTC Part 34 Rules are met, the SEC will regulate securities with one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more non-security commodities (hybrid instruments).

If the conditions for the exclusion in CEA section 2(f) or the CFTC Part 34 Rules are met, both agencies potentially could assert jurisdiction over securities with one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more non-security commodities.

**Cash Market Transactions**

Retail leveraged, margined, or financed transactions in commodities that are not securities or foreign currencies.

Retail leveraged, margined, or financed transactions in foreign currencies offered by futures commission merchants or retail foreign exchange dealers.

Spot and forward transactions in securities.

Retail leveraged, margined, or financed transactions in foreign currencies offered by broker-dealers. (SEC currently prohibits such activity.)
i The CEA does not define the term broad-based security index, but it does define the term narrow-based security index, in CEA section 1a(35). An index is narrow-based if: (i) it has nine or fewer component securities; (ii) it has a single component security that comprises more than 30% of the index weighting; (iii) its five highest weighted component securities comprise in aggregate more than 60% of the index weighting, or (iv) its lowest weighted component securities that comprise in aggregate 25% of the index weighting have an aggregate dollar value of average daily trading volume of less than $50 million (or $30 million if the index has 15 or more component securities). The CFTC and SEC have jointly adopted rules defining the methodology for applying the statutory criteria. See 17 C.F.R. §§ 41.11, 41.12. In addition, they have jointly adopted rules defining the criteria for an index comprised of debt securities to be classified as non-narrow, and have agreed, pursuant to joint orders, to apply alternative criteria for classifying a volatility index as non-narrow.

ii The term exempted securities is defined in Exchange Act section 3(a)(12). 15 U.S.C. § 78c(a)(12). For purposes of allocating jurisdiction over futures and options on futures over exempted securities, the CEA limits the term to the definition as in effect on the date of enactment of the Futures Trading Act of 1982, but excluding municipal securities. 7 U.S.C. § 2(a)(1)(C)(iv). The Exchange Act definition includes U.S. government securities and any securities designated as exempted securities by the SEC by rule or regulation. Exchange Act section 3(a)(12) refers to “government securities” as defined in Exchange Act section 3(a)(42). That definition covers, e.g., securities that are direct obligations of the United States or whose obligations are guaranteed as to principal or interest by the United States.

iii The SEC, in Rule 3a12-8, has designated debt obligations issued by the governments of 21 countries as exempted securities for the purpose of permitting futures contracts on such instruments to trade on U.S. futures exchanges (i.e., designated contract markets) under the CEA regulatory framework. 17 C.F.R. § 240.3a12-8.


vi The first was issued in 2008, covering futures on a gold ETF that the OneChicago Exchange proposed to list. Order exempting the trading and clearing of certain products related to SPDR® Gold Trust Shares Exemption Order, 73 Fed. Reg. 31,981 (June 5, 2008) [hereinafter SPDR Exemption Order].

vii The swap definition in CEA section 1a(47) includes options on commodities (as well as options on “interest or other rates, currencies . . . securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind”). The CFTC also has separate plenary authority to regulate options involving commodities under CEA section 4c(b). As explained above, the CFTC regulates commodity options as swaps, with the exception of trade options.

viii 7 U.S.C. § 2(a)(1)(C)(i)(I) provides that the CEA does not apply to options on securities or on any group or index of securities, or any interest therein or based on the value thereof. Such options also are excluded from the CEA “swap” definition in 7 U.S.C. § 1a(47). In contrast, such options are included in the definitions of “security” in the Exchange Act and the Securities Act.

ix The first was issued in 2008, covering listed options on a gold ETF. SPDR Exemption Order, 73 Fed. Reg. 31,981.


xi The CFTC’s jurisdiction over swaps on a broad-based securities index is circuitous, via cross-reference in the CEA swap definition to the broad definition of “security-based swap agreements” in section 206A of the Gramm-Leach-Bliley Act (15 U.S.C. § 78c note) in conjunction with Exchange Act provisions limiting the scope of security-
based swaps to swaps on a narrow index of securities and excluding such swaps from the security-based swap agreement definition. The Gramm-Leach-Bliley Act provision defines the term security-based swap agreement to mean “a swap agreement (as defined in Section 206A) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.” This definition, and the related swap agreement definition, were added to the Gramm-Leach-Bliley Act as part of the CFMA amendments enacted in 2000 and thus pre-date the Dodd-Frank amendments. The elements of the Exchange Act definition of security-based swap covering index products are limited by their terms to indexes that are a “narrow-based security index.” 15 U.S.C. §§ 78c(a)(68)(A)(ii)(I), (III). The exclusion of security-based swaps from the separate definition of security-based swap agreement is set out in Exchange Act section 3(a)(78)(B), 15 U.S.C. § 78c(a)(78)(B).

xi The CFTC’s jurisdiction over swaps on exempted securities comes about through an exclusion in the Exchange Act definition of the term security-based swap for swaps on exempted securities. 15 U.S.C. § 78c(a)(68); see also 7 U.S.C. § 1a(43) (cross-referencing the Exchange Act definition).

xii See Swap Definition Rule, 77 Fed. Reg. at 48,291 (“The category of mixed swap is described, in both the definition of the term ‘security-based swap’ in the [Securities] Exchange Act and the definition of the term ‘swap’ in the CEA, as a security-based swap that is also based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(ii)(III) [of section 3(a)(68) of the Exchange Act]). A mixed swap, therefore, is both a security-based swap and a swap.” (second alteration in original) (footnote omitted)).
SECTION 3. FEDERAL SECURITIES REGULATION: SECURITIES ACT AND EXCHANGE ACT*

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2020 UPDATES TO SECTION 3

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The market for digital assets has grown rapidly in recent years, from a global market capitalization of nearly $12 billion as of September 2016 to over $320 billion as of September 2020—albeit down from a high of over $800 billion in January 2018. At the same time, questions concerning the application of the federal securities laws to digital assets and the intermediaries that facilitate transactions in them have come into sharp focus.

The SEC’s earliest digital asset enforcement activities focused on run-of-the-mill fraud or other misconduct, where the digital nature of the instrument was not central to the case. The SEC brought actions in a pair of bitcoin-related Ponzi schemes in 2013 and 2014, though these

* This Section is current as of September 2020 and does not reflect subsequent developments. The authors wish to thank associates Ledina Gocaj and Adam Fovent for their substantial contributions to this Section, and associates Ledina Gocaj and Jeremy M. Sklaroff and summer associate Brian Pollock for their substantial contributions to the 2020 updates thereto.


somewhat routine fraud cases did little to address the application of the federal securities laws to
digital assets generally. July 2017 marked the first time the SEC provided detailed guidance on
the application of the federal securities laws to the issuance of digital assets in the absence of
fraud allegations. In its section 21(a) report concerning tokens issued by The DAO, a blockchain-

based enterprise supported by the German corporation Slock.it UG, the SEC clarified that the
agency would apply the traditional test outlined in *SEC v. W.J. Howey Co.* to this new asset
class to determine whether an instrument is an investment contract, and therefore a security.

Though refraining in that case from bringing enforcement charges, the SEC explained that the
report was meant to:

> caution the industry and market participants: the federal securities laws apply to
> those who offer and sell securities in the United States, regardless whether the
> issuing entity is a traditional company or a decentralized autonomous
> organization, regardless whether those securities are purchased using U.S. dollars
> or virtual currencies, and regardless whether they are distributed in certificated
> form or through distributed ledger technology.

Since the DAO Report was issued, the SEC has brought a multitude of enforcement actions
based on the legal arguments developed in the report.

Three major developments in the wake of the DAO Report have further clarified how the
SEC views the application of federal securities laws to digital assets. First, the SEC staff

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281 328 U.S. 293 (1946) [hereinafter *Howey*].

282 DAO REPORT, supra note 87, at 11.


[hereinafter *Paragon Order*]. Courts generally have accepted the application of *Howey* to digital assets. See, e.g.,
*Solis v. Latium Networks, Inc.*, No. 18-10255, 2018 WL 6445543 (D.N.J. Dec. 10, 2018);
*United States v. Zaslavskiy*, No. 17-cr-00647, 2018 WL 4346339 (E.D.N.Y. Sept. 11, 2018);
published guidance describing how certain features of a digital asset would make that asset more or less likely to be a security under elements of the Howey test (the “Digital Asset Framework”)—though it has been criticized as overly complex and difficult to apply. The SEC staff also issued the first digital asset-related no-action letters, confirming that two digital assets that essentially function as stored-value cards would not be deemed securities. These no-action letters also have been criticized on the basis that the assets were so clearly not securities that granting conditional no-action relief may add to confusion by implying they might be securities but for meeting the letter’s conditions.

Finally, the SEC succeeded in its litigation against Kik Interactive, and its enforcement action against Telegram reached an advanced stage of litigation. Both cases tested industry arguments regarding the Simple Agreement for Future Tokens (SAFTs), a digital asset offering structure designed to combine a private offering of securities with a later public distribution of


288 Hester M. Peirce, Commissioner, SEC, Remarks at the Securities Enforcement Forum: How We Howey (May 9, 2019), https://www.sec.gov/news/speech/peirce-how-we-howey-050919 (“This transaction is so clearly not an offer of securities that I worry the staff’s issuance of a digital token no-action letter—the first and so far only such letter—may in fact have the effect of broadening the perceived reach of our securities laws. If these tokens were securities, it would be hard to distinguish them from any medium of stored value. Is a Starbucks card a security?”).

non-security tokens. However, there are still significant open questions about how the SEC will apply the Howey test to the wide array of novel digital asset types and how the requirements of the federal securities laws will be applied to intermediaries transacting in digital asset securities.

This Section aims to provide a roadmap of the open questions in this area. First, this Section describes the primary legal test to determine whether a digital asset is an “investment contract” and therefore a security, as outlined by the Supreme Court in *Howey*, as well as its fact-intensive application to particular digital assets. The term “security,” as defined under the Securities Act and the Exchange Act, includes not only traditional “securities” such as stocks and bonds, but other instruments that fall into the catch-all category of “investment contracts.” The *Howey* test therefore is critical, as the federal securities laws will apply to a digital asset that is a “security.”

This Section then considers the implications for digital assets that are securities, laying out potentially applicable requirements under the Securities Act and the Exchange Act. Once it is determined that a particular digital asset is a security, a broad swath of federal securities laws and regulations may apply to its offer and sale, as well as to the intermediaries involved in transacting in these products. For example, digital assets that are securities may only be in offerings that comply with the registration and disclosure requirements of the Securities Act,

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290 *See Kik, supra* note 289, at 3–6; *Telegram, supra* note 284. SAFTs are designed to segment an offering of digital assets into two phases, in order to avoid SEC registration requirements. Initially, the issuer would raise capital by offering an investment contract representing the right to receive tokens to be created in the future. That offering would be conducted as a private placement on the basis that it would qualify for an exemption from registration under Regulation D. Once the digital asset has been fully developed and has ostensible utility, the SAFT investors and the issuer would sell the tokens to the public, on the basis that the digital asset would not constitute a security at that time. *See, e.g.*, Protocol Labs and Cooley LLP, *SAFT Project: Toward a Compliant Token Sale Framework* (Oct. 2, 2017), https://saftproject.com/static/SAFT-Project-Whitepaper.pdf. For more detail about how SAFTs are structured in relation to the federal securities laws, *see infra* note 425.
unless the asset or sale qualifies for an exemption. The SEC has focused on ensuring the protections of the Securities Act apply to ICOs, which, according to Chairman Clayton, are often simply “interests in companies, much like stocks and bonds, under a new label.”

Under the Exchange Act, in turn, a determination that a digital asset is a security may implicate, depending on the activity, regulatory requirements applicable to securities broker-dealers, exchanges, alternative trading systems, transfer agents, or clearing agencies.

1. Digital Assets as Securities—The Howey Test

Due to the varying characteristics of digital assets, any analysis of whether a particular digital asset is a “security” is fact-intensive and must be applied on a case-by-case basis. Section 2(a)(1) of the Securities Act and section 3(a)(10) of the Exchange Act each define the term “security.” While the definitions differ slightly, courts do not draw meaningful distinctions between the meanings of the term under the two statutes. Although the definitions of “security” capture a broad swath of instruments, most digital assets that are not specifically

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293 See In re Munchee, Inc., Securities Act Release No. 10445, at III.35 (Dec. 11, 2017) [hereinafter Munchee Order] (“Determining whether a transaction involves a security does not turn on labelling . . . but instead requires an assessment of the economic realities underlying a transaction.” (internal quotation marks and citation omitted)).


295 Securities Act § 2(a)(1) defines “security” as:

any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, reorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security . . . or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim
intended to be securities are only potentially captured by the catch-all term “investment contract.”

The analysis of whether an instrument is an “investment contract” is primarily based on the landmark 1946 Supreme Court decision in Howey. The case involved a company’s sale of 250 acres of citrus acreage to the public, along with a contract to service the groves and sell the produce for investors, while the proceeds of the sale would “help [it] finance additional development.” In holding that this transaction constituted an “investment contract”—and thus an illegally unregistered securities offering—the Court laid out a four-part test that continues to underpin the modern interpretation of the term “investment contract.” Under the Howey test, an investment contract exists when there is:

(i) an investment of money;
(ii) in a common enterprise;
(iii) with a reasonable expectation of profits; and
(iv) the expectation of profits is based upon the entrepreneurial or managerial efforts of others.

Importantly, this test requires that any particular asset satisfy each of its four elements based on a fact-specific analysis of each asset. The Supreme Court emphasized both in Howey and subsequent opinions that the test “embodies a flexible rather than a static principle, one that

 certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

See also Exchange Act § 3(a)(10).

Howey, 328 U.S. at 295.

Id. at 301 (“The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others”); see also United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852–53 (1975) (expanding on Howey definition of an investment contract and holding that the “touchstone” of the test is “the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”).
is capable of adaptation to meet the countless and variable schemes devised by those who seek
the use of the money of others on the promise of profits.” In the digital asset context, the SEC
repeatedly has emphasized that it applies a facts-and-circumstances analysis to each individual
token to determine whether it is a security. The SEC also has stressed that “form should be
disregarded for substance,” and that the focus must be on the “economic realities underlying a
transaction, and not on the name appended to it.”

The Howey test eschews any simplistic, one-size-fits-all application to digital assets. In a
2018 speech, the SEC’s Director of the Division of Corporation Finance, William Hinman,
expressed his view that two of the most highly valued digital assets—bitcoin and ether—are not
securities under the Howey test. At the same time, and in an important departure from any
prior SEC statements or analysis, Director Hinman emphasized that whether any particular
digital asset is a security is not static, and a digital asset that might have been sold in a securities
offering can change its character over time and cease to be a security. The determination
whether a digital asset is an investment contract at a particular time, therefore, will be unique not

298 Edwards, 540 U.S. at 393 (quoting Howey, 328 U.S. at 299).

299 See Chairman Clayton Statement, supra note 291.

300 See DAO REPORT, supra note 87, at 11 (quoting Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); United Hous.
Found., 421 U.S. at 849 (internal quotation marks omitted)); see also Munchee Order, supra note 293, at III.28
(quoting the same); Stephanie Avakian and Steven Peikin, Directors, SEC and CFTC Divisions of Enforcement,
Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions
(stating that “the SEC . . . will look beyond form, [to] examine the substance of the activity and prosecute violations
of the federal securities . . . laws”).

301 Hinman, supra note 54. The SEC’s Division of Investment Management also has publicly taken the position that
bitcoin is not a security, in rejecting a request to register a fund whose assets would consist substantially of bitcoin
as an investment company under the Investment Company Act of 1940. See Re: Cipher Technologies Bitcoin Fund
Registration Statement on Form N-2 (filed May 13, 2019) Pre-Effective Amendment No. 1 (filed Sept. 11, 2019), File

302 Hinman, supra note 54.
only to that digital asset but perhaps also to facts and circumstances at the time it is being sold or resold.

More recently, in April 2019, the SEC’s Strategic Hub for Innovation and Financial Technology (FinHub) published the Digital Asset Framework. While the Digital Asset Framework is not a rule, regulation, or statement of the Commission, and the Commission has not approved its content, it provides guidance regarding FinHub’s view as to whether a given digital asset would be considered a digital asset under Howey.\(^\text{303}\) This Section outlines the complex application of the four factors of the Howey test to digital assets.

(a) An “Investment of Money”

Perhaps the most straightforward element of the Howey test is the requirement that a party invest money in the enterprise. At a high level, this element requires the investor “to give up a specific consideration in return for a separable financial interest with the characteristics of a security.”\(^\text{304}\) The Supreme Court has stated the consideration must be “tangible and definable.”\(^\text{305}\) Government-issued “fiat” currency is plainly “specific consideration,” but the federal courts and the SEC have stated that an investment of “money need not take the form of cash.”\(^\text{306}\)

Specifically, in the DAO Report, the SEC determined that a purchase of DAO tokens with payment made in ether tokens, another digital asset, fulfilled this first element of the Howey test.\(^\text{307}\) Courts similarly have found that payment made in bitcoin, or other digital assets, may

\(^{303}\) Digital Asset Framework, supra note 285.


\(^{305}\) Id. at 560.

\(^{306}\) DAO REPORT, supra note 87, at 11 (internal quotation marks omitted).

count as investment of money and therefore satisfy the “investment of money” prong of

*Howey.*

Beyond fiat currency and other digital assets, the Digital Asset Framework takes the view that the “investment of money” prong may be satisfied by the acquisition of a digital asset “in exchange for value . . . in the form of . . . other type[s] of consideration.” According to the Digital Asset Framework, other types of consideration may include digital assets distributed via so-called “bounty programs,” which may include incentives offered to participants for various activities associated with an initial coin offering, or “air drops,” which are “digital asset[s that are] distributed to holders of another digital asset, typically to promote its circulation.” Some commenters, however, have questioned whether the Digital Asset Framework’s assertions in this regard are actually consistent with or supported by the applicable case law.

There also are open questions regarding how to apply the investment of money prong to digital assets that are created through “mining.” As described in Figure 1 below, digital assets available on the market today can be acquired by a variety of methods, including mining. There are two primary types of mining: proof-of-work mining and proof-of-stake mining. For those

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310 Id. at n.9.

311 Id.

312 Id.

digital assets that are created by proof-of-work mining, miners compete to resolve mathematical problems to validate transactions on the network in order to add new blocks to the blockchain. To oversimplify, the first miner to solve the problem is rewarded by a new issuance of that digital asset. All bitcoins, for example, were and are initially created through mining alone, although non-miners can purchase bitcoin in secondary market transactions. Proof-of-work mining can be energy intensive and requires specialized, costly equipment to perform.\textsuperscript{314} Proof-of-stake mining similarly is a way to validate transactions on a blockchain, but rather than engaging in solving mathematical problems, holders of a particular digital asset (or their delegates) validate transactions by “staking” an amount of tokens they hold—being rewarded with newly mined tokens for their efforts—but subject to the risk of their staked tokens being “slashed” if they attempt to validate transactions improperly.\textsuperscript{315}

A digital asset’s mechanism of creation also may change over time, further complicating the application of this first element of the \textit{Howey} test. An amount of ether, in contrast to bitcoin, was initially created and sold in exchange for bitcoin in a “presale” before the Ethereum network was fully developed and launched.\textsuperscript{316} Since the Ethereum network launched, however, new ether can be created only through proof-of-work mining, although existing and newly mined ether also

\begin{itemize}
\item \textsuperscript{316} Vitalik Buterin, \textit{Launching the Ether Sale}, ETHEREUM BLOG (July 22, 2014), https://blog.ethereum.org/2014/07/22/launching-the-ether-sale/.
\end{itemize}
can be purchased on the secondary market. Further, the Ethereum network is expected to transition to proof-of-stake mining in the future.317

<table>
<thead>
<tr>
<th>Digital Asset</th>
<th>Form of Acquisition</th>
</tr>
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<tbody>
<tr>
<td>Bitcoin (BTC)</td>
<td>Proof-of-work mining</td>
</tr>
<tr>
<td>Ether (ETH)</td>
<td>Proof-of-work mining*</td>
</tr>
<tr>
<td>Ripple (XRP)</td>
<td>Sale or giveaway</td>
</tr>
<tr>
<td>Bitcoin cash (BCH)</td>
<td>Proof-of-work mining</td>
</tr>
<tr>
<td>EOS</td>
<td>Sale</td>
</tr>
<tr>
<td>Litecoin (LTC)</td>
<td>Proof-of-work mining</td>
</tr>
<tr>
<td>Zcash (ZEC)</td>
<td>Proof-of-work mining**</td>
</tr>
<tr>
<td>Stellar Lumens (XLM)</td>
<td>Sale or giveaway</td>
</tr>
<tr>
<td>Cardano (ADA)</td>
<td>Proof-of-stake mining***</td>
</tr>
<tr>
<td>IOTA (IOT)</td>
<td>Sale</td>
</tr>
</tbody>
</table>

**Figure 1: Selected digital assets and form of acquisition**

* Ether initially was available for purchase through a presale. Since then, all ether must be purchased either by mining or on the secondary market, although the Ethereum network may transition to proof of stake.

** For a period of several years, a portion of mined ZEC was automatically allocated to the founders of ZEC, among others. Although that “Founders’ Reward” has expired, a portion of mined ZEC is now allocated to certain other groups that provide network support.

*** Cardano was initially sold at a presale. Since then, Cardano is issued through proof-of-stake mining.

Whether miners give up “tangible and definable” consideration to obtain digital assets such as to satisfy the “investment of money” element of the Howey test has yet to be answered.

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by the SEC or the courts, and the concept of mining does not fit neatly into this first element of the Howey test. Proof-of-work miners could be viewed, however, as giving consideration in the form of their labor or the opportunity cost of the resources (including substantial electricity cost) expended to mine the digital assets. Courts have determined that, in specific circumstances, giving up resources that one otherwise would have can be consideration sufficient to fulfill this element of the Howey test. For example, in Uselton v. Commercial Lovelace Motor Freight, Inc., the Tenth Circuit held the investment-of-money element was fulfilled when employees contributed to a voluntary stock ownership plan at their company because the employees “contributed their legal right to a portion of their wages . . . in return for the right to . . . participate in [the employer’s] profit-sharing plan.” In contrast, the Supreme Court held this element was not met in an earlier case, International Brotherhood of Teamsters v. Daniel. In Daniel, employees similarly received a pension plan from their employer as part of their compensation package, but the plan was both “noncontributory” and “compulsory,” meaning that “by definition, [the employee] ma[de] no payment into the pension fund. He only accept[ed] employment, one of the conditions of which [was] eligibility for a possible benefit on retirement.” Exchanging labor for a perceived return therefore may sometimes fulfill this element of the Howey test, but not—as the Daniel court noted—when “[o]nly in the most abstract sense may it be said that an employee ‘exchanges’ some portion of his labor in return for these possible benefits.”

319 940 F.2d 564, 575 (10th Cir. 1991).
321 Id. at 558.
322 Id. at 560.
Nonetheless, the *Daniel* and *Uselton* cases do not resolve the question for digital assets that are mined. In *Daniel* and *Uselton*, the employees were giving up a percentage of a guaranteed and predetermined salary. When proof-of-work miners expend computational power to mine for bitcoin, however, they generally are giving up the opportunity cost of their time and resources. The question whether such opportunity cost is “tangible and definable” consideration is more difficult. Thus, although the “investment of money” element likely will be straightforward for those digital assets that are sold in exchange for fiat currency or other digital assets, mining adds an element of ambiguity in determining whether this element of the *Howey* test is met. Similarly, the use of proof-of-stake mining in general, and the specific details of how it is used in any given network, also may affect the analysis of this element, as it may be unclear what tangible and definable consideration is given up when engaging in this type of activity.

Another question that has yet to be answered by the SEC or the courts is whether a digital asset that was not a security upon initial issuance (for example, because it was mined rather than sold by an issuer) can become an investment contract by virtue of secondary market trading. For example, although bitcoin is mined in the first instance, it is subsequently purchased and sold in the secondary market. One argument that the purchase and sale in the secondary market do not alter the nature of the underlying asset would hold that a contract’s character is determined upon initial issuance, and no “investment of money” was made in return for the issuance. Indeed, the Supreme Court has noted that, in order to constitute an investment contract under *Howey*, a purchaser’s profits must stem from “capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors’ funds”\(^{323}\)—but secondary market purchasers’ funds are not used by the issuer. Further, there are numerous

\(^{323}\) *Forman*, 421 U.S. at 852.
examples in which secondary market trading does not cause an asset to be a security, such as foreign currencies and precious metals.

(b) A Common Enterprise

Broadly, the “common enterprise” element focuses on the ties among individual owners of the asset. Courts have looked to two different methods for fulfilling this element: horizontal commonality or vertical commonality. The analysis of the “common enterprise” element, particularly under vertical commonality, is closely related to the final element of the Howey test regarding the reliance by purchasers on the efforts of others in order to realize their profit. The Digital Asset Framework assumes that this element generally is satisfied (whether by horizontal or vertical commonality) for digital assets.324

(1) Horizontal Commonality

Courts requiring horizontal commonality look to whether there is “a pooling of investors’ contributions and distribution of profits and losses on a pro-rata basis among investors.”325 In a traditional example of horizontal commonality, the Third Circuit found this element met when a trust’s “solicitation and membership materials stated that [the trust] would pool participant contributions to create highly-leveraged investment power that would yield high rates of return while protecting the investors’ principal contributions.”326 Similarly, the First Circuit held that

324 Digital Asset Framework, supra note 285 (“[I]nvestments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter’s efforts.”).
326 Id.
this element was met when the operator of a “fantasy investment game” pooled participants’ funds into a single account.\textsuperscript{327}

Applying this factor to digital assets is a fact-specific inquiry. The relevant factors to assess whether there is horizontal commonality between investors in a digital asset include whether a centralized entity supports the digital asset, whether investors’ assets are pooled in a central location, and whether any entity controls those pooled assets.\textsuperscript{328} An analysis of bitcoin, in particular, draws out the most important considerations for this factor. Purchasers of bitcoin are a disparate, unaffiliated group.\textsuperscript{329} The open-source Bitcoin network permits a purchase of bitcoin to be registered on a public ledger and allows the owners of bitcoin to exchange value over the network. Because all bitcoins are initially mined, there are no assets to pool in the traditional sense. Further, there is neither a central account that holds any assets nor any third party that can be said to have control over any assets. Holders of bitcoin may share in the market value fluctuations of the digital currency on a pro-rata basis, but that feature alone would not seem to fulfill the element of horizontal commonality, as it is present with respect to many commodities that are not securities.

This element also is emblematic of how the Howey analysis of a digital asset may evolve over time. Ether’s origin, for example, differs from the purely decentralized nature of bitcoin and even from ether’s current state. Ether was first sold in a presale of 60 million units of the digital

\textsuperscript{327} SEC v. SG Ltd., 265 F.3d 42, 49–53 (1st Cir. 2001).

\textsuperscript{328} Telegram suggests that digital assets themselves can constitute a form of asset pooling and therefore satisfy horizontal commonality. See Telegram, supra note 284, at *32 (“[F]urther, horizontal commonality exists after the launch of [the digital asset]. The plain economic reality is that, post-launch, the [digital assets] themselves continue to represent the Initial Purchasers’ pooled funds.”).

currency in 2014. Whether or not purchasers in the initial sale could be considered to have pooled assets, after the presale, new ether could be generated only by mining. Therefore, much like the case of bitcoin, it is difficult to argue that, today, assets are pooled by miners of ether.

(2) Vertical Commonality

In those circuits that use the test of vertical commonality, courts look to whether the success of the investors is dependent upon the efforts of the promoters. The example of bitcoin illustrates the close ties of vertical commonality with the final element of the Howey test regarding reliance on the efforts of a third party. In fact, some circuits have rejected the use of the vertical commonality test on the basis that it collapses the second and final elements of the Howey test. For entirely decentralized networks such as the Bitcoin network, it is difficult to say that investors are dependent upon an identifiable third party. Investors in bitcoin are dependent upon the efforts of all of the participants in the Bitcoin network generally in order to sustain the network, but the association between the various, dispersed network participants does not fit the usual paradigm applied by the courts that presumes a construct involving investors, on one hand, and promoters, on the other.

Characteristics that are indicative of vertical commonality in any digital asset would include whether the developers or promoters of the asset hold a significant stake in the asset, such that they would be incentivized to support the value of the asset and third-party holders


331 See, e.g., SG Ltd., 265 F.3d at 49–50.

332 See, e.g., Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994).
would expect them to do so.\textsuperscript{333} Bitcoin, for example, would not possess these characteristics.\textsuperscript{334} There is no identifiable promoter of bitcoin upon whose role, interests, or motivations other owners would depend.

Many other digital assets, however, do have an identifiable promoter. The \textit{Telegram} court found that the SEC made a substantial showing of strict vertical commonality because investors in the Telegram SAFT “anticipated profits were directly dependent on Telegram’s success in developing and launching” the digital asset.\textsuperscript{335} The court highlighted the developer’s financial and reputational interests in the success of the asset it was developing. At the time of the launch, the developer would control a large share of the digital asset, thus the developer’s fate was “inextricably linked” to the fortunes of the digital asset and, by extension, to the digital asset’s initial purchasers.\textsuperscript{336} Moreover, if the launch failed, the developer would be contractually bound to return any unspent money to investors.\textsuperscript{337} Similarly, the \textit{Kik} court focused on the developer’s financial stake in the success of its new digital asset, evidenced by the developer’s decision to retain roughly 30 percent of the digital asset it had created.\textsuperscript{338} Indeed, though considering reliance on the “efforts of others,” the Digital Asset Framework points to the promoter’s

\textsuperscript{333} See Hinman, supra note 54 (asking: “Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?”).

\textsuperscript{334} See id.

\textsuperscript{335} Telegram, supra note 284, at *33.

\textsuperscript{336} Id. at *34.

\textsuperscript{337} Id.

\textsuperscript{338} Kik, supra note 289, at 12–13 (“Kik had a unique incentive to increase demand for Kin because it retained for itself 30% of the tokens created.”).
retention of a significant stake in the digital asset as a factor indicating that other purchasers would expect the promoter to engage in efforts to enhance its value.\(^{339}\)

The case of ether indicates how this factor of the analysis may change over time for a particular digital asset. Though ether had centralized origins, the SEC staff seems to have concluded that “putting aside the fundraising that accompanied the creation of ether,”\(^{340}\) there is no longer a central party with a sufficient continuing role to fulfill the elements of the Howey test. For digital assets where there was an identifiable promoter, such as with ether in its early stages, factors such as the evolution of the role of the promoter since the inception of the currency and the extent to which efforts by the promoter are still necessary for the functioning of the currency will affect the analysis.\(^{341}\)

(c) A Reasonable Expectation of Profit

The final two elements of the Howey test are the most complex of the four and also those most indicative of a digital asset’s status as a security.\(^{342}\) The third element—a reasonable expectation of profit—is the “touchstone” of the Supreme Court’s decisions defining a security.\(^{343}\) To assess whether there is an expectation of profit, courts traditionally have defined

\(^{339}\) See Digital Asset Framework, supra note 285.

\(^{340}\) Hinman, supra note 54.

\(^{341}\) Id. (explaining that, besides Bitcoin and Ethereum, “[o]ver time, there may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required. And of course there will continue to be systems that rely on central actors whose efforts are a key to the success of the enterprise. In those cases, application of the securities laws protects the investors who purchase the tokens or coins.”)

\(^{342}\) Indeed, the Digital Asset Framework cast some doubt on whether the SEC staff believes it is necessary for a digital asset to meet the first two elements of the Howey test—those requiring an investment of money and a common enterprise—for purposes of finding that the digital asset is a security. See Digital Asset Framework, supra note 285, at n.9 (“The lack of monetary consideration for digital assets . . . does not mean that the investment of money prong is not satisfied.”) & n.10 (“The Commission . . . does not require vertical or horizontal commonality per se, nor does it view a ‘common enterprise’ as a distinct element of the term ‘investment contract.’”).

\(^{343}\) Forman, 421 U.S. at 852.
profit as that derived from “capital appreciation resulting from the development of the initial investment,” for example as in “the sale of oil leases conditioned on promoters’ agreement to drill [an] exploratory well.” 344 Profit also may come from “a participation in earnings resulting from the use of investors’ funds,” such as through “dividends on the investment based on [a] savings and loan association’s profits.” 345 Along these lines, the SEC determined that investors purchasing DAO tokens reasonably expected to earn profits because “the various promotional materials disseminated by Slock.it and its co-founders informed investors that the DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment.” 346 The Digital Asset Framework further views an expectation of profit as likely when “[t]he digital asset gives the holder rights to share in the enterprise’s income or profits or to realize gain from capital appreciation of the digital asset.” 347

Digital assets may attract investors seeking to profit from the investment, even though the assets also have credible, real consumptive uses that are independent of the expectation of profit. For example, some use bitcoin as a medium of exchange, 348 and spending ether is necessary for its owners to deploy smart contracts to the Ethereum network, which have broad practical applications such as permitting companies to share data securely or trigger the effectiveness of insurance policies. 349

344 Id. (citations omitted).

345 Id. (citations omitted).

346 DAO REPORT, supra note 87, at 11–12.


When considering the varying motivations of holders of an asset, courts have asked which of the uses is “incidental” to the other. Stated otherwise, the question for this element is whether “the purchase of a token looks a lot like a bet on the success of the enterprise and not the purchase of something used to exchange for goods or services on the network.” To draw out these different motivations for purchase, courts and the SEC have focused on the actions of the promoter (to the extent there is one), as well as on the behavior of purchasers.

Like the focus on the promotional material used for the DAO, courts and the SEC will scrutinize any statements by the promoters promising a return on investment, as such statements would lead investors to expect profits. In addition, the SEC might look to the characteristics of the investors targeted by promoters in order to ascertain whether there is a true consumptive use being promoted, versus an investment purpose. As such, marketing and selling a digital asset to members of the general public might indicate that the promoters are marketing an item for its potential for profit, while marketing to groups that would be expected to use the digital asset for its consumptive uses would indicate the promoters recognize that consumptive use is a significant driver of the demand for the currency.

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350 See *SG Ltd.*, 265 F.3d at 54.

351 Hinman, *supra* note 54.

352 See *supra* note 346.


354 The Digital Asset Framework states that it is more likely there is a reasonable expectation of profit if “[t]he digital asset is offered broadly to potential purchasers as compared to being targeted to expected users of the goods or services or those who have a need for the functionality of the network.” *Digital Asset Framework, supra* note 285; see also Hinman, *supra* note 54.
In the Digital Asset Framework, the SEC staff elaborated on certain marketing statements or tactics that will make it more likely that there is a reasonable expectation of profit, including: highlighting the expertise of the promoter, sponsor, or other third party or their ability to grow the value of the digital asset; an implicit or explicit promise to build a business operation, as opposed to delivering currently available goods or services for use on an existing network; the ready transferability of the digital asset as a key selling feature; and an emphasis on the potential profitability of the operations or the network or the potential application of the value of the digital asset.355

The motivations of purchasers is another critical part of this analysis. For example, the Kik court found that Kin token purchasers reasonably expected to earn profits, focusing on statements by Kik’s CEO that as demand for Kin rose, the “value of [Kin] would go up,” such that early purchasers “could make a lot of money.”356 The court evidently agreed with the SEC’s characterization of the Kin token sale as “plainly a capital raising event for which the mere possibility that [the token] could be used in a future, Kik-sponsored, Ecosystem was of secondary importance to investor profits.”357

Promoters also may reveal an intent to sell digital assets for investment purposes by, for example, selling the assets in increments that correlate with investment, not consumptive,358


356 Kik, supra note 289, at 12.

357 Mem. of Law in Opp. to Def.’s Motion for Summary Judgment at 4, SEC v. Kik Interactive, No. 19-cv-5244 (S.D.N.Y. Apr. 24, 2020); see also Kik, supra note 289, at 13 (“[W]ithout the promised ecosystem, Kin would be worthless.”).

358 The Digital Asset Framework states that it is more likely there is a reasonable expectation of profit if “[t]he digital asset is offered and purchased in quantities indicative of investment intent instead of quantities indicative of a user of the network.” Digital Asset Framework, supra note 285.
uses, or applying other terms that indicate the primary motivation is not for personal use or consumption.\footnote{See Hinman, supra note 54.} For example, in \textit{Telegram}, the court stated that certain lock-up provisions in the SAFT at issue suggested the asset was a security because “simply put, a rational economic actor would not agree to freeze millions of dollars for up to 18 months (following a lengthy development period) if the purchaser’s intent was to obtain a substitute for fiat currency.”\footnote{\textit{Telegram}, supra note 284, at *41–42.} Conversely, promoters could “buil[d] in incentives that compel using the tokens promptly on the network,”\footnote{See Hinman, supra note 54.}—like a mechanism that degrades token value over time.\footnote{See \textit{id}.} Similarly, the digital asset analyzed in \textit{TurnKey Jet} imposed a discount that essentially penalized redemption of tokens for cash instead of services\footnote{\textit{TurnKey Jet}, supra note 287.}—which seemingly would discourage holding the asset for investment and indicate that the promoters are seeking users, not investors. The design of a digital asset’s ecosystem also is relevant. In \textit{Telegram}, for example, the developer’s plan to eventually integrate its new digital asset with its preexisting and widely used messaging platform—combined with the fact that the supply of these tokens would be fixed—in the court’s view supported a finding that a reasonable investor would expect high demand for the digital asset and thus a return on its initial investment.\footnote{\textit{Telegram}, supra note 284, at *42–43.}

Even when digital assets have purported consumptive uses, an important aspect of the inquiry for this element of the \textit{Howey} test will be the extent of development and widespread
application of those uses. The more proven, actual uses by current holders of the digital asset, the less likely it is that expectation of profit is a motivation of holders of the asset. On the other hand, where the digital asset being sold has only contemplated or speculated future uses, an argument that purchasers had consumptive, rather than investment, intent will be difficult to sustain. Indeed, in *Kik*, the court rejected Kik’s attempt to characterize Kin tokens as having existing consumptive use when offered to the public, finding that such use “would materialize only if the enterprise advertised by Kik turned out to be successful.”

Similarly, the Digital Asset Framework suggests that if a digital asset will be redeemable for particular goods or services only in the future—in other words, only once the network is further developed—it typically will be priced at a significant discount to the actual market price of such goods or services, implying that purchasers are purchasing the asset as an investment. The Digital Asset Framework provides a long list of factors that the SEC staff believes could distinguish digital assets with real use cases from those with superficial use cases, such as whether the digital asset’s value shows a direct and stable correlation to the value of these goods and services it represents; whether its trading volume corresponds to levels of demand for such goods or services; and whether “any economic benefit that may be derived from appreciation in

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365 *Kik*, supra note 289, at 13. In its complaint in *Kik*, the SEC focused on whether the intended uses of Kin were genuine, scrutinizing the “Minimum Viable Product” that purportedly gave Kin tokens their functionality, and argued that the tokens were not actually necessary to access features included in the product. See *Complaint, SEC v. Kik Interactive*, No. 19-cv-5244 (S.D.N.Y. June 4, 2019), ECF No. 1 (noting that the Minimum Viable Product had such limited functionality that it appeared to be developed solely for “compliance purposes”).

366 *Digital Asset Framework*, supra note 285 (noting that “where a digital asset can be used to purchase goods or services on a network, where that network’s or digital asset’s functionality is being developed or improved, there may be securities transactions if . . . the digital asset is offered or sold to purchasers at a discount to the value of the goods or services”).
the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.”\textsuperscript{367}

(d) The Entrepreneurial or Managerial Efforts of the Promoter or Other Third Parties

The final and frequently most important element of the \textit{Howey} test asks “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”\textsuperscript{368} Traditionally, in separating securities from non-security commodities, courts have asked whether the increase in value of the instrument purchased derives from the efforts of an identifiable third party or from general market fluctuations. For example, in \textit{Noa v. Key Futures, Inc.}, the Ninth Circuit held that contracts for the sale of silver were not securities because purchasers did not rely upon the efforts of others to realize their profits: “[o]nce the purchase of silver bars was made, the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of [the sellers].”\textsuperscript{369} Similarly, in \textit{SEC v. Belmont Reid & Co.}, the Ninth Circuit held that investors purchasing gold coins on a pre-payment basis were not relying upon the managerial efforts of the promoters because their profits depended upon “the world gold market” and not the skills of the promoters.\textsuperscript{370} The gold purchasers acted as ordinary buyers relying on the seller to deliver the goods that they purchased.\textsuperscript{371} In contrast, the Second Circuit in \textit{Glen-Arden Commodities, Inc. v. Costantino} held that purchasers in whiskey warehouse receipts relied upon the managerial efforts

\textsuperscript{367} \textit{Id.}

\textsuperscript{368} \textit{SEC v. Glenn W. Turner Enters., Inc.}, 474 F.2d 476, 482 (9th Cir. 1973).

\textsuperscript{369} 638 F.2d 77, 79 (9th Cir. 1980).

\textsuperscript{370} 794 F.2d 1388, 1391 (9th Cir. 1986).

\textsuperscript{371} \textit{Id.}
of others because they “entrust[ed] the promoters with both the work and the expertise to make the tangible investment pay off.” 372 The promoters of the interests in the whiskey and casks—the warehouse receipts, which were akin to a commodity future—promised the investors that they would find buyers in the future and investors would double their money in four years. 373

In considering how this element applies to digital assets, analyzing the case of bitcoin is illustrative. Bitcoin miners profit by obtaining new tokens as a result of their own mining efforts. Certainly, a portion of their profits relies upon the greater network of miners and users on the Bitcoin network, but such reliance on the continued existence of this network is less from the reliance on the “essential managerial efforts” of others and closer to the reliance on the world gold market that was deemed not to be sufficient to fulfill this factor in *Belmont Reid*. 374

Nonetheless, few digital currencies in recent years have replicated the extensive decentralization of bitcoin, with many being sold specifically to finance promoters’ efforts at building a new system or service or based on the expectation that the promoters will support the project after the sale. For example, in the DAO Report, the SEC stated: “[t]he expertise of The DAO’s creators and Curators was critical in monitoring the operation of The DAO, safeguarding investor funds, and determining whether proposed contracts should be put for a vote.” 374 Further, “[a]lthough DAO Token holders were afforded voting rights,” those voting rights “did not provide them with meaningful control over the enterprise, because (1) DAO Token holders’

372 493 F.2d 1027, 1035 (2d Cir. 1974).
373 Id.
374 DAO REPORT, supra note 87, at 12–13.
ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.”

Determining whether the role of the creator of a particular token rises to the level of essential managerial efforts is a fact-specific analysis. At a minimum, the analysis must take into account whether there is an identifiable individual or group promoting the asset, and then assess the specific role of that party. A minimal role, without more, is unlikely to be sufficient to constitute “efforts of others” for purchasers to rely upon. For example, in *Belmont Reid*, the gold purchasers relied upon the promoter to mine gold in order to produce gold coins. The Ninth Circuit held that this reliance did not change the fact that the investors’ profit was determined by the world gold market. Instead, the reliance was like “any sale-of-goods contract in which the buyer pays for advance delivery and the ability of the seller to perform is dependent, in part, on both his managerial skill and some good fortune.”

Enforcement actions brought by the SEC against the issuers and promoters of ICO tokens provide further insight into when the SEC believes that the role of the creator of a particular digital asset rises to the level of “essential managerial efforts.” In its November 2018 cease-and-desist order against Paragon Coin, Inc., the SEC placed particular emphasis on Paragon’s stated plans to create an “ecosystem” of uses and applications that it said would increase the value of its token. Likewise, in its cease-and-desist order entered on the same date against Airfox, which

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375 *Id.* at 13.

376 *Belmont Reid*, 794 F.2d at 1389.

377 *Id.* at 1391.

378 *Id.*

379 *Paragon Order, supra* note 284, at III.34.
had sold a digital asset (AirTokens) through an ICO, the SEC reasoned that investors’ expected profits “were to be derived from the significant entrepreneurial and managerial efforts of others—specifically AirFox and its agents—who were to create the ecosystem that would increase the value of AirTokens, and facilitate secondary market trading.”

Similarly, in determining whether the involvement of a digital asset’s developer rises to the level of “essential managerial efforts,” the Telegram court endorsed a version of the so-called “Bahamas Test” first proposed by academic commentators. As applied by the court, the test proposes a counterfactual—imaging a scenario in which, immediately after the launch of the digital asset, the development team decamped to an island in the Caribbean and ceased all further efforts to support the asset. If the team thus completely exited the stage, would the digital asset likely exhibit “the mass adoption, vibrancy, and utility that would enable the [initial investors] to earned their expected . . . profits?” In Telegram, the court found the Bahamas Test indicated that there was continued reliance on the developers because the success of the digital asset was dependent on its not-yet-completed integration with the developer’s preexisting messaging platform, among other similar factors. Moreover, the issuer’s pledge to distribute a portion of the new digital asset as a form of compensation to the development team, subject to a lock-up

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380 Airfox Order, supra note 284, at III.22.

381 Telegram, supra note 284, at *49 (citing M. Todd Henderson and Max Raskin, A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets, 2 COLUM. BUS. L. REV. 443, 461 (2019)).

382 Id.

383 Id. at *50.
agreement, fed expectations that the team would continue to play a role in the digital asset’s growth post-launch.³⁸⁴

Consistent with the Telegram court, the SEC appears to view post-launch activity to maintain and grow demand for a digital asset as essential managerial efforts by the developer. For example, in granting the SEC’s motion for summary judgment, the Kik court emphasized the central role that the developer of a new cryptocurrency would play in fostering the token’s “ecosystem” and providing integration with the developer’s preexisting social media platform.³⁸⁵ This mirrors many of the arguments made in the SEC’s complaints against Paragon Coin and AirFox, where it emphasized the role of the developers in creating an “ecosystem” that would increase the value of the tokens post-launch.³⁸⁶

Pinpointing whether purchasers are relying upon the efforts of others is important because the separation (and resulting information asymmetries) between those investors and promoters is what underlies the disclosure requirements of securities offerings, discussed in more detail below.³⁸⁷ The protections of the federal securities laws are needed where investors rely upon the efforts of a third party to realize gains from an investment because, in that scenario, “learning material information about the third party—its background, financing, plans, financial stake and so forth—is a prerequisite to making an informed investment decision.”³⁸⁸

³⁸⁴ Id.

³⁸⁵ Kik, supra note 289, at 13 (“The demand for Kin, and thus the value of the investment, would not grow on its own. Growth would rely heavily on Kik’s entrepreneurial and managerial efforts . . . These efforts by Kik were crucial because without the promised digital ecosystem, Kin would be worthless.”).

³⁸⁶ Paragon Order, supra note 284, at III.34; Airfox Order, supra note 284, at III.22.

³⁸⁷ See also Hinman, supra note 54.

³⁸⁸ Id.
Importantly, the SEC seems prepared to take into account how reliance on the efforts of others may change over the course of a digital token’s lifecycle.\(^{389}\) The Digital Asset Framework, for example, highlights multiple factors used to determine whether a digital asset that previously sold as a security should be reevaluated at the time of later offers or sales. These could include whether the efforts of the developer, promoter, or their successor continue to “be important to the value of an investment in the digital asset;” “whether the network on which the digital asset is to function operates in such a manner that purchasers would no longer reasonably expect [a developer, promoter, or other third party] to carry out essential managerial or entrepreneurial efforts;” and whether a developer, promoter, or other third party has “access to material, non-public information or could otherwise be deemed to hold material inside information about the digital asset.”\(^{390}\)

Ether’s evolution illustrates how the answers to these questions can change over time and potentially affect a \textit{Howey} analysis, though the SEC has not spoken with specificity as to how this element of the \textit{Howey} test applies to ether. The initial developers of ether and the Swiss entity that managed the presale and dissolved upon its conclusion—The Ethereum Switzerland GmbH\(^{391}\)—had a role in the establishment of the blockchain and the presale.\(^{392}\) Ether was purposefully established, however, to be an open-source, consensus-based blockchain that would not be controlled by any one holder of ether. Three years after its initial sale, over 30,000

\(^{389}\) \textit{Id.}

\(^{390}\) \textit{Digital Asset Framework, supra} note 285.


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developers participate in the Ethereum platform, a large and disperse enough group that holders of ether can be said to rely significantly less upon the efforts of any identifiable others today than at the time of the presale. Few other tokens initially sold through ICOs, however, have gained such widespread adoption such that the initial development team has fully extricated itself from continued development efforts.

2. **Implications for the Requirements of the Securities Act and Exchange Act**

Although the ICO and digital asset space has “grown rapidly, gained greater prominence in the public conscience and attracted significant capital” over the past few years, the risks inherent in any under-regulated space “are high and numerous—including risks caused by or related to poor, incorrect or non-existent disclosure, volatility, manipulation, fraud and theft.”

The SEC’s goal in regulating securities is to mitigate these risks while facilitating capital formation through increased transparency, and its authority to do so comes primarily from two statutes: the Securities Act and the Exchange Act. If a particular digital asset is classified as a security, dealings or transactions in that digital asset would be subject to the requirements of

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394 Block.one, which developed the EOS Network, appears to have attempted to mirror this model, selling tokens to fund the development of the network code and then releasing it as open source software and inviting other third parties to initially launch the network. *See* Brady Dale, *How to Watch the EOS Blockchain Launch*, COINDESK.COM (June 2, 2018), https://www.coindesk.com/watch-eos-blockchain-goes-live. Nonetheless, the SEC believed that the initial fundraising to fund Block.one’s development of the EOS Network was an unregistered securities offering. *See In re Block.one*, Securities Act Release No. 10714 (Sept. 30, 2019), https://www.sec.gov/litigation/admin/2019/33-10714.pdf.

395 *Chairman Clayton Statement, supra* note 291.

396 *Id.* (stating that the agency’s goals are “to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation”). Other regulators have described their goals in similar terms. *See, e.g.*, Jay Clayton and J. Christopher Giancarlo, *Regulators are Looking at Cryptocurrency*, WALL ST. J.: COMMENTARY (Jan. 24, 2018, 6:26 PM), https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363 (describing the combined roles of the SEC and CFTC as “to set and enforce rules that foster innovation while promoting market integrity and confidence”).

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these statutes. This Section analyzes those requirements and exemptions that may be available to parties transacting in or facilitating transactions in digital assets. It also references some of the challenges of applying existing regulations to this new asset class.

(a) The Securities Act

The Securities Act regulates the offer and sale of securities, including digital assets deemed to be securities, and requires either registration or the reliance on an exemption for the sale of such securities. It focuses primarily on ensuring transparency and preventing fraud by making it “unlawful [with certain exceptions] for any person . . . to offer to sell . . . any security, unless a registration statement has been filed as to such security” and the sale is accompanied by a prospectus containing certain required information.

In practical terms, section 5 of the Securities Act requires that before selling a security, an issuer must register the offering with the SEC or satisfy an exemption from registration; for example, offering the securities in a private placement in accordance with Regulation D. Registration requires issuers to provide extensive disclosure related to both the security being offered and the registrant itself, including details about the financial condition of the company, how it will use the proceeds from the sale, and the risk factors presented by investing in the security.

With respect to digital assets, these disclosure requirements, and the concerns animating them, are especially important for promoters who use digital asset sales in place of conventional securities offerings. These disclosure requirements were not written with digital assets in mind,

397 See Securities Act § 2(a)(3).
398 Id. § 5(c).
399 Id. § 10.
creating compliance difficulties for potential digital-asset issuers. However, over the past year, the SEC has allowed several issuers to successfully offer digital assets that fit within the legal framework for securities offerings. In July 2019, the SEC qualified two Regulation A offerings—a “registration light” exemption from full registration\(^{400}\)—of security tokens by Blockstack\(^{401}\) and YouNow.\(^{402}\) On August 20, 2020, the SEC declared effective the full Securities Act registration by INX Limited of INX Tokens, a digital asset that would entitle holders to a share of the not-yet-operational company’s operating cash flows.\(^{403}\) On July 6, 2020, Arca Capital Management, LLC, a digital asset investment firm, announced that the SEC had declared effective the registration of its Arca U.S. Treasury Fund.\(^{404}\) The fund is a closed-end registered investment company built on Ethereum. Building the fund on Ethereum will allow the fund’s shareholders, all of whom are required to be whitelisted\(^{405}\) by the fund’s transfer agent, to conduct peer-to-peer transactions via blockchain.\(^{406}\)

\(^{400}\) See infra text accompanying notes 434–443 discussing Regulation A.


\(^{405}\) Whitelisting requires that each purchaser complete an anti-money laundering/know-your-customer process to establish a fund account with the transfer agent.

\(^{406}\) Arca U.S. Treasury Fund, Form N-2 (as filed with the SEC on June 24, 2020) https://www.sec.gov/Archives/edgar/data/1758583/000121465920005869/s624200n2a2.htm.
Some commenters have argued that in “the wild west of ICOs,” the disclosure requirements in section 5 are particularly crucial.\textsuperscript{407} Indeed, they are the primary means by which the SEC can ensure “transparency in [] securities markets” by “reduc[ing] opacity and, thereby, enhanc[ing] . . . efforts to deter, mitigate, and eliminate fraud.”\textsuperscript{408} This concern about opacity ties into the final element of the Howey test—reliance on the efforts of others—because the more holders of digital assets rely on the efforts of others, the larger the concerns about information asymmetries between the promoters and investors.\textsuperscript{409}

The link between failure to disclose accurate information and fraud becomes apparent when examining past SEC enforcement actions. Many of those targeted by the SEC have attempted to issue tokens while making false statements about their activities with the intent of creating an inflated impression of the value of the digital asset. For example, according to the SEC, the co-founders of Centra, which conducted an ICO that raised over $32 million in 2017, claimed that funds raised from their “CTR Token” would help “build a suite of financial products . . . that would allow users to instantly convert hard-to-spend cryptocurrencies into U.S. dollars or other legal tender.”\textsuperscript{410} The SEC alleged that in making these statements, the co-founders claimed to have agreements in place with Visa and Mastercard to create debit cards


\textsuperscript{409} Hinman, supra note 54 (“The impetus of the Securities Act is to remove the information asymmetry between promoters and investors.”).

serving this function.\textsuperscript{411} Although the statements allegedly were false, such statements, along with Centra’s marketing and promotion efforts more generally, supported the value of the ICO. The SEC charged Centra’s co-founders with violating the anti-fraud and registration provisions of the Securities Act.\textsuperscript{412}

Several exemptions potentially are available to market participants, depending upon the nature of the transaction, amount of the offering, and participants involved. The section 4(a)(1) exemption, for example, applies to transactions by anyone other than an issuer, underwriter, or dealer.\textsuperscript{413} However, if a person purchases from an issuer “with a view to, or offers or sells for an issuer in connection with, the distribution of any security,” including digital assets deemed securities, then he or she is operating as an underwriter and cannot rely on the section 4(a)(1) exemption.\textsuperscript{414} This point was raised by the Telegram court, which found that the initial set of purchasers in the defendant’s ICO functioned as statutory underwriters in a “disguised public distribution.”\textsuperscript{415} According to the court, the developer’s goal was “to establish [its tokens] as ‘the first mass market cryptocurrency,’”\textsuperscript{416} which required that the tokens not come to rest with their initial purchasers. Instead, the offering was designed so that the tokens would “reach the public at large via post-launch resales by the [i]nitial purchasers,” thus positioning the initial purchasers as statutory underwriters.\textsuperscript{417}

\textsuperscript{411} Id.


\textsuperscript{413} Securities Act § 4(a)(1).

\textsuperscript{414} Securities Act § 2(a)(11) (defining underwriters).

\textsuperscript{415} Telegram, supra note 284, at *61.

\textsuperscript{416} Id.

\textsuperscript{417} Id. at *62.
Transactions not involving a public offering may qualify for the exemption under section 4(a)(2), including by relying on the safe harbor in Regulation D. Rule 506 of Regulation D provides that private placements of securities would be deemed to meet the section 4(a)(2) exemption so long as certain conditions are met, primarily that the issuer’s securities are sold only to “accredited investors,” a term that includes, among others, most entities with more than $5 million of assets and individuals that meet certain minimum income or net worth tests. For example, in 2017, Overstock.com’s blockchain-focused subsidiary, tZero, Inc., proposed to sell $250 million of preferred equity in the form of blockchain tokens. Although tZero conceded the tokens were securities, it sought to issue the tokens in a private placement offering under Regulation D of the Securities Act.

Other firms have sought to conduct ICOs of digital assets that may be deemed securities in reliance on Regulation D through SAFTs. Generally, SAFT purchasers invest in the developer of a blockchain network or application, but instead of receiving debt or equity

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418 Securities Act § 4(a)(2).


422 t0.com, Inc., Confidential Private Placement Offering Memorandum (Mar. 1, 2018), https://www.sec.gov/Archives/edgar/data/1130713/000110465918013731/a18-7242_1ex99d1.htm. tZero also is a joint venture partner in a platform to facilitate issuing and trading of digital-asset securities, see infra note 489, and Overstock has proposed an alternative trading system to facilitate trading of digital asset securities, see infra note 499.

securities of the developer, they receive a promise that the company will, at some point in the future, once the blockchain system has been developed, deliver to the investors a token that will have some use or value in the system.\textsuperscript{424} The theory underlying the SAFT structure is that once the network is developed and the fully functional tokens are delivered, token recipients should no longer be relying on the efforts of the promoters, and as a result, the digital asset would not be a security under \textit{Howey}.\textsuperscript{425}

As noted above, the usefulness of SAFTs, however, has been called into question by the \textit{Telegram} decision, which rejected the theory that SAFTs as a private placement could be evaluated separately from subsequent public digital asset distribution.\textsuperscript{426} The \textit{Telegram} court stated that both the SAFTs and the future distribution of the token were a “[single] scheme to be evaluated under \textit{Howey} [consisting] of the full set of contracts, expectations and understandings centered on the sales and distribution of the [token].”\textsuperscript{427} However, \textit{Telegram} was decided by one district court at the preliminary injunction phase and not fully litigated on the merits, so it is possible that future cases may lead to different outcomes.\textsuperscript{428}

\textsuperscript{424} See, e.g., Protocol Labs and Cooley LLP, \textit{supra} note 290.

\textsuperscript{425} \textit{Id.} More precisely, SAFT-based token sales involve two stages. In the first stage, SAFTs are offered to a limited group of investors in compliance with one of the private offering safe harbors in Regulation D. The terms of the SAFTs entitle these investors to an amount of the digital asset to be issued in the future, and can include other commercial provisions like special governance rights over the digital asset and specific development milestones that trigger additional digital asset distributions. Proceeds generated from sales of the SAFTs are used by the digital asset issuer to develop technology and use cases for the underlying digital asset. Once that is complete, the issuer distributes the digital asset to the SAFT investors, as well as to the general public. The wider distribution occurs under the theory that the digital assets do not meet the \textit{Howey} test due to the extent of their then-existing use cases, and therefore are not securities subject to registration requirements for public offerings.

\textsuperscript{426} See \textit{supra} note 290; \textit{Telegram}, \textit{supra} note 284, at *60.

\textsuperscript{427} See \textit{Telegram}, \textit{supra} note 284, at *60.

\textsuperscript{428} Indeed, the judge considering the \textit{Kik} case indicated in oral arguments that he does not view the \textit{Telegram} decision as binding precedent. See Sandali Handagama, \textit{Telegram’s Defeat Isn’t ‘Binding’ in Kik Case, Judge Tells SEC}, COINDESK.COM (July 10, 2020), https://www.coindesk.com/telegrams-defeat-isnt-binding-in-kik-case-judge-tells-sec.
The *Kik* and *Telegram* decisions\(^{429}\) and the SEC’s issuance of subpoenas to ICO companies applying the SAFT framework\(^{430}\) suggest that the agency may be considering whether tokens initially sold through a SAFT structure continue to be securities.\(^{431}\) If the SAFT-derived tokens are securities, even if initially sold in an exempt offering structured to rely on Regulation D, questions arise as to whether investors who received the digital assets through a SAFT can resell them without registration. As previously noted, section 4(a)(1) of the Securities Act exempts from registration transactions by a person who is not an issuer, underwriter, or dealer. Although investors may rely on this exemption to resell securities, they would need to ensure that they would not be deemed to be an “underwriter,” *i.e.*, someone who purchased the securities from the issuer with a view to distribution.\(^{432}\) Persons not affiliated with the issuer who have held the securities for at least one year may be able to rely on a safe harbor from “underwriter” status under Rule 144.\(^{433}\) When considering whether the one-year period begins with the investment in the SAFT or the delivery of the underlying tokens, a complicating factor is the question whether the holding periods can be “tacked” together.

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\(^{429}\) See *Kik*, [*supra* note 289], at 3–6, 14; see also *Telegram*, [*supra* note 284].


\(^{432}\) Securities Act § 2(a)(11) (defining underwriters); see also *Telegram*, [*supra* note 284], at *61* (finding that initial purchasers of a token from a developer were acting as statutory underwriters because the developer intended for them to resell the tokens on the secondary market in order to “establish [its tokens] as ‘the first mass market cryptocurrency’”).

\(^{433}\) 17 C.F.R. § 230.144. The application of Rule 144 to digital assets that were sold without reliance on an exemption is less clear. By its terms, Rule 144 is available only with respect to “restricted securities,” which generally is defined as either (i) securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering, or (ii) securities sold in reliance on particular exemptions from section 5. If the securities were initially sold in a public offering without reliance on an exemption, they may not be “restricted securities” under Rule 144, and holders may not be eligible for the safe harbor from status as an “underwriter.”
Another alternative for issuers of digital-asset securities is the so-called “Regulation A-Plus,” adopted under the Jumpstart Our Business Startups Act of 2012 (the “JOBS Act”). The JOBS Act tasked the SEC with implementing rules to exempt small issuers from registration requirements. 434 Regulation A-Plus provides for two tiers of offerings, with Tier 1 encompassing offerings of up to $20 million in a 12-month period with no more than $6 million in offers by selling security holders that are affiliates of the issuer, and Tier 2 encompassing offerings of securities of up to $50 million in a 12-month period with no more than $15 million in offers by selling security holders that are affiliates of the issuer. 435

Certain basic requirements apply to both Tier 1 and Tier 2 offerings under Regulation A-Plus, such as the requirement that an issuer file an offering statement with the SEC and have it qualified before the issuer may begin selling securities. 436 Tier 2 offerings are subject to additional disclosure and reporting requirements. 437 Accordingly, a Regulation A-Plus offering requires issuers of digital assets to engage more closely with the SEC than they would under a Regulation D offering, primarily because the SEC must “qualify” the offering statement. 438

A central benefit of a Regulation A-Plus offering is that securities issued in such an offering are not subject to resale restrictions, at least under the federal securities laws. 439 The possibility of immediate trading may encourage the development of a vibrant secondary

434 See Securities Act § 3(b)(2).
435 17 C.F.R. § 230.251(a).
437 See, e.g., 17 C.F.R § 230.257(b).
438 17 C.F.R. § 230.251(d).
market. However, Regulation A-Plus preempts state securities laws (which may separately require registration) only “with respect to primary offerings of securities by the issuer or secondary offerings by selling security holders that are qualified pursuant to Regulation A and offered or sold to qualified purchasers pursuant to a Tier 2 offering.” Tier 1 offerings, and resales of securities purchased in Tier 2 offerings, will still require a state-by-state analysis. As previously noted, the SEC to date has qualified two Regulation A offerings.

Even if a digital asset is exempt from the registration requirements, the digital asset nevertheless may be subject to other requirements under the Securities Act. For example, section 17(a) of the Securities Act makes it unlawful for any person to use fraudulent means to effect any securities sale, including making “any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made . . . not misleading.” This provision applies regardless of whether the security has been registered.

Section 17(b) likewise makes it unlawful for any person to publish, give publicity to, or circulate any advertisement for a security in exchange for consideration from the issuer, underwriter, or dealer of that security without fully disclosing the receipt of that consideration. Paid promotions or endorsements of digital assets that constitute securities thus may be unlawful absent full disclosure of any underlying consideration being paid for the promotion. Indeed, in


442 Id.

443 See supra notes 401–402.

444 See Securities Act § 17(c).

445 Id. § 17(b).
December 2018, the SEC brought enforcement actions for violation of section 17(b) against boxer Floyd Mayweather Jr. and music producer DJ Khaled. The SEC alleged that Mayweather and Khaled had both received consideration from ICO issuers in exchange for promoting the relevant ICOs through social media posts, but failed to disclose their receipt of consideration. Similarly, in February 2020, the SEC brought claims against actor Steven Seagal.

(b) The Exchange Act

While the Securities Act focuses on the registration of securities, the Exchange Act regulates secondary trading of securities. The Exchange Act imposes registration requirements and substantive regulations on the financial intermediaries that engage in or facilitate the trading of securities, including broker-dealers, exchanges, transfer agents, and clearing agencies. If a particular digital asset is determined to be a security, then market participants that act in these capacities in connection with the digital asset may be subject to registration and regulation, as they would with any other security. Although the SEC’s initial enforcement actions and public statements involving digital assets largely focused on Securities Act violations, Exchange Act considerations are more recently the focus of attention. For example, in September 2018, the

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SEC brought its first enforcement action against a person the SEC alleged acted as an unregistered broker-dealer in connection with the sale of ICO tokens and facilitation of secondary market trading in the digital assets.\(^\text{451}\)

This subpart highlights certain of the Exchange Act requirements for securities market intermediaries and infrastructure. While the secondary market infrastructure for traditional securities is highly regulated, much of the digital asset trading infrastructure was established without regard to the securities laws. In addition, some of the Exchange Act requirements, and the rules and regulations thereunder, do not apply neatly to digital assets as a class. The application of the Exchange Act requirements to these mostly unregulated activities also may significantly impact this business, and as a result, discourage transactions in digital assets that may be securities.\(^\text{452}\)

(1) **Brokers and Dealers**

Section 15 of the Exchange Act makes it “unlawful for any broker or dealer . . . to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered” with the SEC.\(^\text{453}\) Brokers and dealers (typically referred to as “broker-dealers”), and associated natural persons (“associated persons”), are subject to extensive substantive regulation.

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\(^{453}\) Exchange Act §15(a)(1). Unless an exemption is available, non-U.S. firms “that, from outside the United States, induce or attempt to induce trades by any person in the United States” also may be subject to U.S. broker-dealer registration. *See* Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 27017 (July 11, 1989).

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A “broker” is a person “engaged in the business of effecting transactions in securities for the account of others.”454 This definition has been expansively interpreted by the SEC and courts. In addition to those persons executing securities transactions and holding custody of customers’ funds and securities, a person or entity may be deemed a broker if it assists issuers with structuring a securities offering, identifies potential purchasers, or advertises a securities offering, among other things.455 The SEC has highlighted that a person who is compensated through the receipt of commissions or similar transaction-based fees in connection with securities activity likely is acting as a broker.456

A person is a “dealer” if it is “engaged in the business of buying and selling securities . . . for such person’s own account,” but only insofar as such transactions are part of that person’s “regular business.”457 Importantly, a person must both buy and sell securities in order to qualify as a dealer. The SEC and courts have distinguished between dealers and traders, who also buy and sell securities, based on whether the dealer is buying and selling as a business, rather than as an investor.458 Indicia of dealer activity include whether the person holds itself out as willing to buy or sell securities on a continuous basis or provides liquidity to the market (as a market maker), is involved in originating new securities (such as an underwriter), has regular customers


456 Id. at 2-18.


or clientele, has a regular turnover inventory of securities, and provides securities-related services in connection with its transactions (such as providing advice or extending credit).\footnote{459}

The SEC has focused recently on broker-dealer requirements relating to digital asset activity. In September 2018, the SEC entered a cease-and-desist order against TokenLot LLC and its owner-operators, Lenny Kugel and Eli Lewitt, for unregistered broker-dealer activity.\footnote{460} TokenLot operated a website marketed as an “ICO Superstore,” through which it sold digital assets both in connection with ICOs and secondary market trading.\footnote{461} More than 6,100 individual investors placed over 8,400 purchase orders on the TokenLot platform.\footnote{462} The SEC alleged that TokenLot and its operators acted as brokers by facilitating the sale of digital assets as part of other entities’ ICOs, including by marketing the digital assets, accepting investors’ orders, accepting payment for orders, and working with issuers to transfer digital assets to investors after payment.\footnote{463} The SEC alleged that TokenLot and its operators also acted as dealers by purchasing digital assets for accounts in TokenLot’s name, often at a discount to the ICO price, and then selling the digital assets to investors for profit immediately or at a later time after being held in inventory.\footnote{464} The SEC concluded that TokenLot and its operators violated the Exchange Act by engaging in such activity without the required broker-dealer registration.

\footnote{459} Id.

\footnote{460} TokenLot Order, supra note 451.

\footnote{461} Id. at III.3, III.6.

\footnote{462} Id. at III.6.

\footnote{463} Id. at III.11, III.12.

\footnote{464} Id. at III.13.
More recently, in September 2019, the SEC filed a complaint against ICOBox and its
creator Nikolay Evdokimov, alleging in part that the defendants had acted as unregistered
brokers for their clients’ ICOs.\footnote{Complaint at ¶ 1, SEC v. ICOBox, No. 2:19-cv-08066 (C.D. Cal. Sept. 18, 2019), ECF No. 1.} ICOBox was a service designed to “structur[e], promot[e], and
solicit[] investors” for its clients’ token offerings.\footnote{Id. at ¶ 11.} According to the complaint, the service had
facilitated token sales for more than 30 clients, raising over $650 million.\footnote{Id. at ¶ 10.} In alleging that
ICOBox and Evdokimov acted as unregistered brokers, the SEC’s complaint emphasized the
“marketing services” that they offered their clients, which included “advising investors on the
merits of the clients’ offerings and actively soliciting investors to purchase the clients’
tokens.”\footnote{Id. at ¶ 89.} For these services, ICOBox charged clients both a flat fee and a “success fee,” which
was tied to the amount raised during the clients’ offerings.\footnote{Id. at ¶ 92–93.} The SEC concluded that ICOBox
and Evdokimov violated the Exchange Act by engaging in such activity without broker
registration.

Registration and operation of a broker-dealer is not a light undertaking. Firms seeking to
comply with the broker-dealer registration requirements face a high compliance burden—made
more difficult by the fact that the relevant rules were designed for traditional securities, custody,
and transfer models. Broker-dealers are subject to an extensive list of regulatory requirements,
including, without limitation:

- minimum regulatory capital requirements;
• restrictions on the distribution of assets to affiliates;
• regulation concerning the handling of customers’ funds and securities;
• restrictions on margin lending;
• significant event and financial reporting, as well as annual financial audits;
• books and records obligations;
• supervision and surveillance requirements;
• anti-money-laundering and know-your-customer requirements;
• restrictions on communications with the public;
• requirements to obtain FINRA approval for material changes in business or certain changes in ownership; and
• generally adhering to high standards of commercial honor and just and equitable principles of trade.470

In addition to registration with the SEC, broker-dealers also are generally required to become members of FINRA and register with applicable states. A natural person seeking to become associated with a broker-dealer must pass qualifying examinations administered by FINRA, subject themselves to fingerprinting, and provide disclosure of extensive background information. Registered individuals may be subject to restrictions on the business activities in which they engage outside the scope of their association with the broker-dealer, including personal securities transactions, must meet continuing education requirements, and are subject to various ongoing reporting requirements.471 Broker-dealers and associated natural persons are

471 Id.
subject to examination and enforcement by the SEC, applicable states, FINRA, and any other
self-regulatory organization of which the broker-dealer is a member.\textsuperscript{472}

While the SEC insists that persons acting as brokers or dealers in digital asset securities
must register with it or face enforcement, its staff has made clear a number of concerns that it has
with registered broker-dealers dealing in digital asset securities. Specifically, in a joint statement
with FINRA staff, the SEC staff indicated that it has significant concerns regarding how a
registered broker-dealer could comply with the applicable customer protection rules when it
maintains custody of digital asset securities for customers, and currently appears willing to
permit registered broker-dealers to provide only non-custodial digital asset security services.\textsuperscript{473}

The result has left firms seeking to engage in digital asset securities brokerage services legally in
a difficult situation—they cannot provide digital asset securities brokerage services without
registration, yet the SEC and FINRA appear unwilling to permit them to conduct the full suite of
brokerage services even if they register.\textsuperscript{474}

\textbf{(2) Exchanges and Alternative Trading Systems}

Among other things, the Exchange Act regulates the activities of securities exchanges.

Section 3(a)(1) defines an exchange as any entity that “constitutes, maintains, or provides a
marketplace or facilities for bringing together purchasers and sellers of securities,” although the

\textsuperscript{472} Id.

\textsuperscript{473} Division of Trading and Markets, SEC, Office of General Counsel. FINRA, Joint Staff Statement on Broker-

\textsuperscript{474} SEC and FINRA Staffs Highlight Broker-Dealer Regulatory Challenges Raised by Digital Assets—And Hint at
term does not include persons that merely route orders or operate single-dealer platforms.\textsuperscript{475} Section 5 of the Exchange Act makes it “unlawful for any . . . exchange, directly or indirectly . . . to effect any transaction in a security” unless it is registered with the SEC as a national securities exchange.\textsuperscript{476}

Many existing digital asset trading platforms, which maintain limit order books of bids and offers for digital assets and match buyers with sellers, would appear to be acting as an “exchange” if the digital assets traded on the platforms are securities.\textsuperscript{477} Indeed, in November 2018, the SEC brought an enforcement action against Zachary Coburn, the former operator of the EtherDelta online platform, on the basis that EtherDelta had operated as an unregistered exchange in violation of the Exchange Act.\textsuperscript{478} Although ostensibly a “decentralized” exchange operating through a smart contract, EtherDelta’s website provided a user-friendly interface that allowed buyers and sellers to access a secondary market for certain digital tokens, particularly ether and ERC 20 tokens (including many digital assets issued in ICOs).\textsuperscript{479} EtherDelta’s website provided access to the EtherDelta order book, allowing users to enter buy or sell orders for supported digital assets at a specified price and with a specified time for the order to remain

\textsuperscript{475} See 17 C.F.R. § 240.3b-16.

\textsuperscript{476} Exchange Act § 5.


\textsuperscript{478} In the Matter of Zachary Coburn, Exchange Act Release No. 84553 (Nov. 8, 2018) [hereinafter EtherDelta Order].

\textsuperscript{479} Id. at III.1, III.2.
Between July 12, 2016, and December 15, 2017, more than 3.6 million orders were traded on EtherDelta platform. In this regard, the SEC alleged that EtherDelta operated as a marketplace for bringing together the orders of multiple buyers and sellers in digital assets that constituted securities, and thereby itself constituted an exchange for the purposes of the Exchange Act. By not registering as an exchange, or qualifying for an exemption from registration, Coburn operated EtherDelta in violation of the Exchange Act.

The activities of registered national securities exchanges are subject to extensive regulation by the SEC. The exchange’s rules and stated policies, practices, and interpretations are subject to filing with, and in most cases approval by, the SEC before they can become effective. A national securities exchange’s rules, among other things, must be “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest.” National securities exchanges also are themselves SROs and therefore must enforce their members’ compliance with the exchanges’ rules and the federal securities laws.

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480 Id. at III.2.

481 Id. at III.4.

482 Id. at III.26.


484 Exchange Act § 19(b)(1).

485 Id. § 6(b)(5).

486 Id. § 19(g)(1).
In practice, firms wishing to offer a trading platform for digital assets may find that doing so through a registered national securities exchange is impractical. In addition to the extensive regulatory obligations imposed on exchanges, status as a national securities exchange also may limit the business that the platform can undertake. Only registered broker-dealers and their natural person associated persons—rather than direct investors—may become members of a national securities exchange.\footnote{Id. § 6(c)(1).} In addition, only securities registered under the Exchange Act may be traded on national securities exchanges.\footnote{Id. § 12(a).}

One existing national securities exchange sought to create a facility of the exchange that would operate as a platform for trading digital asset securities. The Boston Security Token Exchange, or BSTX, was a proposed facility of the BOX Exchange LLC (“BOX”). As proposed, BSTX would have been “a fully automated, price-time priority execution system to list and trade [National Market System] stocks . . . for which ancillary records of ownership reflecting certain end-of-day security token balances as reported by market participants would be created and maintained using distributed ledger technology built on Ethereum.”\footnote{See Self-Regulatory Organizations; BOX Exchange LLC; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change in Connection with the Proposed Commencement of Operations of the Boston Security Token Exchange LLC as a Facility of the Exchange, Securities Exchange Act Release No. 34-88536, at 2 (Apr. 1, 2020) [hereinafter BOX Proceedings Release].} Note that these would be only “ancillary records”—the securities would actually clear and settle under existing clearing agency rules and procedures.\footnote{See Self-Regulatory Organizations; BOX Exchange LLC; Notice of Filing of a Proposed Rule Change in Connection with the Proposed Commencement of Operations of Boston Security Token Exchange LLC as a Facility of the Exchange, Securities Exchange Act Release No. 34-87868 (Dec. 30, 2019).} Nonetheless, the securities traded on the system would be
referred to as “security tokens.” In order to build the new system, BOX, a preexisting exchange that was co-developing BSTX in partnership with tZero, was required to seek regulatory approval from the SEC for certain rule changes to its corporate governance and trading policies. The SEC instituted proceedings to determine whether to approve or disapprove the proposal, after which the proposal was withdrawn by BOX, which may indicate that BOX anticipated that the SEC would disapprove it.

Given the regulatory burden of operating as a national securities exchange and the limitations on the sorts of securities that may trade, many have considered operating trading platforms for digital assets as an ATS operated by a registered broker-dealer. Although a broker-dealer would meet the definition of an “exchange” by providing a marketplace for bringing together purchasers and sellers of securities, a broker-dealer (although not others) may rely on an exemption from exchange status if it operates an ATS in compliance with Regulation ATS.

While ATS registration is less burdensome than registration and regulation as a national securities exchange, ATSs are subject to regulation as broker-dealers and cannot engage in all of the same activities as national securities exchanges. In particular, under Regulation ATS,

491 See Box Proceedings Release, supra note 489.


493 See BOX Proceedings Release, supra note 489.


495 See 17 C.F.R. § 240.3a1-1(a)(2).

496 ATSs that effect five percent of the trading volume with respect to a non-exchange listed equity security, however, may become subject to Regulation SCI, which seeks to ensure the operational integrity and continuing
ATSs cannot “[s]et rules governing the conduct of subscribers other than the conduct of such subscribers’ trading on such organization” or “[d]iscipline subscribers other than by exclusion from trading.” 497 ATSs must register as broker-dealers with the SEC in addition to filing Form ATS, and must become members of the requisite SRO. 498

At least one firm has structured an ATS to facilitate secondary market trading in digital asset securities, although with limited functionality and limited to only a small number of securities. The tZero ATS, operated by a subsidiary of Overstock.com, currently facilitates trading in only three securities: (i) its own tZero preferred stock, (ii) a preferred stock issued by Overstock.com through a dividend to its existing shareholders, 499 and (iii) a digital security issued by a third party representing fractional ownership in the St. Regis Aspen Resort. 500

Unlike open networks like Bitcoin, which allow anyone to open a wallet and hold the asset, the tZero ATS system is a “closed trading system available only to broker-dealer availability of critical securities market infrastructure. See 17 C.F.R. § 240.1000 (clause (2) of definition of SCI alternative trading system).

497 17 C.F.R. § 242.300(a)(2).

498 Id. § 242.301(b); see also SEC, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets, supra note 292.

499 While Overstock.com refers to these securities as “digital securities,” they are not digital asset securities in the ordinary sense, as they “are not issued, traded, cleared, settled or custodied using distributed ledger or blockchain technology.” Instead, record ownership of digital securities is kept by:

a[n SEC] regulated transfer agent in its traditional books and records and they are traded on the relevant regulated trading venues on a book-entry basis. To enhance the investor experience, issuers arrange for a digital courtesy carbon copy of the transfer agent’s share registry of holders of record to be viewable on the blockchain. The digital courtesy carbon copy of the transfer agents’ books and records on the blockchain are pseudonymized (that is, such records do not identify the holders of record by name but each holder’s assets are shown under a digital wallet address) and do not govern ownership of these securities. The transfer agent’s conventional books and records remain as the only controlling record of ownership for corporate and securities law purposes.


subscribers. [The system] does not accept orders from non-broker-dealers, nor does it hold, own or sell securities.” 501 Further, one broker-dealer, Dinosaur Securities, “is the only broker-dealer that facilitates trades of any security on the tZERO ATS,” so anyone interested in accessing the ATS must establish an account with that one broker-dealer. 502

(3) Clearing Agencies and Transfer Agents

One of the primary innovations of blockchain technology is that settlement of transactions in digital assets can occur without involving or relying on a particular intermediary. When the digital asset is a security, however, this innovation raises a round hole, square peg problem, as the federal securities laws assume that intermediaries are involved in settlement and seek to regulate those intermediaries. In particular, section 17A(b)(1) of the Exchange Act requires a person acting as a “clearing agency” to register with the SEC. A clearing agency operates as an SRO 503 and is subject to a regulatory regime similar to national securities exchanges—including that it must adopt and operate in accordance with rules that are subject to filing and, typically, approval by the SEC. 504

A person is a “clearing agency” if, among other things, the person acts as an intermediary to “permit[] or facilitate[] the settlement of securities transactions . . . without physical delivery of securities certificates.” 505 With regard to traditional exchange-traded securities, the Depository

501 Overstock.com, Quarterly Report (Form 10-Q) (Mar. 31, 2020);

502 See Overstock.com Annual Report (Form 10-K), supra note 499.

503 Exchange Act § 3(a)(26).

504 Id. § 19(b)(1).

505 Id. § 3(a)(23). The definition of “clearing agency” excludes a bank or broker-dealer that would “be deemed to be a clearing agency solely by reason of functions performed by such institution as part of customary banking, brokerage, [or] dealing” activities.
Trust Company and its affiliate, the National Securities Clearing Corporation, are each registered clearing agencies that, together, net down a large number of transactions and maintain records of changes in beneficial ownership among their participants.  

For digital assets that are securities, where transactions settle on a blockchain through the activities of miners, it is unclear who—if anyone—might be acting as a clearing agency. At first glance, the miners might fit this definition, as they most directly facilitate settlement, but because their operations are decentralized and uncoordinated, it is difficult to imagine how, practically, they each could be subject to clearing agency registration with the SEC. Further, miners may not even be aware that they are facilitating settlement of securities; for example, many ICO tokens have been built as ERC 20 smart contracts on the Ethereum network, rather than being separately mined. Where these tokens are securities, Ethereum miners may be unwittingly facilitating the settlement of securities transactions. Alternatively, the firm that created the system initially, or the firm that seeks to use an existing system for securities settlement, might be considered to be a clearing agency—but this, too, is unclear, if such a firm is not itself facilitating settlement.  

The SEC staff has identified this issue, although its views are not yet known. In connection with an offering of so-called digital securities by Overstock.com, the SEC staff asked “whether [Overstock] anticipate[s] interaction with or involvement of a registered clearing agency.”  

In part based on the unique structure of its offering, Overstock argued that no clearing agency was involved because (i) changes of ownership were actually reflected on the books of the issuer maintained by its transfer agent, and (ii) certain other functions were

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performed by a registered broker-dealer that may benefit from the exemption for certain broker-dealer functions.\(^{508}\) However, the SEC staff again made at least a passing reference to the issue in a March 2018 warning that the activities of certain online trading platforms “may trigger other registration requirements under the federal securities laws, including broker-dealer, transfer agent, or clearing agency registration, among other things.”\(^{509}\)

One firm has sought to facilitate the settlement of traditional exchange-listed securities using blockchain technology and recognized the potential clearing agency status implications. Paxos Trust Company (“Paxos”) proposed to offer a service using blockchain technology to facilitate settlement and changes to beneficial ownership of securities held by Paxos on behalf of its customers in its own account at the Depositary Trust Company (“DTC”). SEC staff issued a no-action letter to Paxos, confirming it would not recommend enforcement action during a short-term feasibility study. However, the no-action letter imposes significant operational requirements on the system. Among other restrictions, no more than seven participants at a time will be eligible to use the service, volume limits will be imposed on the securities settled on the service, and the service will be subject to ongoing monitoring and reporting requirements. Notably, many of the SEC’s concerns about the use of blockchain technology (e.g., securities becoming irretrievably lost) are not present in this arrangement, because all of the securities Paxos would transfer between its customers ultimately would reside within DTC, not solely on a blockchain.

Status as a “transfer agent” also is potentially triggered by activities involving the settlement of securities over a blockchain, although registration may not actually be required. A “transfer agent” is a person that, on behalf of an issuer, among other things, “register[s] the

\(^{508}\) Id.

\(^{509}\) SEC, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets, supra note 292.
transfer of . . . securities” or “transfer[s] record ownership of securities by bookkeeping entry without physical issuance of securities certificates.” As with clearing agencies, this statutory definition could apply to various parties involved in the settlement of securities transactions over a blockchain.

Although registration as a transfer agent triggers certain regulatory requirements, merely acting as a transfer agent does not always require registration. Under section 17A(c)(1) of the Exchange Act, unless registered, a transfer agent may not engage in transfer agent activities with respect to securities registered under section 12 of the Exchange Act, or certain securities exempt from section 12 registration. Because most digital assets have not been registered under section 12, transfer agent registration may not be a current concern, although it may become one should firms in the future seek to register securities that will settle over a blockchain.

* * *

This Section has sought to explore the regulatory questions and potential hurdles for firms dealing in digital assets that are determined to be securities. The Howey test as applied to digital assets is still very much under development by the SEC and the courts, but it is evident at this early stage that the analysis is necessarily fact-specific and requires a close understanding of

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511 See also Concept Release: Transfer Agent Regulations, Exchange Act Release No. 76743 (Dec. 22, 2015) (“Section 17A(c)(1) of the Exchange Act requires any person performing any of these functions with respect to any security registered pursuant to Section 12 of the Exchange Act or with respect to any security which would be required to be registered except for the exemption contained in subsection (g)(2)(B) or (g)(2)(G) of Section 12 . . . to register.”).

512 In the case of Overstock’s registered preferred stock digital securities, ComputerShare Trust Company, a registered transfer agent, was used and, notwithstanding the blockchain aspects of the offering, the securities ultimately were “issued as book-entry digital securities directly registered in the stockholder’s name in the stockholder books and records maintained for us by Computershare.” Overstock.com, Prospectus Supplement to Prospectus dated Dec. 9, 2015, https://www.sec.gov/Archives/edgar/data/1130713/000104746916016691/a2230280z424b2.htm.
the underlying blockchain technology and the operations of the promoter at present and over time. This Section has outlined several issues facing intermediaries dealing in digital assets once a Howey analysis suggests the SEC is likely to view the asset as a security, including the often high and unexpected burdens associated with registration as a broker-dealer or national securities exchange. The federal securities laws no doubt will continue to evolve to account for the particular characteristics of this burgeoning industry. Until then, market participants must carefully try to assess how the traditional federal securities laws will be applied to the rapidly developing technology of digital assets.
SECTION 4. FEDERAL SECURITIES REGULATION: INVESTMENT COMPANY ACT AND INVESTMENT ADVISERS ACT*

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Introduction

If a digital asset is deemed to be a security, the regulatory regimes of the Investment Company Act of 1940 (ICA) and the Investment Advisers Act of 1940 (IAA), which regulate, respectively, the operations of securities investment funds and the provision of securities-related investment advice, also may apply. As more fully discussed in this Section, an investment company generally is (1) an issuer of securities that (2) meets certain tests involving investing, reinvesting, trading, owning, or holding (3) securities. Investment vehicles in the digital assets space, and their sponsors, therefore must consider the vehicle’s status as an investment company under the ICA, based on whether the vehicle will issue interests that are securities and invest in or hold interests that are securities, and the ICA issues triggered by investment company status. Investment companies, including investment companies that do not necessarily consider

* The authors of Section 4 wish to thank Patrick Green and Aliza Khan for their substantial contributions to this Section. The authors of the 2020 updates to Section 4 wish to thank Tanin T. Kazemi for her substantial contributions to this Section.
themselves to be in the digital assets space, also must consider ICA issues if they invest in or hold digital assets, or assets related to digital assets, whether or not those assets themselves are securities. This Section also addresses investment vehicles that are structured in a manner designed to avoid regulation under the ICA.

An investment adviser generally is a person that (1) provides advice, or issues reports or analyses regarding securities, (2) is in the business of providing such services, and (3) provides such services for compensation. The provision of advice, or the issuance of reports or analyses, regarding digital assets therefore can cause a person to be subject to regulation as an investment adviser under the IAA if the digital assets are securities and the business and compensation prongs of the investment adviser definition are met. IAA issues also can arise if a person otherwise meeting the definition of investment adviser provides advice regarding digital assets, even where those digital assets are not securities.

1. The Investment Company Act

   (a) Overview and Scope of Discussion

   While the SEC, market participants, industry commenters, and the courts have scrutinized the jurisdiction of the SEC over ICOs, tokens, and other digital assets under the Securities Act and the Exchange Act, there has been far less public dialogue on the status of these products or related participants under the ICA. For example, in the SEC’s cornerstone pronouncement on its jurisdiction in this area, the DAO Report, the SEC expressly determined not to conduct an investment company analysis under the ICA, and in the one subsequent case in which the SEC charged ICA violations, there is little discussion or analysis.\footnote{See DAO REPORT, supra note 87, at 1 n.1; Crypto Asset Mgmt., Securities Act Release No. 10544, Advisers Act Release No. 5004, Investment Company Act Release No. 33222, Admin. Proc. File No. 3-18740 (Sept. 11, 2018), https://www.sec.gov/litigation/admin/2018/33-10544.pdf [hereinafter Crypto Asset Order].} The SEC staff’s Framework for
“Investment Contract” Analysis of Digital Assets mentions the ICA only once, in a footnote referring to the definition of “security” in the various federal securities laws. Nonetheless, because investment company status, and the attendant regulatory consequences, could be functionally unworkable in the context of ICOs and other digital asset products, the application of the ICA in this area warrants the close attention of market participants.

At the same time, investment vehicles of all types have sought to enter the markets expressly for the purpose of providing investors with investment exposure to digital assets through digital asset funds. A number of such funds, for the most part structured as exchange-traded funds (ETFs), have sought to register as investment companies under the ICA, thereby implicating the Act’s regulatory consequences for digital asset funds. Other issuers, based on the nature of the digital assets they intend to invest in (e.g., direct investments in bitcoin or other non-security tokens), have sought registration only for their securities under the Securities Act and not fund registration under the ICA (these are referred to herein as “Securities Act-only” registrants).

Most of these Securities Act-only registrants also seek to trade their securities on exchanges (they are referred to as “exchange-traded products” or ETPs) and thus need additional

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The Strategic Hub for Innovation and Financial Technology, or FinHub, serves as a point of contact for external engagement with the SEC on FinTech-related issues, including distributed ledger technology and digital assets. See SEC, Strategic Hub for Innovation and Financial Technology (FinHub), https://www.sec.gov/finhub. The SEC staff encourages parties seeking to structure and sell a digital asset, or to engage in related activities, to contact the FinHub staff with any questions they may have to help ensure that such digital assets are structured, marketed, and operated in compliance with the federal securities laws. SEC FinHub Staff, SEC FinHub Staff Statement on OCC Interpretation (Sept. 21, 2020), https://www.sec.gov/news/public-statement/sec-finhub-statement-occ-interpretation.

515 As discussed below, a “Securities Act-only” registrant also will file reports under the Exchange Act. See infra note 612 and accompanying text.
approvals both from the SEC under the Exchange Act and from the relevant securities
exchange.\textsuperscript{516}

To date only one digital asset fund, a closed-end interval fund seeking to invest in cash-
settled bitcoin futures, has succeeded in registering under the ICA. In response to the first wave
of ICA registration filings by digital asset funds, the SEC staff raised threshold concerns about
the ability of funds that invest substantially in cryptocurrencies and related products to comply
with key investor protection provisions of the ICA, with a focus on issues raised by open-end
funds and ETFs. The staff explained these concerns in a letter and request for information
directed to investment company trade groups on January 18, 2018.\textsuperscript{517} At the request of the staff,
all ICA registration statements for digital asset funds that had been filed or were pending at that
time were withdrawn, and there was, in effect, a moratorium on ICA registration of digital asset
funds pending further study of these issues.

Subsequently, in December 2019, the SEC granted the effectiveness of the closed-end
interval fund registration statement referenced above, under both the ICA and the Securities
Act.\textsuperscript{518} In a public statement accompanying the launch of the interval fund, the SEC staff stated
that the fund had responded to each of the issues the staff had raised in its letter.\textsuperscript{519} It is

\textsuperscript{516} Technically, ETFs also fall within the general category of exchange-traded products, but in this Section we use
the term ETP specifically to refer to exchange-traded investment vehicles that are not regulated as investment
companies under the ICA.

\textsuperscript{517} See SEC Staff Letter from Dalia Blass, Dir., Div. Inv. Mgmt., SEC, to Paul Schott Stevens, President & CEO,
Inv. Co. Inst., & Timothy W. Cameron, Asset Mgmt. Grp. – Head, SIFMA (Jan. 18, 2018),
Cryptocurrency Funds Letter].

\textsuperscript{518} See Stone Ridge Trust VI: NYDIG Bitcoin Strategy Fund, Prospectus (Jan. 2, 2020),
https://www.sec.gov/Archives/edgar/data/1764894/000119312520000654/d832474d497.htm [hereinafter Stone
Ridge Prospectus].

\textsuperscript{519} Dalia Blass, Dir., Div. Inv. Mgmt., SEC, Keynote Address — 2019 ICI Securities Law Developments
noteworthy that interval funds, unlike open-end funds, do not offer daily redemption of their shares, and, unlike ETFs, their shares are not traded on an exchange. Instead, an interval fund provides liquidity to its shareholders by offering to repurchase a portion of its shares at periodic intervals.\(^{520}\) Accordingly, these funds inherently do not raise the concerns expressed by the staff to the same extent as the open-end fund and ETF filings submitted prior to the letter.

No Securities Act-only registration statements filed by ETPs have become effective. The ETPs have been unable to persuade the SEC that they meet the standards for exchange listing (which is required for the operation and sale of ETPs), and to date, the SEC has not approved the listing of any digital asset ETPs.\(^ {521}\) There are a small number of effective Securities Act-only registration statements for funds with significant investments in digital assets that trade only over-the-counter and therefore do not require exchange listing.\(^ {522}\)

Digital asset funds also may be structured and operated in a manner that avoids the need for either ICA or Securities Act registration. Funds can avoid investment company status, and thus the need for ICA registration, by investing directly in bitcoin or other digital assets that are not securities for ICA purposes. These funds can offer their shares in private offerings that are exempt from the Securities Act registration requirements. Funds that invest in securities but offer their shares only in private placements to qualified purchasers, or a limited number of accredited developments-conference [hereinafter Blass Speech]. The fund is the NYDIG Bitcoin Strategy Fund, a portfolio of Stone Ridge Trust VI, ticker symbol BTCNX.


\(^{521}\) See infra notes 614–618 and accompanying text.

investors, may be able to rely on the private fund exception from the ICA provided by section 3(c)(1) or 3(c)(7) of the ICA, as well as the Securities Act exemption.

This Section will identify and address a range of issues raised by digital products under the ICA, focusing primarily on two areas: (1) investment company status of ICOs and digital asset funds, and (2) regulatory implications of ICA registration for investment companies that invest in digital assets, and the related concerns raised by the SEC staff that have served as impediments to such registration.

While the purpose of this Section is to describe the application of the ICA to digital asset funds, the ICA also plays a significant role in determining how market participants structure digital asset funds that are not subject to the ICA.\textsuperscript{523} For this reason, we also include these non-ICA digital funds in our discussion. A chart summarizing the current status of possible ICA and non-ICA investment vehicles that might invest primarily in digital assets or related interests is attached as \textbf{Exhibit A} to this Section 4.

\textbf{(b) Overview of Regulatory Framework}

The ICA, which has been called “the most complex of the entire SEC series of securities laws,”\textsuperscript{524} was enacted in 1940 to combat widespread abuses identified in the formation and sale to the public of interests in collective investment vehicles, primarily conduct involving self-dealing, conflicts of interest, misappropriation of funds, overreaching, and misleading disclosure to investors on the part of the sponsors and promoters of these vehicles. As a consequence, unlike the Securities Act and Exchange Act that preceded it, the ICA is not primarily a disclosure

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\textsuperscript{523} One indication of the influence that the ICA has over non-ICA funds is that the registration statement (or private offering memorandum) for a non-ICA fund may include disclosure, often extensive, with respect to the possibility that the issuer could be considered an investment company and subject to regulation under the ICA. \textit{See infra} Section 4.1(b)(2).

\textsuperscript{524} \textsc{1 louis loss \& joel seligman, securities regulation} 263–64 (3d ed. 1989).
statute, but extensively regulates the conduct and operation of “investment companies,” as the term is defined under the Act, and their sponsors, service providers, first- and second-tier affiliates, and distributors. It has famously been described as “the most intrusive financial regulation known to man or beast.”

Enactment of the ICA reflected “a congressional recognition that substantive protections beyond the disclosure requirements of the [Securities Act] and the [Exchange Act] were needed because of the unique character of investment companies and their role in channeling savings into the national economy.”

(1) **Registration and Regulation Under the ICA**

Issuers that fall within the definition of “investment company” and offer their shares to the public must register as such with the SEC, in addition to registering their shares for sale under the Securities Act. The SEC has designed special “dual registration” forms for these companies. In keeping with the congressional goals described above, once registered, these companies are subject to a comprehensive federal regulatory framework that “places substantive restrictions on virtually every aspect of the operations of investment companies: their valuation of assets, their governance and structure, their issuance of debt and other senior securities, their

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527 Form N-1A is the registration statement form for open-end management investment companies, including mutual funds and most ETFs; Form N-2 is the registration statement form for closed-end management investment companies, including closed-end interval funds. *See* Form N-1A, https://www.sec.gov/files/formn-1a.pdf; Form N-2, https://www.sec.gov/files/formn-2.pdf.
investments, sales and redemptions of their shares, and, perhaps most importantly, their dealings with service providers and other affiliates.”

The ICA imposes different types of regulation depending on the type of registered investment company. Registered investment companies may be either open-end or closed-end investment companies. Open-end investment companies (such as mutual funds) must issue only “redeemable securities,” which are securities that are redeemable on request by shareholders, on a daily basis, for a proportionate amount of the shareholder’s investment based on net asset value per share (NAV). Shares of open-end funds are offered to the public (including to retail investors) on a continuous basis, and are sold on a principal basis from the issuer at NAV. Closed-end funds, by contrast, do not offer redeemable securities and typically are traded by investors on exchanges, at prices set by the market, rather than in continuous offerings at NAV. Open-end funds are subject to additional regulation relating to the issuer’s obligation to redeem shares at NAV.

ETFs generally are registered as open-end funds, but are traded by public investors on exchanges, at prices that are set by the market but designed to be aligned with NAV through an arbitrage mechanism. They operate pursuant to exemptions from a number of ICA provisions designed to adapt the requirements of the ICA to their operational structure, and also are subject to exchange listing requirements under the Exchange Act. The exchange proposing to list the ETF must apply to and obtain approval from the SEC under Rule 19b-4 for an exchange rule change that will permit the listing.

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Closed-end funds that are traded on exchanges are subject to additional regulation under the Exchange Act relating to the listing of their shares described above for ETFs. Interval funds generally do not trade on an exchange or over-the-counter, but instead provide liquidity to shareholders by offering at periodic intervals to repurchase a portion of their shares at NAV. Unlike other closed-end funds, interval funds are permitted to (and many interval funds do) continuously offer their shares at a price based on NAV.

Because of the significant regulatory consequences that follow from the characterization of an issuer as an investment company, there is an extensive and well-developed body of law surrounding the threshold “status” issue as to whether the issuer falls within the ICA definition of an “investment company.” In many situations, the regulatory consequences of investment company status will be prohibitive, and an affirmative answer to this threshold question would present potentially insurmountable hurdles. On the other hand, for issuers that can comply with the regulatory obligations and restrictions imposed by the ICA, registered investment company status offers many benefits in terms of market acceptance, access to continuous capital flows (for open-end funds and interval funds), and significant tax benefits.

An issuer can be characterized as an investment company under either of two scenarios:

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529 Given the stringent investor protection provisions of the ICA, in particular those that provide investors with daily liquidity at NAV, transparency (with respect to investment strategy, holdings, fees and expenses), safekeeping of assets, governance safeguards, and protections against overreaching by affiliates, mutual funds have become the investment of choice as a savings vehicle for U.S. investors of all types, including retail investors and a large segment of the investing public referred to by SEC Chairman Clayton as “Mr. and Mrs. 401(k).” See Jay Clayton, Chairman, SEC, Remarks at the Economic Club of New York (July 12, 2017), https://www.sec.gov/news/speech/remarks-economic-club-new-york [hereinafter Clayton Remarks]. As of 2019, assets in U.S. mutual funds were $21.3 trillion, compared to $4.3 trillion for assets in ETFs and $278 billion for assets in closed-end funds, including interval funds. See INV. CO. INST., 2020 INVESTMENT COMPANY FACT BOOK 56, 84, 105 (60th ed. 2020), https://www.ici.org/pdf/2020_factbook.pdf.

530 Investment companies that qualify as “regulated investment companies” or “RICs” under Sub-Chapter M of the Internal Revenue Code enjoy pass-through taxation, so that investors pay taxes on distributed income and gains, but the RIC itself does not pay federal income taxes. See 26 U.S.C. § 852.
(1) **Orthodox Investment Companies**—the issuer is engaged primarily in the business of investing in securities or holds itself out as such;\(^{531}\) or

(2) **Inadvertent Investment Companies**—the issuer meets a statistical investment test (*i.e.*, 40% or more of its assets are invested in investment securities).\(^{532}\)

The ICA provides an exception from the definition of investment company for issuers that fall within the “inadvertent” investment company definition, but are primarily engaged in an operating or other type of business. The ICA also provides exceptions to the definition of investment company for certain types of collective investment vehicles (*e.g.*, private funds and pension plans), in each case where the vehicle meets specific conditions.

### (2) Implications for ICOs and Digital Asset Funds

The regulatory scheme of the ICA, which was designed for investments in securities and other traditional assets, raises novel issues when applied to either (1) issuers of tokens or other digital assets, in ICOs or otherwise, which in most cases could not realistically function under such a regime, or (2) digital asset funds that fall within the definition and seek to register under the ICA. These will be discussed in more detail below, but it is helpful to keep the basic “digital asset” issues in mind while reading the description of the regulatory scheme.

**ICOs—Inadvertent Investment Company Status.** The DAO Report, and later pronouncements by the SEC and its staff, have clarified that the digital tokens issued in an ICO can be securities and the entity offering those tokens can be an issuer of securities. That issuer also could be an investment company if it holds instruments determined to be securities at levels

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\(^{532}\) Id. § (a)(1)(C), 15 U.S.C. § 80a-3(a)(1)(C).
breaching the “inadvertent investment company” test. This could happen, for example, if the issuer invested cash held pending use for various funding proposals.

**Digital Asset Funds—Compliance with ICA Investor Protections.** Sponsors of a number of digital asset funds have sought ICA registration and regulation, and are willing to be subject to the ICA’s regulatory regime. For reasons relating primarily to market acceptance, the initial approach taken was to seek to organize these funds as open-end rather than closed-end funds, primarily using the ETF structure. These registration efforts encountered SEC staff concerns about the “fit” of these funds and their holdings with the ICA’s investor protection provisions, especially those relating to valuation, liquidity, custody, the ETF arbitrage mechanism, and fraud and manipulation. As discussed in greater detail below, in early 2018, the SEC staff announced that it would not be appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products until these concerns could be addressed satisfactorily. While a number of digital asset funds have filed ICA registration statements and one digital asset fund has successfully registered under the ICA, it remains clear

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533 Characterization of an ICO issuer as an investment company would not be the first time a novel structure or enterprise found itself inadvertently caught in the ICA regime. See, e.g., Prudential Ins. Co. of Am. v. SEC, 326 F.2d 383 (3d Cir. 1964) (holding that an insurance company separate account funding variable annuity contracts sold to the public was an investment company under the ICA). In a more analogous scenario, high-tech startups have faced these issues based on high capital needs and low physical assets, and in some cases extremely profitable investment deployment of cash. See, e.g., Yahoo! Inc., Investment Company Act Release No. 24494, 2000 WL 870891 (June 13, 2000) [hereinafter Yahoo! Order] (granting an order exempting Yahoo from investment company status under ICA section 3(b)(2)). To give some indication of the potential stakes involved in these determinations, Yahoo was later sued by shareholders challenging the ICA exemption, although Yahoo prevailed, based on the Ninth Circuit Court of Appeals’ holding that the ICA does not establish a private right of action for challenging the continued validity of an ICA exemption. See UFCW Local 1500 Pension Fund v. Mayer, 895 F.3d 695 (9th Cir. 2018).

that funds seeking to invest substantially in digital assets are expected to address these issues before filing a registration statement and must be prepared to respond to all of these issues to the staff’s satisfaction. 535 Given that the one fund that has successfully registered under the ICA is a closed-end interval fund, it remains to be seen whether the staff’s concerns can be met by digital asset funds structured as ETFs or other types of open-end funds.

In addition, funds registered under the ICA that invest in digital assets to any extent, even where digital assets are not part of the fund’s primary strategy, will have to face the same issues, even though the overall impact will not be as significant. 536

(3) Investment Company Status—Digitized Product Issuers and Vehicles for Investment in Digitized Products

In general, an “investment company” under the ICA is an issuer that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. 537

In addition, the definition of an “investment company” includes any issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis. 538 However, an issuer that falls within this part of the

535 See infra Section 4.1(b)(5).
537 ICA § 3(a)(1)(A), 15 U.S.C. § 80a-3(a)(1)(A), defines “investment company” as any issuer which “is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.”
538 Id. § 3(a)(1)(C), 15 U.S.C. § 80a-3(a)(1)(C), defines “investment company” to include any issuer which “is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities,
definition is not an investment company if it is “primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.” The definition of “investment company” in the ICA thus applies both to intentional or “orthodox” investment companies, which ordinarily are marketed as securities investment vehicles, and to “inadvertent” investment companies, which are companies that are presumed to be investment companies because of the percentage of their assets invested in investment securities.

(i) The Issuer Requirement

As a preliminary matter, for a person to be an investment company, it must be an issuer—that is, a “person who issues or proposes to issue any security, or has outstanding any security which it has issued.” This definition is similar to the definition of “issuer” in the Securities Act, and is likely to be interpreted in a similar manner.

The term “person” includes all companies, and the term company in turn includes funds and all organized groups of persons, whether incorporated or not. As stated in the DAO

and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.”

539 Id. § 3(b)(1), 15 U.S.C. § 80a-3(b)(1).

540 The body of law interpreting ICA status issues is extensive and complex, and this White Paper necessarily provides only a basic introduction to these issues. For a full discussion of these issues, see ROBERT H. ROSENBLUM, INVESTMENT COMPANY DETERMINATION UNDER THE 1940 ACT: EXEMPTIONS AND EXCEPTIONS (2d ed. 2003); see also 1 THOMAS P. LEMKE, GERALD T. LINS & A. THOMAS SMITH III, REGULATION OF INVESTMENT COMPANIES § 3.02[1] (2018).


543 ICA § 2(a)(8), 15 U.S.C. § 80a-2(a)(8), which defines “company” as—
Report, the term “issuer” under the Securities Act is “broadly defined to include ‘every person who issues or proposes to issue any security,’” and “person” includes “any unincorporated organization;” the term is “flexibly construed in the Section 5 context ‘as issuers devise new ways to issue their securities and the definition of a security itself expands.’” 544

Thus, an “issuer” need not be an identifiable business entity. In the DAO Report, the SEC concluded that The DAO, an unincorporated organization, was an issuer of securities for purposes of section 5 of the Securities Act. Information about The DAO, according to the Report, was “crucial” to the DAO Token holders’ investment decision. The DAO was “responsible for the success or failure of the enterprise.” 545 Accordingly, The DAO was the entity about which the investors needed information material to their investment decision.

While (as explained below) the definition of “security” for some ICA purposes can be interpreted differently than under the Securities Act or Exchange Act, the term “issuer” for ICA purposes is likely to follow the reasoning in the DAO Report and authorities cited. Thus, in the ICO context, whether a person is an “issuer” under the ICA will depend primarily on whether the token or other instrument the person is offering investors is a “security” separate from the

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544 DAO REPORT, supra note 87, at 15–16 (citing Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 909 (5th Cir. 1977)); accord SEC v. Murphy, 626 F.2d 633, 644 (9th Cir. 1980) (“[W]hen a person [or entity] organizes or sponsors the organization of limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer . . . .”).

545 DAO REPORT, supra note 87, at 16 (citing Murphy, 626 F.2d at 643–44) (“Here there is no company issuing stock, but instead, a group of individuals investing funds in an enterprise for profit, and receiving in return an entitlement to a percentage of the proceeds of the enterprise.” (citation omitted)).
securities or other assets held by the person, and whether the information about that person is critical to the investors’ investment decision.\(^{546}\)

(ii) ICA Definition of Security

The definition of “security” in the ICA is largely the same as in the Securities Act and the Exchange Act.\(^{547}\) As a general matter, courts have analyzed the ICA definition similarly under those statutes.\(^{548}\) For a full discussion of the definition of “security” under the Securities Act and the Exchange Act, see Section 3.1 above.

The term “security” under the ICA, however, serves two distinct purposes. First, as discussed above, the term “security” is used to determine whether a person is an “issuer,” and for that purpose generally would follow the Securities Act interpretation. The second use of the term “security,” which is of broader significance for the investment company status issue, is to identify the types of investments that, when held by the issuer, count as “securities” under the definition of investment company.\(^{549}\) For that purpose, the SEC and its staff have long held that

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\(^{546}\) See *Lemke, Lins & Smith*, supra note 540.

\(^{547}\) 15 U.S.C. § 80a-2(a)(36). The full definition is as follows, with changes marked to show differences from the definition in Securities Act section 2(a)(1):

“Security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, (including a certificate of deposit), or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.


there are differences between the Securities Act and the Exchange Act definitions, on the one hand, and the ICA definition, on the other, and that the ICA definition can be broader.\(^{550}\) Thus, some instruments can be securities for purposes of the ICA even though they are not securities under the Securities Act or Exchange Act.\(^{551}\)

As a consequence, tokens and other instruments determined to be securities under the Securities Act and Exchange Act likely will be treated as securities under the ICA. In addition, in a close case, the SEC or the courts could determine that a particular digital asset is a security for purposes of determining whether a fund’s holdings trigger investment company status under the

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\(^{550}\) The classic examples of the distinction in the interpretation of the term “security” in the ICA relative to the Securities Act and Exchange Act relate to bank CDs and certain other types of debt instruments. The Supreme Court has held that CDs generally are not securities for purposes of the Securities Act and Exchange Act, and that the securities status of bank loans turns on the particular facts and circumstances. See Marine Bank v. Weaver, 455 U.S. 551 (1982), and Reves v. Ernst & Young, 494 U.S. 56 (1990), respectively. These decisions relied on the introductory language to the definition in each statute: “unless the context otherwise requires.” Nevertheless, the SEC has taken the position that CDs, promissory notes, and certain other evidence of indebtedness that the Supreme Court held not to be securities under the Securities Act and Exchange Act still could be securities for purposes of applying the definition of investment company under the ICA. While the definition texts may be the same, the regulatory purposes behind each statute—regulation of the management of a portfolio of securities rather than the issuance or trading of such securities—are different, and thus the “context” permits, and indeed may require, different interpretations. See, e.g., Brief for the United States as Amicus Curiae, Marine Bank v. Weaver, 455 U.S. 551 (1982) (No. 80-1562) (“The legislative history of that clause [‘unless the context otherwise requires’], and the decisions construing it, establish that courts are not bound by the literal terms of the statutory definition in all cases, and should not treat particular instruments as ‘securities’ if that would extend the federal securities laws to contexts not intended to be regulated by those laws . . . .” Since, among other things, “the exclusion of certificates of deposit from the definition of security in the Investment Company Act would seriously undermine the protections contemplated by Congress, the SEC believes that the relevant context requires that the term ‘security’ take on a ‘different coloration’ under the Investment Company Act.”); see also Bank of America Canada, SEC No-Action Letter (July 25, 1983) (stating that a determination that a note evidencing a commercial transaction is not a security under the Securities Act and the Exchange Act is, in the SEC staff’s view, not applicable in determining whether a person engaged in the business of investing in such notes is investing in “securities” in the context of a determination of whether the person is an investment company under the ICA).

\(^{551}\) Notably, however, it appears that this difference is a “one-way ratchet.” That is, while some instruments may be “in” as securities under the ICA while “out” under the Securities Act and the Exchange Act, we are aware of no instances where the reverse has been true (i.e., there do not appear to be any instances where instruments that are securities under the Securities Act and the Exchange Act have been determined to be “not securities” for purpose of the ICA).
ICA, without necessarily coming to the same conclusion under the Securities Act or Exchange Act (or even having come to a contrary conclusion). As an additional complication to the analysis (and putting aside the extent to which this view is grounded in the relevant case law), the view of SEC Director Hinman, described in Section 3.1, that the characterization of an instrument is not “static” and can change over time,\(^\text{552}\) could have implications for whether a token in its second “non-security” phase, when purchased by a collective investment vehicle, still could be considered a security for ICA status issues.

Orthodox Investment Companies. ICA section 3(a)(1)(A) defines the term investment company to include any issuer that (1) is engaged primarily in the business of investing, reinvesting, or trading in securities, (2) holds itself out as being so primarily engaged, or (3) proposes to engage primarily in that business.\(^\text{553}\) Such an issuer has been referred to as an “orthodox” investment company, and has been described as “a company that knows that it is an investment company and does not claim to be anything else.”\(^\text{554}\)

In determining whether the “engaged primarily” criterion is met, the SEC has looked to five principal factors, often referred to as the “Tonopah” factors, based on the SEC administrative proceeding in which they were first stated.\(^\text{555}\) The five Tonopah factors are: (1) the company’s historical development; (2) its public representations of policy; (3) the

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\(^{552}\) Hinman, supra note 54; see also Digital Asset Framework, supra note 285.


\(^{555}\) Tonopah Mining Co. of Nev., 26 S.E.C. 426 (1947). Although Tonopah was issued in the context of an application for an order declaring the applicant not to be an investment company, the SEC has stated that the same standards are applicable to other determinations of investment company status. See also Certain Prima Facie Investment Companies, Investment Company Act Release No. 10937, 44 Fed. Reg. 66,608, 66,610 n.24 (proposed Nov. 13, 1979) (to be codified at 17 C.F.R. pt. 270) [hereinafter Release IC-10937].
activities of its officers and directors; (4) the nature of its present assets; and (5) the sources of its present income. The last two factors are the most important and are weighed most heavily in the analysis. If an issuer invests in both securities and non-security assets, the SEC would consider of first importance the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss, rather than simply the percentage of its assets invested in securities.556

There are three entry points to investment company status based on the “engaged primarily” test—(1) actually being so engaged, (2) holding out as being so engaged, or (3) proposing to be so engaged—and there are cases and authorities interpreting all three. Because the last two (holding out and proposing) imply intent to be an investment company, they fall, to some extent, within the control of the issuer and its public statements. “Holding out,” in particular, is conceptually similar to estoppel—under ICA section 3(a)(1)(A), an issuer that holds itself out as an investment company will be held to that characterization, regardless of its actual holdings.557

For issuers that do not hold themselves out as or propose to be investment companies, whether the issuer is in fact engaged in the business of an investment company involves a facts and circumstances analysis of actual investments and activities. The issuer’s intent, or its descriptions of its intent, will not be determinative.

Inadvertent Investment Companies. ICA section 3(a)(1)(C) defines the term investment company also to include an issuer based on owning or holding securities, even if it is not


engaged primarily in the business of investing, reinvesting, or trading in securities. An issuer is presumed to be an investment company if it (1) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and (2) owns or proposes to acquire investment securities having a value exceeding 40% of the value of its total assets (exclusive of Government securities and cash items) on an unconsolidated basis.\textsuperscript{558} For this purpose, “investment securities” include all securities except (1) government securities, (2) securities issued by employees’ securities companies, and (3) securities issued by majority-owned subsidiaries which are operating companies (\textit{i.e.}, neither investment companies nor private investment companies).\textsuperscript{559}

There are two components of this test. First, the issuer must be engaged in, or propose to engage in, the business of investing, reinvesting, owning, holding, or trading in securities. Second, the issuer must meet the 40% ownership test. As a practical matter, the tests typically are merged in the analysis, and issuers that meet the 40% test generally are found to have met the “engaged in the business” test as well.\textsuperscript{560} Issuers that qualify as investment companies under ICA

\textsuperscript{558} 15 U.S.C. § 80a-3(a)(1)(C). When used in this title, “investment company” means any issuer which—

(C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

\textsuperscript{559} ICA §3(a)(2), 15 U.S.C. § 80a-3(a)(2). “As used in this section, ‘investment securities’ includes all securities except (A) Government securities, (B) securities issued by employees’ securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c) [the private investment company exceptions].”

\textsuperscript{560} Note that the ICA section 3(a)(1)(C) “engaged in the business” test is significantly broader than the “engaged primarily” test for ICA section 3(a)(1)(A), in two respects: (1) it does not require “primary” engagement, and (2) the business can include “owning” or “holding” securities, not only “investing, reinvesting, or trading.” As a result, ICA section 3(a)(1)(C) can sweep in companies that are more passively involved in securities holdings, without intending an investment company business.
section 3(a)(1)(C) are often called “inadvertent” investment companies because passive holdings can trigger investment company status. They also are referred to as “prima facie” investment companies because ICA section 3(a)(1)(C) creates a rebuttable presumption of investment company status for such issuers.

**Exceptions for Certain Inadvertent Investment Companies.** Notwithstanding the presumption of investment company status created by ICA section 3(a)(1)(C), ICA section 3(b)(1) provides that such an issuer is not an investment company if it is primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.\(^{561}\) This exception is self-executing and does not require an SEC order. Issuers (and in the case of a challenge, the SEC or the courts) determine whether they are primarily engaged in a business other than investing, owning, or trading in securities based on the *Tonopah* factors described above.\(^{562}\) This provision is designed primarily to exclude holding companies and companies that are essentially operating companies but have a substantial part of their assets in marketable securities.\(^{563}\) Although by its terms this exception applies only to inadvertent investment companies, the SEC staff has recognized that an issuer meeting this test also will not be an orthodox investment company.\(^{564}\)

A second exception, similar in purpose and analysis, is available if the SEC, upon application, finds and by order declares the issuer to be primarily engaged in a business or

\(^{561}\) 15 U.S.C. § 80a-3(b)(1); see also *Yahoo! Order, supra* note 533.

\(^{562}\) *Tonopah*, 26 S.E.C. 426.

\(^{563}\) See *LEMKE, LINS & SMITH, supra* note 540, § 3.05[1].

businesses other than that of investing, reinvesting, owning, holding, or trading in securities.\textsuperscript{565}

The filing of an application under this provision in good faith exempts the applicant for 60 days from all provisions of the ICA applicable to investment companies as such, and the SEC, for cause shown, may extend the period of exemption for an additional period or periods.\textsuperscript{566}

\textbf{Rule 3a-1—The 45% Asset and Income Test Exception.} To provide more certainty for companies that may fall into the “inadvertent investment company” category, SEC Rule 3a-1 excepts from investment company status under ICA section 3(a)(1)(C) those “prima facie” investment companies “whose asset composition and sources of income would provide conclusive evidence” that they are not investment companies for ICA section 3(a)(1)(C) purposes.\textsuperscript{567} Specifically, SEC Rule 3a-1 provides an exception from the ICA section 3(a)(1)(C) presumption if no more than 45% of the value of the issuer’s total assets (exclusive of government securities and cash items) consists of and no more than 45% of its net income after taxes (for the last four fiscal quarters combined) is derived from securities other than government securities (with certain other exclusions).\textsuperscript{568} These percentages are determined on an

\textsuperscript{565} ICA § 3(b)(2), 15 U.S.C. § 80a-3(b)(2), states:

\begin{quote}
Any issuer which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses. The filing of an application under this paragraph in good faith by an issuer other than a registered investment company shall exempt the applicant for a period of sixty days from all provisions of this title applicable to investment companies as such. For cause shown, the Commission by order may extend such period of exemption for an additional period or periods. Whenever the Commission, upon its own motion or upon application, finds that the circumstances which gave rise to the issuance of an order granting an application under this paragraph no longer exist, the Commission shall by order revoke such order.
\end{quote}

\textsuperscript{566} \textit{Id.}

\textsuperscript{567} Release IC-10937, \textit{supra} note 555, 44 Fed. Reg. at 66,611.

\textsuperscript{568} Other securities that are not counted for the tests are securities issued by employees’ securities companies, securities issued by majority-owned subsidiaries of the issuer (other than subsidiaries relying on the exclusion from the definition of investment company in ICA section 3(b)(3) or section 3(c)(1)), and securities issued by companies controlled primarily by such issuer, through which such issuer engages in a business other than that of investing,
unconsolidated basis, except that the issuer must consolidate any wholly-owned subsidiaries. In order to rely on SEC Rule 3a-1, the issuer must not be an orthodox investment company within the definition of ICA section 3(a)(1)(A).\(^{569}\)

In addition to providing certainty, Rule 3a-1 can have advantages over the statutory test in that it permits consolidation of wholly-owned subsidiaries and provides more flexibility on the asset component (45% as opposed to 40% in ICA section 3(a)(1)(C)). On the other hand, SEC Rule 3a-1 also imposes an income test, which is not required under ICA section 3(a)(1)(C), and may be a disadvantage for some issuers.

**Exception for Transient Investment Companies.** SEC Rule 3a-2 under the ICA provides an exception for “transient” investment companies, for a period not to exceed one year, that can be used for an issuer that intends to be in a non-investment business, but holds and invests in securities for a limited time either pending or after commencement of operations.\(^{570}\)

The rule provides that for purposes of either ICA section 3(a)(1)(A) or section 3(a)(1)(C) (that is, either orthodox or inadvertent investment companies), an issuer is deemed not to be engaged in the business of investing, reinvesting, owning, holding, or trading in securities during a period of time not to exceed one year, provided that the issuer has a bona fide intent to be engaged primarily, as soon as is reasonably possible and in any event by the termination of such period of time, in a business other than of investing, reinvesting, owning, holding, or trading in securities. That intent must be evidenced by both (1) the issuer’s business activities and

\(^{569}\) 17 C.F.R. § 270.3a-1(a)(1)–(4).

\(^{570}\) Id. § 270.3a-2.
appropriate corporate resolutions. The rule includes specific provisions regarding when the one-year time period commences based on the issuer’s investments. Significantly, the rule prohibits issuers from relying on this exception more frequently than once during any three-year period.

Exceptions for Certain Private Investment Companies. Certain types of collective investment vehicles that otherwise would fall within the ICA definition of investment company are expressly excepted from investment company status, and thus are not regulated as investment companies under the Act.571 For purposes of this White Paper, the most important exception category applies to private funds, which are issuers described in ICA section 3(c)(1) or section 3(c)(7). ICA section 3(c)(1) generally applies to any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and that is not making and does not presently propose to make a public offering of its securities. ICA section 3(c)(7) generally applies to any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition, are qualified purchasers, and that is not making and does not at that time propose to make a public offering of such securities.572 Both of these exceptions are designed for private offerings to institutional investors or sophisticated high net worth individuals, and not for offerings of securities to retail investors.

(4) Application to ICOs

In the DAO Report, the SEC determined that DAO Tokens were securities under the

571 Some of the main categories of excepted entities are private funds, banks, insurance companies, pension plans, and charitable foundations. See generally ICA § 3(c), 15 U.S.C. § 80a-3(c).

572 A “qualified purchaser” generally is defined as a natural person who owns not less than $5 million in investments, and any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis not less than $25 million in investments, as well as certain companies and trusts owned by such persons. ICA § 2(a)(51), 15 U.S.C. § 80a-2(a)(51).
Securities Act and the Exchange Act, but expressly declined to address whether The DAO was an investment company under the ICA. In a footnote at the beginning of the DAO Report, the SEC noted the absence of an ICA analysis, explaining that this was based, in part, on the fact that The DAO had never commenced its business operations funding projects. Nonetheless, the report cautioned users of virtual obligations that they themselves should consider their obligations under the ICA. The DAO Report also did not address the status of DAO Tokens as securities under the ICA definition of the term, which, as discussed above, serves two purposes under the ICA and, for purposes of determining the extent of a person’s holdings of securities when determining investment company status under the ICA, has been interpreted more broadly than the Securities Act and Exchange Act definition.

For purposes of determining whether a person is an issuer of securities, in most cases it is likely that the ICA analysis will follow the Securities Act and Exchange Act definitions of these terms. For example, since it has been determined that the DAO Tokens are securities, it could be expected that the entity issuing the Tokens would be considered an issuer of securities for ICA purposes as well.

The additional analysis (beyond issues resolved by the Securities Act and Exchange Act cases) for ICA implications is whether the issuer falls within the definition of investment company, either because it is, proposes to be, or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities (in which case it would be an “orthodox” investment company under ICA section 3(a)(1)(A)) or because its holdings of

[573 DAO REPORT, supra note 87, at 1 n.1:](DAO REPORT, supranote 87, at 1 n.1:)

This Report does not analyze the question whether The DAO was an “investment company,” as defined under Section 3(a) of the Investment Company Act of 1940 (“Investment Company Act”), in part, because The DAO never commenced its business operations funding projects. Those who would use virtual organizations should consider their obligations under the Investment Company Act.
securities exceed the 40% test (in which case the issuer would be an “inadvertent” investment company under ICA section 3(a)(1)(C), unless it is primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities). This determination will depend both on how the issuer’s business is described in the offering documents and the nature and extent of its actual holding and investments, including an analysis of whether specific digital assets should be considered securities under the potentially broader ICA definition.\textsuperscript{574} The nature of the holdings must be addressed both in terms of intended investments and investments that will be made during any start up or transitional period.

Investment company status issues relating to ICO issuers could focus on either the inadvertent or orthodox investment company definition. The need for an inadvertent investment company analysis could be triggered by the issuer’s holding, or planning to hold, assets pending investment in any projects or proposals contemplated by the ICO, in excess of the 40% test (unless the issuer can meet the 45% asset and income test under Rule 3a-1).\textsuperscript{575} An issuer also could be considered an orthodox investment company based on its investment-related intent, as indicated in its marketing materials.

While neither the SEC nor the courts have applied the ICA status issues specifically to ICOs, in situations raising these issues, we would expect issuers, the SEC, and the courts to refer to the statutory and rule provisions and the authorities that historically have provided the

\textsuperscript{574} Such an issuer nevertheless would not be an investment company if it is able to rely on one of the exceptions for private funds. It should be noted, however, that the private fund exceptions are not available to an issuer that is making, or presently proposing to make, a public offering of its securities, and thus may not be available to an ICO.

\textsuperscript{575} According to the DAO’s promotional materials, “[t]he DAO would earn profits by funding projects that would provide DAO Token holders a return on investment.” DAO REPORT, supra note 87, at 5–6. The business of funding projects never commenced, but it appears that the Commission’s reference to ICA issues was triggered by the possibility that the issuer’s funding operations could include investing, owning, holding, or trading securities.
framework for determining whether an issuer is an investment company under the ICA. As the Commission stated in the DAO Report with respect to the Securities Act and Exchange Act, the use of innovative technology in the capital markets does not remove conduct from the purview of the U.S. federal securities laws, and this should be equally true of the ICA.

(5) Application to Digital Asset Funds

Collective investment vehicles that invest in digital assets may or may not fall within the definition of investment company, depending on the nature of the digital assets and other proposed holdings, the sponsor’s promotional statements, and other factors. In some cases, where the characterization is not clear, entities may prefer to be characterized as investment companies for tax, marketing, or other reasons. Funds that seek exposure to digital assets through futures or other derivatives, for example a bitcoin futures ETF, typically involve substantial investments in government securities and cash equivalents to be used as collateral for the derivatives. By seeking such exposure in this manner, a fund may meet the definition of investment company under either or both of ICA sections 3(a)(1)(A) and 3(a)(1)(C). In that case, 

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576 These include, in addition to SEC v. Fifth Ave. Coach Lines, Inc. and Tonopah Mining Co. of Nev., see supra notes 554 and 555, SEC v. Nat’l Presto Indus., 486 F.3d 305 (7th Cir. 2007).

577 To give one other example of how there could be subjective elements in making this determination, the term “value” in the ICA, as defined in section 2(a)(41), has a complex definition that, in the case of securities or other assets without readily available market quotations, is based on “fair value” as determined by the company’s board of directors.

578 In theory, the SEC can refuse to permit ICA registration of companies that do not meet the definition, but has exercised this authority rarely and only in specific cases. For example, the Commission has declined to permit certain real estate companies to register under the ICA, when their asset mix clearly qualified them for the exception under ICA section 3(c)(5), and private investment companies that qualified under ICA section 3(c)(1) (or would have absent express efforts on the part of the issuer to appear to go beyond the 100 investor maximum). Generally, the SEC does not object to ICA registration of companies based on questions about failure to meet the intentional or inadvertent investment company definitions in ICA section 3(a)(1), in part because the issuer can, in effect, fit within the “intentional” definition by stating its intent to engage in the business of investing in securities. FRANKEL & SCHWING, supra note 557, § 5.02.
if the fund makes a public offering of its securities, it would be required to register as such and be regulated under the ICA.\textsuperscript{579}

By contrast, for a fund that seeks exposure to cryptocurrencies through direct investment in the cryptocurrency, investment company status would depend on whether the cryptocurrency itself is a security. For example, direct investments in bitcoin, by themselves, would not result in investment company status, because bitcoin is not considered a security. A fund investing directly in bitcoin that offers its shares to the public would be required to register the offering under the Securities Act, but not the ICA (a “Securities Act-only fund”).\textsuperscript{580} However, direct investments in DAO Tokens (or other tokens that are deemed to be securities) could trigger investment company status, depending on the extent of the holdings, the fund’s other holdings, and how the fund holds itself out.

In September of 2018, the SEC brought its first digital asset case charging violations of the ICA. This case, which was resolved by settlement, was based on findings (which the respondents neither admitted nor denied) that a fund formed for the purpose of investing in digital assets was an unregistered investment company under ICA section 3(a)(1)(C) (the inadvertent investment company definition).\textsuperscript{581} The SEC order stated that Crypto Asset Fund, LLC (“CAF”) engaged in the business of investing, holding, and trading certain digital assets

\textsuperscript{579} To describe in more detail the holdings of a bitcoin futures ETF seeking ICA registration, these funds, for tax purposes, generally propose a structure used by other ETFs that invest primarily in commodities. In order to meet the “good income” requirements of Sub-Chapter M of the Internal Revenue Code, the bitcoin futures (or, in some cases, short positions on bitcoin futures) would be held by a wholly-owned subsidiary domiciled in the Cayman Islands that would be treated as a disregarded entity for accounting purposes but not for tax purposes. The ETFs would have 100% nominal exposure to the bitcoin futures, but the value of the subsidiary’s assets would not exceed 25% of the total assets of the ETFs. The remaining 75% of the ETFs’ total assets would be invested in cash and cash equivalents, including registered money market funds.

\textsuperscript{580} See infra Section 4.1(d).

\textsuperscript{581} Crypto Asset Order, supra note 513.
that were investment securities (as defined in ICA section 3(a)(2)) having a value exceeding 40% of the value of CAF’s total assets (exclusive of government securities and cash items) and thus met the definition of investment company under ICA section 3(a)(1)(C), but did not register with the SEC as an investment company, meet any available exemptions or exclusions, or seek an SEC order under section 3(b) or otherwise request exemptions from any provisions of the ICA. The order stated that as a result of the conduct described, Crypto Asset Management, LP (“CAM”), CAF’s sponsor and manager, had caused CAF to violate ICA section 7(a), which prohibits an investment company not registered with the SEC from offering, selling, purchasing, or redeeming interests in the investment company. The order also charged that CAM violated Securities Act section 5(a) by offering interests in CAF for sale without registration under the Securities Act and in a manner that did not qualify as a private offering, or any other Securities Act registration exemption, and that CAM and its founder violated the anti-fraud provisions of both the Securities Act and, as further discussed in the next Section, the Investment Advisers Act of 1940 by making materially untrue statements in connection with the CAF offering.\footnote{The order states that the respondents, who had consulted counsel in launching CAF, immediately halted the offering when contacted by the SEC, took steps to determine the relevant facts, and made a rescission offer to investors, with accompanying disclosure regarding the previous misstatement. The order also states that beginning in January 2018, the respondents began offering securities pursuant to the Regulation D Rule 506(c) exemption from regulation, which permits general solicitation as long as the securities are sold only to accredited investors. The order does not specifically state whether these securities were securities issued by CAF, and if so, whether they were relying on the ICA section 3(c)(1) or (7) private fund exceptions. The case settled with a cease and desist agreement, a censure, and a civil money penalty of $200,000, to be paid in installments over the course of 10 months.}

The three SEC divisions most directly involved in regulating digital assets (the Divisions of Corporate Finance, Investment Management, and Trading and Markets) highlighted this proceeding in the SEC Digital Asset Statement, in a section captioned “Investment Vehicles Investing in Digital Asset Securities,” with the following admonition:

\begin{quote}
Investment vehicles that hold digital asset securities and those who advise others about investing in digital asset securities, including managers of investment
\end{quote}
vehicles, must be mindful of registration, regulatory and fiduciary obligations under the Investment Company Act and the Advisers Act.\textsuperscript{583}

The statement also referenced the dual role the term “security” serves for investment companies, noting that pooled investment vehicles not only invest in securities but also are themselves issuers of securities.

(c) Regulatory Implications of Investment Company Status

As discussed above, the ICA was enacted to protect investors in collective investment vehicles, including retail investors entrusting their savings to these vehicles, from the patterns of misconduct that had characterized the emergence and initial growth of the fund industry in the 1920s and 1930s.\textsuperscript{584} In accordance with these regulatory goals, investment companies are subject to comprehensive regulation under the ICA, including, among others, the following regulatory requirements:

- Registration with, and examinations by, the SEC;
- SEC enforcement authority against the investment company and its affiliates;
- Restrictions on payments for distribution;

\textsuperscript{583} See SEC Digital Asset Statement, supra note 549. The Statement highlights several recent SEC enforcement actions involving the intersection of longstanding applications of the federal securities laws and new technologies, and addresses a range of activities and securities laws requirements, including offers and sales of digital asset securities under the Securities Act and the Exchange Act, trading of digital asset securities under the Exchange Act, and broker-dealer regulation under the Exchange Act. The Statement describes the facts underlying the CAM proceeding as follows:

On Sept. 11, 2018, the Commission issued the Crypto Asset Management Order, finding that the manager of a hedge fund formed for the purpose of investing in digital assets had improperly failed to register the fund as an investment company. The order found that the manager engaged in an unlawful, unregistered, non-exempt, public offering of the fund. By investing more than 40 percent of the fund’s assets in digital asset securities and engaging in a public offering of interests in the fund, the manager caused the fund to operate unlawfully as an unregistered investment company. The order also found that the fund’s manager was an investment adviser, and that the manager had violated the anti-fraud provisions of the Investment Advisers Act of 1940 (“Advisers Act”) by making misleading statements to investors in the fund.

\textsuperscript{584} See PROTECTING INVESTORS, supra note 526.
• Restrictions on certain investments, particularly investments in other investment companies;

• Governance requirements (including independent director “watchdogs”);

• Restrictions on external investment advisers, including contract approval requirements, a requirement that the investment adviser be registered with the SEC, and potential shareholder suits for the adviser’s receipt of compensation in breach of the adviser’s fiduciary duty;

• Restrictions on transactions with affiliates;

• Requirements for the custody (safekeeping) of assets;

• Code of ethics requirements for insiders;

• Limitations on leverage and capital structure;

• Voting stock requirements;

• Public reporting requirements;

• Compliance program requirements; and

• Valuation of investments at market prices or “fair value.”

It is beyond the scope of this White Paper to provide a full description of the requirements imposed on registered investment companies under the ICA. However, a number of key provisions that would affect digital asset funds in particular are identified and explained in the discussion of the Staff Cryptocurrency Funds Letter, described below.

(1) **Open-End Management Investment Companies (Mutual Funds)**

Funds that register as open-end management companies (referred to as mutual funds) have additional obligations related to the requirement that investors must be able to redeem their shares daily at their proportionate amount of the fund’s NAV. This in turn requires funds to

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585 For a comprehensive discussion of ICA regulation, see LEMKE, LINS & SMITH, supra note 540.

586 “ ‘Open-end company’ means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer.” ICA § 5(a)(1), 15 U.S.C. § 80a-5(a)(1). “ ‘Management company’ means any investment company other than a face-amount certificate company or a unit investment trust.” ICA
value their securities daily (to price purchases and redemptions) and to maintain sufficient liquidity to meet redemptions without diluting the interests of remaining shareholders.\(^{587}\)

(2) **Exchange-Traded Investment Companies (ETFs)**

An ETF issues shares that can be bought or sold throughout the day in the secondary market at a market-determined price that, through the operation of an arbitrage mechanism, tends to track the shares’ NAV. ETFs are open-end funds that are similar in many respects to conventional mutual funds; most ETFs are organized as open-end management companies and ETFs pursue a wide variety of investment strategies. They issue and redeem shares on an ongoing basis, though only to large institutions known as authorized participants, usually on an in-kind basis (\*i.e.*, the authorized participant purchasing or redeeming shares contributes or receives primarily portfolio assets, rather than cash). Other investors purchase or sell ETF shares on an exchange. ETFs are subject to most of the same provisions of the 1940 Act as other open-end funds.

However, there are two key regulatory distinctions. First, because of their distinctive operational structure, ETFs need exemptions from some of the requirements of the ICA. The SEC has broad discretion to provide exemptions from any provisions of the ICA if it finds that the exemption is necessary or appropriate in the public interest and consistent with the protection

\(^{587}\) See 17 C.F.R. § 270.22c-1 (generally requiring that sales, redemptions, and repurchases of a redeemable security of a registered investment company be at a price based on the NAV next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security); see also Investment Company Liquidity Risk Management Programs, Securities Act Release No. 10233, Investment Company Act Release No. 32315, 81 Fed. Reg. 82,142 (Nov. 18, 2016) [hereinafter Rule 22e-4 Adopting Release] (adoption of SEC Rule 22e-4, requiring open-end funds (other than money market funds) and ETFs to adopt formal liquidity risk management programs).
of investors and the purposes fairly intended by the policy and provisions of the ICA.\textsuperscript{588}

Historically, ETFs obtained these exemptions through the exemptive order process. However, in 2019, the SEC adopted an exemptive rule, Rule 6c-11 under the ICA, which makes the necessary exemptions available without individual ETF orders, if all of the rule’s conditions are satisfied.\textsuperscript{589}

Second, because ETFs are traded on exchanges, they are subject to the exchanges’ listing standards and additional Exchange Act requirements that do not apply to traditional open-end funds. To be listed and traded on an exchange, an ETF must meet the exchange’s listing standards, which are set by the exchange’s rules. Historically, the rule changes necessary to list ETFs proposing investments in digital assets required SEC approval on a case-by-case basis, which would raise the same issues that to date have prevented successful exchange listing by digital asset ETPs. However, the SEC in 2020 approved generic listing standards, under which shares of ETFs that operate in reliance on Rule 6c-11 will be permitted to be listed and traded on an exchange without a prior SEC approval order or notice of effectiveness.\textsuperscript{590} Because, to date, the SEC has not permitted the registration statement of any digital asset ETF to become

\textsuperscript{588} ICA § 6(c), 15 U.S.C. § 80a-6(c).

\textsuperscript{589} 17 C.F.R. § 270.6c-11; see Exchange-Traded Funds, 84 Fed. Reg. 57,162 (Oct. 24, 2019) [hereinafter ETF Rule Release].

effective, it is not yet clear how the generic listing standards for Rule 6c-11 compliant ETFs would be applied in the case of a digital asset ETF.

A comprehensive discussion of ETFs is beyond the scope of this White Paper. However, the key features that distinguish ETFs from mutual funds and raise ICA issues are addressed in the Staff Cryptocurrency Funds Letter (most of the registration statements that were the subject of the Staff Cryptocurrency Funds Letter were ETFs).

(3) **Closed-End Funds and Interval Funds**

The ICA also applies to closed-end funds, which are registered investment companies that do not offer daily redeemability of shares. Typically closed-end funds are listed on an exchange or traded over-the-counter, and their market prices may vary, sometimes significantly, from NAV. Listed and over-the-counter closed-end funds generally issue shares only in an initial public offering and typically do not redeem their shares. The constraints on share issuances and redemptions make listed and over-the-counter closed-end funds a less attractive option for potential sponsors and shareholders of digital asset funds.

Closed-end interval funds, however, which are in the nature of a hybrid product, offer periodic liquidity in a manner similar to, although less frequent than, open-end fund liquidity, and thus may have more market appeal. Interval funds make periodic offers to repurchase a portion of their shares at NAV at intervals of three, six, or twelve months. They are allowed to offer their shares on a continuous or delayed basis, so an interval fund, like an open-end fund and in contrast to a listed closed-end fund, can issue additional shares to meet market demand. Typically interval funds are not listed on an exchange, so it is not necessary for an interval fund

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591 *See* ICA Rule 23c-3, 17 C.F.R. § 270.23c-3.

to meet listing requirements. As discussed below, the first digital asset fund to be a registered investment company is an interval fund.593

(4) ICA Registration Filings by Digital Asset Funds

i. Initial Group of Filings

As of the beginning of 2018, sponsors of 14 funds (most of them ETFs) intending to invest primarily in cryptocurrency derivatives and to register their shares for offer and sale to the public had filed registration statements on Form N-1A (the combined Securities Act and ICA registration form for funds seeking to register with the SEC as open-end investment companies or ETFs).594 Most of the funds sought to invest in bitcoin-related derivative instruments, primarily bitcoin futures, but also contemplated investments in pooled investment vehicles, options and swaps, and other instruments providing exposure to bitcoin. Only one of the funds, which was not one of the ETFs, sought more generally to invest in investments linked to digital coins. All of these registration statements were withdrawn as of January 10, 2018, in response to a request from the SEC’s Division of Investment Management, further described below.

ii. Regulatory Issues Under the ICA for Registered Cryptocurrency Funds—The Staff Cryptocurrency Funds Letter

Overview of Staff Letter. On January 18, 2018, Dalia Blass, the Director of the SEC’s Division of Investment Management, sent a letter to the heads of two major industry trade groups, the Investment Company Institute and the Asset Management Group of the Securities

593 See infra notes 608–609 and accompanying text.

594 These funds are to be distinguished from blockchain investment funds and other funds seeking exposure to blockchain technology, which are more similar to traditional equity funds investing in developers and users (e.g., retail companies that accept cryptocurrencies in lieu of fiat currency). These funds may raise other ICA-related issues, such as “names rule” issues (ICA Rule 35d-1(a)(2)(i), 17 C.F.R. § 270.35d-1(a)(2)(i), requires a fund whose name suggests a particular type of investment to invest 80% of its assets in that type of investment).
Industry Financial Markets Association, captioned “Engaging on Fund Innovation and Cryptocurrency-related Holdings,” in which the Division sought information and insight on a number of significant investor protection issues that the staff thought needed to be examined before sponsors begin offering these funds to retail investors.595

The letter focused on five issues raised under the ICA: (1) Valuation, (2) Liquidity, (3) Custody, (4) Arbitrage (for ETFs), and (5) Potential Manipulation and other Risks. The stated purpose of the letter was to facilitate the necessary dialogue, and it accordingly invited the two trade groups and any interested sponsors to engage with the SEC staff on the issues specified in the letter. The letter also stated that until the questions identified in the letter could be addressed satisfactorily, the staff did not believe that it would be appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products, and that it had asked sponsors that have registration statements filed for such products to withdraw them.596

*Context of the Staff Letter.* In addition to identifying the five regulatory issues, which are discussed in more detail below, the letter made a number of points describing the regulatory context in which the Division was addressing cryptocurrency-related holdings by registered funds at that time:

- **Importance of the U.S. fund market.** The U.S. investment fund market is one of the most robust, varied, and successful markets for investment products in the world, which is in significant part due to the commitment of fund sponsors to responsible innovation and product improvement. This commitment is especially important because of the reliance on registered funds by America’s Main Street investors for their education, retirement, and other investment goals.

595 Staff Cryptocurrency Funds Letter, *supra* note 517.

596 All of the relevant registration statements were withdrawn. For the current status of this suspension, *see* Current Status of the Staff Letter, below.
• **Challenges inherent in using the existing regulatory framework for these novel products.** The innovative nature of cryptocurrencies and related products, as well as their expected use and utility in our financial markets, means that they are, in many ways, unlike the types of investments that registered funds currently hold in substantial amounts.

• **Seriousness of questions raised.** The staff identified significant outstanding questions concerning how funds holding substantial amounts of cryptocurrencies and related products would satisfy the requirements of the 1940 Act and its rules.

• **Agency-wide nature of issues.** Resolution of the ICA issues also will be important to the ongoing analysis of filings for ETPs and related changes to exchange listing standards by the SEC’s Division of Corporation Finance, Division of Trading and Markets, and Office of the Chief Accountant; accounting, audit, and reporting implications under the Exchange Act; and registered offerings of Securities Act-only funds holding similar products and pursuing similar investment strategies. The Divisions and Offices throughout the Commission will be working closely together.

• **Other digital assets.** The letter stated that although it addressed issues arising from funds potentially focused on cryptocurrency-related products, other types of digital assets and related products could present similar issues.

**Specific ICA Concerns Raised.** The letter addressed the following regulatory issues under the ICA and related provisions within each of the five categories of concerns raised by the SEC:

• **Valuation.** Mutual funds and ETFs value their assets on each business day to strike NAV, which is the basis for pricing purchases and redemptions and also is used to measure fund performance. To calculate NAV, the fund must value portfolio assets using a bifurcated methodology set forth in section 2(a)(41) of the ICA, which is the definition of “value,” depending on whether or not the asset is a security for which market quotations are readily available. Securities for which market quotations are readily available are valued at market

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597 ICA Rule 22c-1(a), 17 C.F.R. § 270.22c-1, requires investment companies that issue redeemable securities to sell and redeem their shares at prices based on the current net asset value of those shares. Redeemable securities are defined in section 2(a)(32) of the ICA as any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof. 15 U.S.C. § 80a-2(a)(32).
value. Other securities and assets are valued at fair value as determined in good faith by the fund’s board of directors.\(^{598}\) Appropriate valuation, either based on market prices or a fair valuation process overseen by fund boards, is critical to investor protection.

The staff’s questions regarding valuation focused on how funds would value their assets, given the volatility, fragmentation, and general lack of regulation of underlying cryptocurrency markets and the “nascent state” and current trading volume in the cryptocurrency futures markets. In particular, the staff asked how funds would: (1) develop and implement procedures to value, including to “fair value,” cryptocurrency related products; (2) address “forks” and “air drops;” (3) take into account the impact on valuation of differences among types of cryptocurrencies; and (4) address the impact of market information and any potential manipulation in the underlying cryptocurrency markets on the determination of the settlement price of cryptocurrency futures.

- **Liquidity.** A key feature of open-end funds is daily redeemability, and funds must maintain sufficiently liquid assets to provide daily redemptions. SEC Rule 22e-4, which was adopted in 2016 with phased-in compliance starting on December 1, 2018, now requires open-end funds (other than money market funds), among other things, to classify their investments in four liquidity buckets: highly liquid investments, moderately liquid investments, less liquid investments, and illiquid investments, based on the number of days in which the fund reasonably expects the investment to be convertible into cash (or, in the case of the less liquid and illiquid categories, sold or disposed of) without the conversion significantly changing the market value.

of the investment.\footnote{See Rule 22e-4 Adopting Release, \textit{supra} note 587. Compliance with the classification requirement was required on June 1, 2019, for larger entities, and December 1, 2019, for smaller entities.} Rule 22e-4 also codifies longstanding limitations on a fund’s acquiring illiquid investments if the acquisition would result in the fund’s holding more than 15% of its net assets in assets that are illiquid investments, and it requires board and nonpublic SEC reporting if a fund’s investments in illiquid assets exceeds the 15% threshold.

Under SEC Rule 22e-4, the classification determinations must be made using a complex, multi-step methodology that takes into account, among other factors, market information (such as trading volumes and spreads) and “market depth.” Market depth is not a defined term, but refers to the requirement that a fund determine, and take into account for liquidity classification, whether trading varying portions of a position in a particular investment, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of that investment.

The letter asked, in light of the limited trading experience and market data for digital assets and the other issues mentioned for valuation, how these funds could ensure adequate liquidity and how they will classify their investments. The staff asked a number of questions related to specific requirements of SEC Rule 22e-4, including: (1) how funds would take into account the trading history, price volatility, and trading volume of cryptocurrency futures contracts; (2) whether funds would be able to conduct a meaningful market depth analysis in light of these factors; (3) whether, again for market depth analysis, funds would need to assume an unusually large potential daily redemption amount, given the fragmentation and volatility in the cryptocurrency markets; and (4) how funds would prepare for the possibility that funds investing in cryptocurrency-related futures could grow to represent a substantial portion of the
cryptocurrency-related futures markets, and the impact of such a development on the fund’s portfolio management and liquidity analysis.

- **Custody.** The 1940 Act imposes safeguards to ensure that registered funds maintain safe custody of their holdings, including use of a qualified custodian and verification of holdings.\(^{600}\) The staff asked how these requirements would be complied with for cryptocurrencies, noting that the staff was not aware of a custodian currently providing fund custodial services for cryptocurrencies.

The letter also noted that while the currently available bitcoin futures contracts are cash settled, it was the staff’s understanding that other derivatives related to cryptocurrencies may provide for physical settlement, and physically settled cryptocurrency futures contracts may be developed. Under these circumstances, the staff asked how a fund planning to hold cryptocurrency directly would: (1) satisfy the ICA custody requirements; (2) validate existence, exclusive ownership, and software functionality of private cryptocurrency keys and other ownership records; and (3) assess the impact of cybersecurity threats or the potential for hacks on digital wallets on the safekeeping of fund assets under the ICA. With respect to cryptocurrency-related derivatives that are physically settled, the staff asked under what circumstances the fund would have to hold cryptocurrency directly, and, if the fund may take delivery of cryptocurrencies in settlement, what plans it would have in place to provide for the custody of the cryptocurrency.

- **Arbitrage Mechanism (for ETFs).** ETFs obtain Commission orders that enable them to operate in a specialized structure that provides for both exchange trading of their shares

\(^{600}\) See ICA § 17(f), 15 U.S.C. § 80a-17(f), and the rules thereunder; see also infra Section 4.2(b)(4) (discussion of IAA custody requirements and developments).
throughout the day at market-based prices, and an arbitrage mechanism that involves purchases and redemptions by authorized participants of large blocks of shares priced at NAV. In order to promote fair treatment of investors, an ETF is expected to have a market price that would not deviate materially from the NAV. The staff asked: (1) how ETFs would comply with this term of their orders in light of the fragmentation, volatility, and trading volume of the cryptocurrency marketplace; (2) whether funds have engaged with market makers and authorized participants to understand the feasibility of the arbitrage mechanism for ETFs investing substantially in cryptocurrency and cryptocurrency-related products; (3) how volatility-based trading halts on a cryptocurrency futures market would impact this arbitrage mechanism; and (4) how the shutdown of a cryptocurrency exchange would affect the market price or arbitrage mechanism.  

- **Potential Manipulation and Other Risks.** Referring to a statement by SEC Chairman Jay Clayton, SEC orders denying exchange listing proposals for shares of trusts holding cryptocurrency, and a number of media reports, the letter notes that concerns have been raised that cryptocurrency markets, as they are currently operating, feature substantially less investor protection than traditional securities markets, with correspondingly greater opportunities for fraud and manipulation. While some funds may propose to hold cryptocurrency-related products, rather than cryptocurrencies, the pricing, volatility, and resiliency of these derivative markets generally would be expected to be strongly influenced by the underlying markets.

The staff asked: (1) how these concerns about fraud and manipulation inform views provided on the questions above (for example, on valuation and liquidity); (2) how these concerns should be weighed in offering funds to retail investors; (3) whether there have been

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Note that since most of the then pending ICA registration statements for cryptocurrency-related funds stated an intent to invest primarily in cash settled bitcoin futures, most of the custody concerns raised in the letter would not have been applicable.
discussions with broker-dealers as to how they would analyze the suitability of offering the funds to retail investors in light of these risks; and (4) what challenges investment advisers would face in meeting their fiduciary obligations when investing in cryptocurrency-related funds on behalf of retail investors.

**Market Participant Responses.** There have been eight letters filed in response to the Staff Cryptocurrency Funds Letter. For the most part, these letters urged that the issues raised by the Staff Letter could be adequately addressed within the existing regulatory framework, especially for registered funds that would invest in cryptocurrency within certain limitations.

Several of these responses were submitted by sponsors of funds proposing to invest in cryptocurrency-related assets that were seeking ICA registration, and addressed the issues raised in the Staff Letter with a view to persuading the staff that such registration would be appropriate. These included letters from: Reality Shares Advisors, the sponsor of the proposed Reality Shares Blockforce Global Currency Strategy ETF, which was designed to have limited (“non-substantial”) exposure to bitcoin futures (approximately 15% of the fund’s notional value, with the remainder in short duration sovereign bonds and/or cash equivalents); Cipher Technologies, the sponsor of a proposed bitcoin focused closed-end interval fund, which planned to invest substantially all of its assets in bitcoins, engage in loans of portfolio bitcoins, write covered calls on portfolio bitcoins, and use bitcoin futures contracts; and Van Eck Associates

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602 Letter from Reality Shares to Dalia Blass, Dir., Div. Inv. Mgmt., SEC (Apr. 9, 2019), https://www.sec.gov/divisions/investment/reality-shares-innovation-cryptocurrency.pdf. The adviser stated that “[a]t this point in time, we believe there is seemingly very little, if any, difference between a ’40 Act fund holding bitcoin futures and a fund holding other commodity-linked derivative contracts.” The letter offered the adviser’s research, experiences, and current operational control processes addressing each of the concerns raised in the Staff Letter (including valuation, liquidity, custody, arbitrage, and potential manipulation and other risks) and stated that most of these concerns were mitigated through the design of the Fund. The Fund withdrew its registration statement, at the request of the SEC staff, on February 12, 2019.

Corporation, the sponsor of the proposed VanEck Vectors Bitcoin Strategy ETF, a futures-based bitcoin ETF.  

Cboe Global Markets, described as a leading operator of securities exchanges for the trading of ETPs and the operator of the first U.S. futures exchange to offer a bitcoin futures product for trading, also filed a response to the Staff Letter. Cboe’s response focused on cryptocurrency ETPs and offered information and insights based on Cboe’s experience as an exchange operator for trading both ETPs generally and bitcoin-related ETPs in particular, as well as bitcoin futures themselves. Generally, Cboe urged that while cryptocurrency-related holdings raise a number of unique issues, such holdings do not require significant revision to the well-established framework for evaluation related to valuation, liquidity, custody, arbitrage, and manipulation. Rather, Cboe stated, “each Cryptocurrency Fund and underlying cryptocurrency-related holdings should be evaluated on a case by case basis in a manner very similar to previous

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604 Letter from Jan F. van Eck, President & CEO, VanEck Assoc. Corp. & Gabor Gurbacs, Dir. Digital Asset Strategy, VanEck Assoc. Corp., to Dalia Blass, Dir., Div. Inv. Mgmt., SEC (July 20, 2018), https://www.sec.gov/divisions/investment/vaneck-associates-innovation-cryptocurrency.pdf. Van Eck had filed a registration statement for the fund in 2017, which had been withdrawn at the staff’s request. The Van Eck letter stated that Van Eck remained interested in bringing a futures-based bitcoin ETF to market. In addition to providing a narrative discussion addressing each of the issues raised in the Staff Letter, Van Eck provided several appendices, setting forth graphs and other presentations of data captioned: Bitcoin Futures Trade Close to the Underlying; Bitcoin spreads; Bitcoin Futures Premium/Discount to Spot; Bitcoin Futures: CME and CBOE Comparison; Bitcoin trading is diversified; and Bitcoin ownership seems well distributed.

605 Letter from Chris Concannon, President and COO, Cboe, to Dalia Blass, Dir., Div. Inv. Mgmt., SEC (Mar. 23, 2018), https://www.sec.gov/divisions/investment/cboe-global-markets-innovation-cryptocurrency.pdf [hereinafter Cboe Letter]. The Cboe Letter stated that Cboe operates the first national securities exchange to submit a proposal to list and trade an ETP that would hold bitcoin, and that it subsequently submitted three proposals to list and trade ETPs that would hold bitcoin futures.
funds and their underlying holdings.”\textsuperscript{606} Cboe added that “this framework can be replicated for other cryptocurrencies as regulatory clarity emerges and the ecosystem continues to grow.”\textsuperscript{607}

Cboe’s letter addressed each issue raised by the staff in turn, and provided factual and historical information intended to support the view that the issues raised are similar to those encountered with respect to other ETPs and underlying assets and can be addressed in a similar manner. The information provided focused primarily on trading in bitcoin and bitcoin futures (for example, price discovery and liquidity in those markets), but parts of the letter referred to the potential applicability of the same principles to other cryptocurrencies as well.

\textbf{Current Status of the Staff Letter.} In a keynote address in December of 2019, Director Blass stated that the industry had taken the letter seriously, recognized that there were open questions, and responded with thoughtful and constructive input, and that the staff greatly appreciated the responses received.\textsuperscript{608} Nonetheless, none of the letters submitted by the sponsors described above, or otherwise included in the comment file for the Staff Letter, persuaded the staff that registration of the proposed fund was appropriate.

By contrast, in the keynote address, Director Blass announced that the engagement prompted by the Staff Letter had led to the satisfactory resolution of the issues with respect to another fund, the NYDIG Bitcoin Strategy Fund, a series of Stone Ridge Trust VI (“Stone Ridge Fund”), which was about to launch. Director Blass stated that the Stone Ridge Fund had responded to each of the issues identified in the Staff Letter. The Stone Ridge Fund is a closed-end interval fund with a bitcoin futures strategy, and it also invests in assets that are securities.

\textsuperscript{606} \textit{Id.} at 2.

\textsuperscript{607} \textit{Id.} at 4.

\textsuperscript{608} Blass Speech, \textit{supra} note 519.
The Stone Ridge Fund’s registration statement on Form N-2 was granted effectiveness by the staff on Dec. 2, 2019.609

Director Blass described how the Stone Ridge Fund’s structure and its disclosure in its registration statement had addressed the staff’s issues:

As a result of this engagement, we are at the point that a registered closed-end interval fund with a bitcoin futures strategy is preparing to launch. To reach this point, the fund first responded to each of the issues identified in the staff letter.

For example, on valuation, this fund expects to generally value its bitcoin futures holdings at daily settlement prices reflected on a CFTC-registered futures exchange, consistent with the principles of the Investment Company Act of 1940 and U.S. GAAP.

With respect to custody, the fund will invest in cash-settled futures and so will not face the challenges presented by direct holdings of digital assets.

Structured as a closed-end interval fund, the fund will not offer daily redemptions and will not be subject to potentially large, unexpected liquidity demands over short periods. And as an unlisted fund, its pricing will not depend on an efficient arbitrage mechanism and the willingness of market makers to make markets in a fund pursuing a digital asset strategy.

The fund also has taken steps to address issues related to potential manipulation in the digital asset markets. This includes prominent risk disclosures, offering the product only through registered investment advisers, and limiting the size and future growth of the fund, with an initial cap of $25 million.

Director Blass noted that the Staff Letter called for funds seeking to invest substantially in digital assets to grapple with the questions raised in the letter before filing a registration statement.

The Stone Ridge Fund registration and Director Blass’s speech indicates that the interval fund structure has a viability for registered funds in the digital asset space that, to date, has not been matched by other registered fund structures. Two additional points related to the concerns raised in the staff letter are noteworthy. First, the fund agreed to limitations on the size and future

609 See Stone Ridge Prospectus, supra note 518.
growth of the fund, with an initial capitalization of only $25 million, to address the staff’s manipulation concerns. Second, since the Stone Ridge Fund does not invest directly in digital assets, the SEC staff’s custody concerns remain an open issue.

(5) **Funds That Issue Digital Securities**

The ICA also applies to registered funds that issue fund shares as digital securities, even if they do not invest in digital securities. An initial example is the Arca U.S. Treasury Fund, an interval fund whose registration statement became effective in July 2020. This fund invests in U.S. Treasury securities and other types of investment grade fixed income instruments; it will not invest directly or indirectly in digital assets. The fund’s shares, which it calls “ArCoins,” can be transferred in peer-to-peer transactions on Ethereum. The fund’s prospectus includes disclosure of the risks of digital securities.  

(d) **Securities Act-Only (Non-ICA) Digital Asset Funds**

(1) **Overview**

Digital asset funds are not investment companies subject to the ICA if they do not invest in or hold securities and do not propose to invest in or hold themselves out as investing in securities. However, their offerings of their own securities remain subject to the registration requirements of the Securities Act, unless they qualify for an exemption from those requirements. Typically such funds file registration statements on Form S-1, the general Securities Act registration form for securities for which no other form is applicable. Funds that file registration statements under the Securities Act must also become reporting companies under...

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the Exchange Act and file annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, all of which are publicly available.612

Most of these funds are designed to seek exposure to bitcoin or other digital assets in a variety of ways, including direct investments in bitcoin, ether, or both, and investments in bitcoin futures. For example, the strategy of BTCS Inc., which filed a registration statement on Form S-1 that became effective in 2018, and whose shares are traded over the counter, is to provide investors with indirect ownership of digital assets that are not securities, such as bitcoin and ether, through the fund’s acquisition of such digital assets, and also to seek to acquire controlling interests in businesses in the blockchain industry.613

A number of Securities Act-only filings have been for companies that sought to become ETPs, sometimes referred to as commodity ETFs. This is a structure similar to ETFs, but without the registration and regulatory requirements of the ICA.614 However, like ETFs, an ETP must meet the exchange’s listing standards to be listed on an exchange. As novel products, ETPs can comply with exchange listing standards only with a change to the exchange’s listing rules, which requires the approval of the SEC. To give that approval, the SEC must find, among other things,


614 In the release accompanying the adoption of Rule 6c-11, the Commission noted that it had received 43 comment letters requesting that it approve an ETP with an investment objective that seeks results that correspond to the performance of bitcoins or other digital assets. ETF Rule Release, supra note 589, at 57,168 n.57. The Commission stated that Rule 6c-11 is based on existing relief for ETFs relating to the formation and operation of ETFs under the ICA and does not relate to specific strategies, citing the Staff Cryptocurrency Funds Letter. The release states that the Commission continues to welcome engagement with the public on issues related to cryptocurrency ETPs.
that the exchange’s rules are designed to prevent fraudulent and manipulative acts and practices and to protect investors and the public interest.615 The burden is on the exchange (which, at that point, becomes the ETP’s advocate) to demonstrate that this standard has been met.616

To date, no proposed digital asset ETPs have met this standard, despite many attempts to do so.617 The SEC has said that exchanges that list ETPs can meet this obligation by demonstrating that there is a comprehensive surveillance-sharing agreement with a regulated market of significant size relating to the underlying assets. The SEC also has indicated that if a listing exchange could establish that the underlying market inherently possesses a unique resistance to manipulation beyond the protections that are utilized by traditional commodity or securities markets, it would not necessarily need to enter into a surveillance-sharing agreement.

While the SEC believes that neither of these standards has been met to date, it recognizes that over time, bitcoin-related markets may develop in a way that would make it possible for a bitcoin ETP to satisfy the requirements of the Exchange Act.618


618 Self-Regulatory Organizations; NYSE Arca, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, To Amend NYSE Arca Rule 8.201-E (Commodity-Based Trust Shares) and To List and Trade Shares of the United States Bitcoin and Treasury Investment Trust Under NYSE Arca Rule 8.201-E, Exchange Act
(2) ICA Risk Disclosure

Reflecting the uncertainty of the ICA analysis with respect to digital assets, which turns substantially on the status of cryptocurrencies and related products as securities, a number of the Securities Act-only filings have included ICA risk disclosure. For example, BTCS Inc. includes the following risk disclosure in its prospectus:

**Because Digital Assets may be determined to be Digital Securities, we may inadvertently violate the 1940 Act and incur large losses as a result and potentially be required to register as an investment company or terminate operations.**

Digital Assets we may own in the future may be determined to be Digital Securities by the SEC or a court. If a Digital Asset we were to hold was later determined to be a Digital Security, we could inadvertently become an investment company, as defined by the 1940 Act, if the value of the Digital Securities we owned exceeded 40% of our assets excluding cash. We are subject to the following risks:

- Contrary to legal advice, the SEC or a court may conclude that bitcoin, ether, or other Digital Assets we later acquire to be securities;

- based on legal advice, we may acquire other Digital Assets which we have been advised are not securities but later are held to be securities;

- we may knowingly acquire Digital Assets that are securities and acquire minority investments in businesses which investments are securities; and

- regardless of the internal procedures we take to avoid surpassing the 40% threshold, future volatility during the course of a day may cause us to exceed the 40% threshold.

- If we exceed the test, we will have one-year to reduce our holdings of securities below the 40% threshold. However, that can only occur once during a three-year period. Accordingly, if changes in the classification of Digital Assets causes us to exceed the 40% threshold, we may experience large losses when we liquidate securities as a result of continued volatility. Further, if we elect to sell a private investment, not only may it be difficult to find a buyer but we could incur a significant loss on the sale of a private investment due to not only the lack of liquidity but also the entity’s poor performance. If we are able to come below the 40% threshold and again face the same problem, it is likely we will be forced to terminate operations, sell all assets and distribute cash to our shareholders who will likely suffer

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Release No. 88284, 85 Fed. Reg. 12,595 (Mar. 3, 2020). This is the most recent order refusing a digital assets ETP listing rule change.
very large losses. Further, the cost of distributing cash to our shareholder may exceed the amount of cash on hand in which case we would use our remaining funds to wind down the Company.\footnote{619}{BTCS Prospectus, supra note 522.}

The BTCS disclosure above comprises only a small part of the full ICA risk disclosure included in the amended BTCS registration statement. In fact, the full text of the ICA risk disclosure could serve as a primer on status and other issues raised for digital issuers by the ICA. Additional captions introducing such disclosures include:

If we acquire Digital Securities, even unintentionally, we may violate the Investment Company Act and incur potential third-party liabilities.

If we become an inadvertent investment company in violation of the 1940 Act, our failure to register under the 1940 Act will adversely affect us and you will likely lose your entire investment.

If regulatory changes or interpretations require the regulation of bitcoins and other Digital Assets (in contrast to Digital Securities) under the Securities Act and the Investment Company Act by the SEC, we may be required to register and comply with such regulations. To the extent that we decide to continue operations, the required registrations and regulatory compliance steps may result in extraordinary, non-recurring expenses to us. We may also decide to cease certain operations. This would likely have a material adverse effect on us and investors may lose their investment.\footnote{620}{Id.}

(e) Private and Exchange Act-Only Digital Asset Funds

As an alternative to Securities Act registration, some funds are exempt from the registration requirement because they offer their securities in private placements, typically made pursuant to Rule 506 of Regulation D under the Securities Act.\footnote{621}{17 C.F.R. § 230.506.} Issuers relying on Rule 506 typically limit their investors to accredited investors.\footnote{622}{See Crypto Asset Order, supra note 513 (including a finding that the fund in question did not meet the requirements of Rule 506 because it made a public offering through its website to individuals who were not verified.} These funds generally are able to avoid
ICA registration, either because they are private funds excluded from investment company status by section 3(c)(1) or section 3(c)(7) of the ICA or because they invest in bitcoin or other digital assets that are not securities. These funds also may be known as hedge funds if they have an active trading strategy, or as private equity funds if they do not. Although private funds’ documents generally are not publicly available, industry publications have reported on the existence of private funds that invest in digital assets.623

Notwithstanding a fund’s exemption from the requirement to register its shares under the Securities Act, a fund will be required to register under the Exchange Act if it is listed on a securities exchange or exceeds certain numerical thresholds.624 Companies registered under the Exchange Act are subject to a number of requirements, including the requirement to file annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K; the requirement to disseminate a proxy statement or information statement in connection with shareholder actions; and the requirement that insiders disclose their trading activities and holdings and, under certain circumstances, disgorge their trading profits. In a widely reported development, a privately offered fund that is excluded from investment company status because it invests in bitcoin voluntarily registered under the Exchange Act. Following this registration,

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624 See Exchange Act §§ 12(b), (g), 15 U.S.C. §§ 78l(b), (g). For an issuer that is not traded on an exchange, registration is required only after the issuer has total assets exceeding $10,000,000 and a class of equity security held of record by either 2,000 persons, or 500 persons who are not accredited investors.
the fund became a public company that files periodic reports with the SEC, and its shares trade in
the over-the-counter market.⁶²⁵

2. The Investment Advisers Act

The Investment Advisers Act of 1940 (Advisers Act or IAA) is the primary federal statute regulating persons who provide investment advice with respect to securities (“investment advisers”). Persons providing advice with respect to digital assets that are securities thus may be investment advisers, subject to regulation and possible SEC registration requirements under the Advisers Act or comparable provisions of state law, by virtue of that advice. In addition, some of the core regulatory obligations that the Advisers Act imposes on investment advisers, in particular the investment adviser’s fiduciary duty to its clients, apply with respect to the investment adviser/client relationship, and thus apply with respect to digital assets subject to the advisory relationship, even when the digital assets themselves are not securities.⁶²⁶ Accordingly, persons meeting the definition of investment adviser because of their securities advisory services, and that also provide advice with respect to non-security digital assets, will be subject to the Advisers Act fiduciary duty requirements with respect to these non-security digital assets as well. Finally, advice with respect to investment in vehicles that invest in digital assets, such as

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registered funds or private funds that hold cryptocurrencies or cryptocurrency derivatives, also may implicate the Advisers Act.

To date, the SEC has not comprehensively addressed the requirements of the IAA with respect to digital assets. The SEC has brought one cryptocurrency-related enforcement case under the Advisers Act, which was based on one of the anti-fraud provisions of the Act.\footnote{627 See Crypto Asset Order, supra note 513. The findings and violations charged in this case, which include charges related to the failure of a digital asset fund to register under the ICA and of violations of other provisions of the federal securities laws, are described in detail in the discussion accompanying notes 582–583. The Advisers Act provisions charged were IAA § 206(4), 15 U.S.C. § 80b-6(4), and IAA Rule 206(4)-8, 17 C.F.R. § 275.206(4)-8, which make it unlawful for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle. Rule 206(4)-8 is discussed in more detail below.}

In addition, pronouncements in this area point to the IAA as an area that needs to be considered by market participants involved in digital assets. In particular, the Digital Asset Statement admonishes that “those who advise others about investing in digital asset securities, including managers of investment vehicles, must be mindful of registration, regulatory and fiduciary obligations” under the Advisers Act, as well as the ICA.\footnote{628 SEC Digital Asset Statement, supra note 549; see also DAO REPORT, supra note 87, at 14 n.38 (stating that persons who would use organizations such as The DAO “should consider their obligations under the Advisers Act”); Staff Cryptocurrency Funds Letter, supra note 517 (asking if there are particular challenges investment advisers would face in meeting their fiduciary obligations when investing in cryptocurrency-related funds on behalf of retail investors); Clayton Remarks, supra note 529 (stating that market participants and their advisers should thoughtfully consider securities laws, regulations and guidance).} Also, two important messages from SEC statements and actions can serve as words to the wise for persons providing advice, directly or indirectly, about digital assets.

First, the general themes expressed in the actions and statements of the SEC, SEC Chairman Clayton, and other SEC officials and staff members have emphasized the need for investors in digital assets to understand the risks of investing and the potential for fraud and
abuse by market participants.\textsuperscript{629} These themes, and the resulting regulatory obligations, are of direct importance to persons that are deemed investment advisers under the IAA, as they have general fiduciary duties to their customers with respect to the advisory services they provide as well as obligations under express and specific disclosure and anti-fraud rules.

Second, with respect to the threshold jurisdictional question under the IAA—whether a person’s advice relates to securities—anyone providing advice with respect to digital assets should be familiar with the analysis and precedents that determine the securities status of a digital asset. As discussed in Sections 3.1 and 4.1, this analysis is complex and often without certainty, and thus market participants that provide advice with respect to digital assets should proceed with caution and ensure that they have given due consideration to their regulatory status.

(a) Investment Adviser Status

(1) Definition of “Investment Adviser” and “Security”

IAA section 202(a)(11) generally defines “investment adviser” to mean:

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

In construing this definition, the SEC applies a three-part test, under which status as an investment adviser depends on whether a person (1) provides advice, or issues reports or analyses, regarding securities; (2) is in the business of providing such services; and (3) provides such services for compensation.\textsuperscript{630} Providing advice encompasses a wide range of activities,


\textsuperscript{630} Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act
including advice on market trends, the value of investing in securities instead of other categories of assets, and selecting an investment adviser or manager. The SEC staff considers a person to be “in the business” of providing advice if the person (1) holds himself or herself out as an investment adviser or as one who provides investment advice, (2) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receives transaction-based compensation if the client implements the investment advice, or (3) on anything other than rare, isolated and non-periodic instances, provides specific investment advice. The compensation element is satisfied by the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the total services rendered, commissions, or some combination of the foregoing, whether paid by the person receiving advisory services or from some other source.

IAA section 202(a)(11) provides an exception from the definition of investment adviser for banks, bank holding companies, professionals such as lawyers, accountants, and teachers, publishers of bona fide financial publications, government securities advisers, and broker-dealers whose advisory services are solely incidental to their broker-dealer business and who receive no special compensation for making recommendations.


631 Id. at 6–7.
632 Id. at 7–9.
633 Id. at 9–10.
While the definition of “investment adviser” is worded broadly, it can apply only if a person provides advice, or issues reports or analyses, regarding securities. The IAA’s definition of “security” is identical to the definition under the ICA.\(^{635}\) Advice about types of assets that are not securities would not, by itself, bring a person within the IAA, but if a person’s advice about investing in non-securities also extends to investments in securities, even if only to a limited extent, the person may be deemed to be giving advice about securities under the IAA and thus fall within the definition of an investment adviser.\(^{636}\) In addition, advice about interests in entities that own or hold non-securities, such as funds or other vehicles that hold digital assets, generally would be considered giving advice about securities to the extent that these interests are themselves securities.\(^{637}\)

To date, the SEC has not addressed with specificity the application of the IAA definition of security to digital assets.\(^{638}\) However, both the DAO Report and the SEC Digital Asset Statement make clear that it is the responsibility of those who advise others about digital assets that may be characterized as securities to be mindful of registration, regulatory, and fiduciary obligations under the IAA.\(^{639}\)

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637 Id.

638 While not expressly stated in the Order, the SEC’s Advisers Act charge in the Crypto Asset Order presumes that the respondents were investment advisers subject to the Act, which is the predicate for their being subject to Rule 206(4)-8, a rule that applies only to persons falling within the Act’s definition of investment adviser. The Order states that the respondents controlled and directed the investment of the assets of an entity that was found to be an investment company.

639 DAO REPORT, supra note 87, at 14 n.38; SEC Digital Asset Statement, supra note 549.
The general standards for determining who is an investment adviser should be equally applicable to digital assets that are securities, or that involve securities, as they are to other types of securities or securities-related transactions. The more difficult issue is the determination of whether a particular digital asset is a security, which is complex and often uncertain. As described in Section 3.1 above, this determination depends on the application of the so-called Howey test, which has been the subject of volumes of commentary, court opinions, and SEC statements, both in general and in connection with the security status of digital assets. Under the Howey test, according to the SEC staff, the status of a digital asset as a security also can change over time and may depend on the circumstances surrounding its sale. Accordingly, this threshold issue is likely to pose a significant challenge for unsophisticated market participants and a trap for the unwary.

(2) Registration Requirement

(i) Investment Adviser Registration

A person falling within the definition of an investment adviser must register with the SEC under the IAA, unless an exemption applies. Exempt advisers include venture capital fund advisers, certain private fund advisers, and foreign private advisers who have no place of business within the United States. Of particular note is an exemption for certain advisers

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registered with the CFTC as commodity trading advisors whose business does not consist primarily of acting as an investment adviser.\textsuperscript{643}

In general, an investment adviser that does not advise an investment company and that has less than $100 million of assets under management (which includes non-securities in a portfolio consisting primarily of securities (a “securities portfolio”))\textsuperscript{644} must register at the state level rather than with the SEC,\textsuperscript{645} unless an exemption from the prohibition on SEC registration is available.\textsuperscript{646} States may not require persons that are registered with the SEC, or that are excepted from the definition of “investment adviser” in the IAA, to register with them as

\textsuperscript{643} IAA § 203(b)(6), 15 U.S.C. § 80b-3(b)(6). This provision states that the registration requirement of the IAA shall not apply to:

(A) any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser, as defined in section 202(a)(11) of this title, and that does not act as an investment adviser to—

(i) an investment company registered under [the ICA]; or

(ii) a company which has elected to be a business development company pursuant to section 54 of [the ICA] and has not withdrawn its election; or

(B) any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor and advises a private fund, provided that, if after the date of enactment of the Private Fund Investment Advisers Registration Act of 2010 [\textit{i.e.}, July 21, 2010], the business of the advisor should become predominately the provision of securities-related advice, then such adviser shall register with the Commission.

\textsuperscript{644} “An account is a securities portfolio if at least 50% of the total value of the account consists of securities. For purposes of this 50% test [securities include] . . . cash and cash equivalents (\textit{i.e.}, bank deposits, certificates of deposit, bankers acceptances, and similar bank instruments) . . . .” SEC, FORM ADV UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION, Instructions & Glossary 20, https://www.sec.gov/about/forms/formadv-instructions.pdf.

\textsuperscript{645} 15 U.S.C. § 80b-3(a). An investment adviser may but is not required to register with the SEC if it has assets under management of at least $100 million but less than $110 million, and it need not withdraw its registration unless it has less than $90 million of assets under management. 17 C.F.R. § 275.203A-1(a)(1).

\textsuperscript{646} See 17 C.F.R. § 275.203A-2 (exemptions from prohibition on registration with SEC).
investment advisers.\textsuperscript{647} Whether registering with the SEC or with one or more states, investment advisers register on SEC Form ADV.\textsuperscript{648}

(ii) Investment Adviser Representative Registration

There is no requirement for the supervised persons or other associated persons of an investment adviser to register with the SEC. However, the large majority of states do impose a registration and testing requirement on investment adviser representatives, and this includes the investment adviser representatives of SEC-registered investment advisers. A state can impose registration and qualification requirements on an investment adviser representative if the following requirements are met:\textsuperscript{649}

- The person is a supervised person (\textit{i.e.}, a partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser);\textsuperscript{650}

- The person has more than five clients who are natural persons, and more than ten percent of the person’s clients are natural persons, except in each case for qualified clients.\textsuperscript{651} For this purpose, a qualified client generally is a natural person or company that has at least $1 million under the investment adviser’s management or a net worth of more than $2.1 million (excluding a primary residence and certain indebtedness), or certain investment adviser personnel; and\textsuperscript{652}

\begin{footnotesize}
\textsuperscript{647} 15 U.S.C. § 80b-3a(b).
\textsuperscript{650} See \textit{id.} § 80b-2(a)(25) (defining “supervised person”).
\textsuperscript{651} See 17 C.F.R. § 275.203A-3(a) (defining “investment adviser representative”).
\end{footnotesize}
- The person has a place of business located within the state.\textsuperscript{653}

Most states require investment adviser representatives to register on the Form U4, Uniform Application for Securities Industry Registration or Transfer.\textsuperscript{654} In addition, most states require investment adviser representatives to successfully complete the Series 65, Uniform Investment Adviser Law Examination, or the Series 66, Uniform Combined State Law Examination.\textsuperscript{655}

(iii) Selection of Investment Advisers and Solicitation Arrangements

Investment advice includes the provision of advice on the selection of an investment adviser or manager.\textsuperscript{656} Thus, depending on whether a person who provides such advice is in the business of doing so and provides such services for compensation, investment adviser status may result.

The issue arises in, among other situations, the context of solicitation arrangements, which are subject to SEC regulation. Arrangements in which a registered investment adviser pays cash referral fees to a solicitor must comply with IAA Rule 206(4)-3. That rule generally requires that the solicitor not have been found to have violated certain statutes and rules, that the arrangement be documented in a written agreement to which the investment adviser is a party, and that certain disclosures be made to the persons solicited. IAA Rule 206(4)-3 applies to

\textsuperscript{653} See 17 C.F.R. § 275.203A-3(b) (defining “place of business”).


\textsuperscript{655} See Exams, http://www.nasaa.org/industry-resources/exams/.

\textsuperscript{656} See, e.g., Release IA-1092, supra note 630, at 7 & n.6; JMB Fin. Managers, SEC No-Action Letter, 1993 WL 343461 (June 23, 1993).
solicitations of any client on behalf of an investment adviser that pays cash referral fees and does not specifically indicate that the client must invest in securities. While no formal SEC statement flatly prohibits the payment of non-cash referral fees to solicitors, the SEC staff may question the propriety of such payments under the IAA, particularly absent full disclosure about the arrangement.657

A solicitor subject to IAA Rule 206(4)-3 is not required to register with the SEC as an investment adviser with respect to its solicitation activities.658 However, a third-party solicitor (i.e., a solicitor who is not a partner, officer, director, or employee of the adviser) will be subject to state qualification and registration requirements to the extent state investment adviser statutes apply to solicitors (which is the case in some states but not others); there is no preemption of state regulation for third-party solicitors.659

(b) Advisers Act Regulatory Requirements with Respect to Digital Assets

For conventional investment advisers, as well as for persons that are investment advisers only because they manage digital assets that are securities, the provision of advice with respect to digital assets raises a number of special issues. While many of these issues are similar or related to issues raised under the ICA and discussed in Section 4.1 of this White Paper and the Staff Cryptocurrency Funds Letter, such as valuation and custody, the Advisers Act imposes separate

657 LEMKE & LINS, supra note 636, § 2:189.


and independent obligations that can differ materially from those under the ICA and apply in different circumstances.

(1) Anti-Fraud Restrictions

IAA section 206 (prohibited transactions by investment advisers) makes it unlawful for any investment adviser to (1) employ any device, scheme, or artifice to defraud any client or prospective client, (2) engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client, (3) act as principal in certain transactions with a client without client consent, or (4) engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative. Notably, IAA section 206 applies to persons that meet the definition of investment adviser, regardless of whether they are registered or exempt from registration, and none of the prohibitions in section 206, other than section 206(1), require fraudulent intent or scienter on the part of the adviser.\(^{660}\) The SEC has adopted a number of rules under IAA section 206 that address specific matters raising anti-fraud and related concerns.\(^{661}\) Some of these rules apply only to SEC-registered investment advisers (or investment advisers that are required to be registered with the SEC), while others apply to exempt as well as registered investment advisers.

IAA section 206 is interpreted to give rise to a general fiduciary duty on the part of investment advisers, which is discussed below. As part of this fiduciary duty, as well as from the


\(^{661}\) For example, the IAA custody rule and compliance program rule, discussed below, are adopted under section 206.
specific provisions of and rules adopted under IAA section 206, investment advisers are subject to a number of general and specific disclosure obligations.

(i) **Conflicts of Interest Disclosure**

IAA section 206 requires investment advisers to make full and frank disclosure of material conflicts of interest to their clients and prospective clients, and a failure to do so is a violation of law, notwithstanding that the investment adviser may have had no intent to defraud its clients and notwithstanding that there may have been no resulting injury.\(^{662}\) IAA section 206 applies to all investment advisers, including those that are registered with the SEC, those that are registered at the state level and not with the SEC, and those that are exempt from any registration requirement.

The anti-fraud provisions of IAA section 206 apply whenever the relevant conduct arises from an investment advisory relationship, whether or not the conduct involves securities.\(^{663}\) Thus, investment advice with respect to non-security digital assets is subject to the same duty to make full and frank disclosure that applies to investment advice with respect to securities. In other words, an investment adviser, *without being asked*, must disclose conflicts of interest to prospective clients before they accept offers of services and to existing clients before they receive recommendations, and must disclose conflicts of interest that arise during the relationship.\(^{664}\)


\(^{664}\) *See Frankel & Schwing, supra* note 557, § 11.01.
(ii) Material Misrepresentations by Investment Advisers to Pooled Investment Vehicles

IAA Rule 206(4)-8 specifically makes it unlawful for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle.665 This is the IAA rule that the SEC invoked in the Crypto Asset Order, which to date is the sole digital asset enforcement case brought under the IAA. In that case, the SEC charged that the respondents, CAM and its founder, violated IAA Rule 206(4)-8 by negligently misrepresenting to actual and prospective investors in CAF, a fund managed by CAM, in certain marketing materials that CAF was the “first regulated crypto asset fund in the United States” and that it had filed a registration statement with the SEC. The order states that the respondents had failed to take reasonable steps to ensure the accuracy of these statements before disseminating them to actual and potential investors. The conduct described was found to have violated IAA Rule 206(4)-8, even though the conduct was only characterized as “negligent,” and the order notes remedial efforts immediately undertaken by the respondents when contacted by the SEC staff.666

(iii) Disclosure of Risks of Investing in Digital Assets

IAA Rule 206(4)-1(a)(5) states that it is a fraudulent practice for a registered investment adviser to publish or distribute any advertisement (broadly defined as a written communication to more than one person) that “contains any untrue statement of a material fact, or which is


666 Crypto Asset Order, supra note 513.
otherwise false or misleading.” This prohibition is broad enough to encompass communications that are misleading by omission of statements, including omissions of disclosures of material risks, that are needed in order to make the statements made not misleading.

In this regard, SEC statements about digital asset fraud in other areas are likely to be relevant. Of particular concern to the SEC is whether investors understand the risks of investing, including the risk of loss and the lack of regulation of digital asset markets. For example, SEC Chairman Clayton expressed this concern in a February 2018 statement to the Senate:

Before discussing regulation in more detail, I would like to reiterate my message to Main Street investors from a statement I issued in December. Cryptocurrencies, ICOs and related products and technologies have captured the popular imagination—and billions of hard-earned dollars—of American investors from all walks of life. In dealing with these issues, my key consideration—as it is for all issues that come before the Commission—is to serve the long term interests of our Main Street investors. My efforts—and the tireless efforts of the SEC staff—have been driven by various factors, but most significantly by the concern that too many Main Street investors do not understand all the material facts and risks involved. Unfortunately, it is clear that some have taken advantage of this lack of understanding and have sought to prey on investors’ excitement about the quick rise in cryptocurrency and ICO prices.667

While the SEC has not applied these specific concerns to investment advisers, the NFA, the self-regulatory organization for commodity interest market participants (including commodity trading advisors and commodity pool operators), has issued a detailed notice to its members spelling out both standardized and non-standardized disclosures that commodity trading advisers and commodity pool operators should provide investors in their marketing materials.668 The NFA’s notice may provide an indication of the types of risks that regulators may consider relevant.

667 Chairman Clayton Statement, supra note 291, at 37–38 (footnote omitted).

Finally, Form ADV, the registration statement form for registered investment advisers that must be filed with an initial registration and updated at least annually, requires an adviser to describe its investment strategies and the related risks. Note that the disclosure requirements in Form ADV are not strictly anti-fraud provisions, and thus the standard for demonstrating inadequacy in ADV disclosure is likely to be lower than the standard for demonstrating an omission under the anti-fraud provisions of the IAA and Rule 206(4)-1.

(2) Fiduciary Obligations of Investment Advisers

The IAA establishes federal fiduciary standards to govern the conduct of investment advisers. While historically the precise parameters of these fiduciary standards have not always been clear, the SEC has now collected, affirmed, and in some cases clarified certain aspects of the IAA fiduciary duty in the Standard of Conduct Interpretation. As stated in the Interpretation, an investment adviser’s fiduciary duty comprises a duty of care and a duty of loyalty, and it requires an investment adviser, at all times, to serve the best interest of its clients and not subordinate its clients’ interest to its own. These standards are made enforceable by the anti-fraud provisions of section 206.

The fiduciary duty that arises from an investment advisory relationship is not limited to securities transactions. Thus, investment advisers owe the same fiduciary duty to their clients

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671 See Standard of Conduct Interpretation, supra note 626.

672 Id. at 33,671.

673 Id.

674 Release IA-4197, supra note 663, at 23.
with respect to digital assets, including non-security digital assets, that they owe with respect to other investment transactions. The fiduciary duty extends to all persons who are investment advisers within the meaning of the IAA definition, not just those registered or required to be registered with the SEC.

In connection with the fiduciary duty arising under the IAA, advice with respect to digital assets would raise the due diligence and risk disclosure concerns highlighted by SEC Chairman Clayton and others. Chairman Clayton has highlighted the types of questions an investor should ask in order to understand the risks of a digital asset investment.\textsuperscript{675} It seems likely that the SEC would expect a fiduciary advising on an investment to know the answers to these questions before recommending an investment. For example, in one recent enforcement case, the SEC alleged that the offering documents for an ICO included fraudulent statements.\textsuperscript{676} One issue that may be raised with respect to investment advisers is the level of their responsibility for detecting such fraudulent statements, or at least circumstances that may raise red flags that expose their customers to risk (or are viewed as red flags in retrospect when a fraud is uncovered).

Also among the duties imposed by the fiduciary duty of care is the obligation of an investment adviser to seek “best execution” of a client’s transactions if it is responsible for arranging execution of those transactions (typically in the case of discretionary accounts). In meeting this obligation, an investment adviser must seek to obtain the execution of transactions for each of its clients such that the client’s total cost or proceeds in each transaction are the most favorable under the circumstances, and the investment adviser should periodically and


systematically evaluate the execution it is receiving for clients.\textsuperscript{677} To date, there is no developed body of law with respect to best execution of transactions in digital assets.

\textbf{(3) Code of Ethics Reporting}

IAA Rule 204A-1 requires registered investment advisers to establish, maintain, and enforce a written code of ethics.\textsuperscript{678} This includes a provision to require all access persons to report periodically their personal securities transactions and holdings, including securities in which the access person has any direct or indirect beneficial ownership.\textsuperscript{679} Access persons are required to provide the chief compliance officer information about their quarterly securities transactions, including information about the broker, dealer, or bank through which the transaction was effected, and they are required to submit reports of their securities holdings at least annually. Access persons also are required to get pre-approval before directly or indirectly acquiring beneficial ownership in any security in an initial public offering or in a limited offering (\textit{i.e.}, an offering that is exempt from registration under certain provisions of the Securities Act of 1933).

The code of ethics rule applies to transactions in and holdings of securities.\textsuperscript{680} Thus, it appears that registered investment advisers currently have an obligation to require their access persons to report their holdings of and transactions in digital assets that are securities, even if the

\textsuperscript{677} Standard of Conduct Interpretation, \textit{supra} note 626.

\textsuperscript{678} 17 C.F.R. § 275.204A-1(a).

\textsuperscript{679} Access persons are any of the investment adviser’s supervised persons (1) who have access to nonpublic information regarding any clients’ purchases or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable funds; or (2) who are involved in making securities recommendations to clients, or who have access to such recommendations that are nonpublic. \textit{Id.} § 275.204A-1(b)(2)(e).

investment adviser is not otherwise involved with digital assets. Digital assets present unique challenges for investment advisers’ obligations under the code of ethics rule. For example, individual investors historically have rarely traded digital assets through banks or registered broker-dealers, so the IAA Rule 204A-1 reporting requirements do not mesh well with digital assets. Investment advisers will face a compliance challenge to ensure that personal trades of access persons do not affect the price of digital assets that are securities, and that they do not profit improperly by front-running client trades in digital assets that are securities. Currently, practices vary with respect to which codes of ethics have been updated to take digital assets into account.

(4) Custody

IAA Rule 206(4)-2 establishes requirements for registered investment advisers that have custody over their clients’ funds or securities. An investment adviser is deemed to have custody if it or a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. Such funds and securities must be maintained by a qualified custodian, i.e., a federally insured bank or savings association, a registered broker-dealer, a registered futures commission merchant (with respect to client funds and security futures), or a foreign financial institution that customarily holds financial assets for its customers.

681 Id.


683 17 C.F.R. § 275.206(4)-2. The IAA custody requirements differ from those applicable to registered funds under the ICA, which have been raised by the SEC staff in connection with registration of funds investing substantially in digital assets. Such ICA custody requirements are discussed in Section 4.1(c)(4)(ii) of this White Paper. However, many of the same regulatory goals and practical issues relating to custody of digital assets apply to both the ICA and IAA.
The qualified custodian must send an account statement at least quarterly to each client, and client funds and securities must be verified at least annually by an independent public accountant.

Digital assets are subject to the custody rule if they are either “funds” or “securities” and if the registered investment adviser has any authority to obtain possession of them (e.g., as a consequence of discretionary trading authority). The custody rule presents particular challenges for investment advisers that trade in digital assets. First, there are as yet only a small number of custodians that represent that they are qualified custodians for digital assets, although the number appears to be growing and the Office of the Comptroller of the Currency in July 2020 concluded that national banks and federal savings associations, which it regulates, may provide cryptocurrency custody services on behalf of customers.684 Second, holding the digital asset—as opposed to cash-settled futures, for instance—presents practical difficulties in connection with custody. Ownership of a digital asset is reflected in a string of numbers on a distributed ledger, accessible only by a public key and a private key, much the same way access to a safe deposit box is accessible by the bank’s key and the depositor’s key.685 The digital asset is at risk of loss from hackers or other thieves who gain access to the private key, or if the storage medium malfunctions or is otherwise compromised.686 Third, it has been challenging at times for


686 One commenter on the Custody Letter, discussed below, suggested that a best practice for a custodian is to split access to the relevant private key, with each part held in multiple physical or digital locations (so as to mitigate the risk of loss) but no two parts held in the same location (so as to mitigate the risk of theft). Letter from Ruby G.
独立的公众会计师用于验证私钥和其他所有权记录的存在性和唯一所有权。

2019年3月，SEC的投资管理部向投资顾问协会发送了一封信，寻求行业和公众对托管规则在数字资产方面的应用的评论，其中包括但不限于数字资产的特征（“托管信”）。688 该托管信是由投资管理部的观察到的数字资产市场迅速增长以及部分投资顾问开始为客户提供数字资产投资而受到启发。该信指出，在这种创新背景下，投资管理部与SEC的FinHub办公室一起，与投资顾问、经纪交易商、服务提供商、市场观察者、学者和其他人进行了接触，以了解与数字资产相关的合规问题，包括遵守托管规则。

托管信识别了数字资产的以下特征作为托管规则下需要考虑的示例：(1) 使用分布式账本技术（DLT）来记录所有权；(2) 使用公开和私有密钥对来转移数字资产；(3) 区块链的“不可变性”；(4) 恢复或恢复丢失的数字资产的不可恢复性；(5) DLT交易的匿名性；以及(6) 审计员在审查DLT和数字资产所面临的挑战。


687 See Staff Cryptocurrency Funds Letter, supra note 517 (raising this issue).

The Custody Letter sought public input to inform the staff’s consideration of how the characteristics of digital assets impact the application of the custody rule with respect to the following matters:

- The challenges investment advisers face in complying with the custody rule with respect to digital assets and considerations the staff should evaluate when considering any amendments to the rule (for example, disclosures or records other than account statements that would similarly address the investor protection concerns underlying the rule’s account statement delivery requirement);

- The extent to which investment advisers are construing digital assets as “funds,” “securities,” or neither, for purposes of the custody rule, and the considerations used to reach this conclusion;

- The use by investment advisers of state chartered trust companies or foreign financial institutions to custody digital assets, and their experience of similarities/differences in custodial practices of such trust companies as compared to those of banks/broker-dealers;

- The role played (or that should be played) by internal control reports, such as System and Organization Controls (SOC) 1 and SOC 2 reports (Type 1 and 2) in an adviser’s evaluation of potential digital asset custodians:

- How concerns about misappropriation of digital assets should be addressed, the most effective ways to leverage technology for this purpose, and how client losses due to misappropriation of digital assets can be remedied most effectively;

- The settlement process for both peer-to-peer digital asset transactions (where there is no intermediary) and intermediated transactions (such as those on trading platforms or on over-the-counter markets) and the risks of each; and

- Concerns generally about the use of DLT with respect to custody and recordkeeping.\(^689\)

Subsequently, the Wyoming Division of Banking in October 2020 issued a no-action letter on the status of state-chartered trust companies as qualified custodians under the SEC’s

\(^{689}\) As additional matters, not strictly related to custody of digital assets, the staff asked about (1) the extent to which investment advisers construe digital assets as securities for purposes of the investment adviser definition, (2) the extent to which investment advisers include digital assets in calculating regulatory assets under management for purposes of meeting SEC registration thresholds for registering with the Commission, and the considerations included within this analysis, and (3) the extent to which DLT could be used more broadly to evidence ownership of securities other than digital asset securities.
custody rule. The letter determined that, on the facts of the letter, a Wyoming-chartered public 
trust company is permitted to provide custodial services for both digital and traditional assets 
under Wyoming law and that the Division would not pursue enforcement action against the trust 
company if it held itself out to the public as a qualified custodian under Rule 206(4)-2. The 
letter noted that it should not be construed to represent the views of the SEC or any other 
regulatory agency. Following the issuance of the letter, the SEC staff issued a statement noting 
that it is not bound by statements or views expressed by state regulators and encouraging 
interested persons to engage with the SEC staff directly on the application of Rule 206(4)-2 to 
digital assets, including with respect to the definition of “qualified custodian” under the rule. The 
statement also expressed interest in receiving public comments on the topic of qualified 
custodians under Rule 206(4)-2, with a particular focus on state-chartered trust companies. 

With respect to custody by broker-dealers, the SEC’s Division of Trading and Markets 
and the staff of FINRA have jointly issued staff guidance on the custody of digital asset 
securities under the rules applicable to broker-dealers. While the joint staff statement did not 
address Rule 206(4)-2, broker-dealers are qualified custodians under that rule, and a registered 
investment adviser that is a broker-dealer with custody, or that uses a broker-dealer custodian, 
would need to take the joint staff statement into account.


(5) Valuation

The IAA does not impose a valuation requirement, per se, but proper valuation of assets under management is critical to many key aspects of an investment adviser’s obligations, including assessment of asset-based fees, calculation and reporting of performance, and disclosure of risks. With respect to digital assets, valuation raises challenges based on the nascent state of the trading markets, and issues relating to volatility, fragmentation, and lack of regulatory oversight. As with custody, these issues have been raised by the SEC staff under the Investment Company Act in connection with digital asset investments by registered funds, and apply in much the same manner under the Advisers Act.693

(c) Other IAA Requirements

A general guide to the requirements of the Advisers Act is beyond the scope of this White Paper. However, managers of digital assets who become registered investment advisers should be aware that registered investment advisers are subject to a number of other requirements, some of which include the following:

- Compliance program requirement;
- Reporting and disclosure requirements;
- Advisory agreement and advisory fee restrictions;
- Restrictions on the use of solicitors;
- Advertising regulation;
- Privacy policy and privacy notice requirements;
- Restrictions on political contributions;
- Recordkeeping requirements;

693 See Staff Cryptocurrency Funds Letter, supra note 517.
• Supervision requirements; and
• SEC examination and enforcement authority.\(^{694}\)

## Exhibit A

### Possible Digital Asset Fund Types

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Nature of Fund</th>
<th>Regulation</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Funds that invest in digital assets that are securities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mutual fund</td>
<td>Issues and redeems shares daily at net asset value per share (NAV).</td>
<td>Registered under the ICA and the Securities Act. Filings reviewed by SEC’s Division of Investment Management (Div. Inv. Mgmt.).</td>
<td>No digital asset mutual funds existing or currently known to be proposed.</td>
</tr>
<tr>
<td>Exchange-traded fund (ETF)</td>
<td>Shares listed and trade on an exchange at prices close to NAV.</td>
<td>Registered under the ICA and the Securities Act with filings reviewed by Div. Inv. Mgmt. Exchange listing may require SEC approval, with filings reviewed by SEC’s Division of Trading and Markets (Div. Trading &amp; Mkts.).</td>
<td>Digital asset ETF proposals to date have not received SEC approval.</td>
</tr>
<tr>
<td>Closed-end fund (other than interval funds)</td>
<td>Shares trade, but at prices that may not approximate NAV. Restrictions on issuer’s ability to sell shares after the initial offering.</td>
<td>Registered under the ICA and the Securities Act with filings reviewed by Div. Inv. Mgmt. If listed on an exchange, the exchange listing requires SEC approval, with filings reviewed by Div. Trading &amp; Mkts.</td>
<td>No digital asset closed-end funds existing or currently known to be proposed.</td>
</tr>
<tr>
<td>Interval fund</td>
<td>Closed-end fund that offers to repurchase a portion of its shares at periodic intervals.</td>
<td>Registered under the ICA and the Securities Act with filings reviewed by Div. Inv. Mgmt.</td>
<td>First digital asset interval fund approved in December 2019.</td>
</tr>
<tr>
<td><strong>Funds that invest in digital assets that are not securities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exchange-traded product (ETP) (aka Securities Act-only ETF)</td>
<td>Shares listed and trade on an exchange at prices close to NAV.</td>
<td>Registered under the Securities Act and files reports under the Exchange Act, with filings reviewed by SEC’s Division of Corporation Finance (Div. Corp. Fin.). Exchange listing requires SEC approval, with</td>
<td>No digital asset ETP exchange listings approved to date.</td>
</tr>
<tr>
<td>Fund Type</td>
<td>Nature of Fund</td>
<td>Regulation</td>
<td>Status</td>
</tr>
<tr>
<td>---------------------------</td>
<td>-------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Securities Act-only fund</td>
<td>Shares trade at prices that may not approximate NAV.</td>
<td>Registered under the Securities Act and files reports under the Exchange Act, with filings reviewed by Div. Corp. Fin.</td>
<td>SEC has not objected to Securities Act-only digital asset fund registration.</td>
</tr>
<tr>
<td>(non-ETP)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private funds (may or may not invest in securities)</td>
<td>Fund securities do not trade. Depending on the fund, there may be some opportunities to redeem shares.</td>
<td>Fund securities issued in private placements exempt from registration under the Securities Act. If the fund invests primarily in securities, it is excluded from investment company status because securities are owned by no more than 100 persons or all security holders are qualified purchasers.</td>
<td>Private funds are known to exist, but their details generally are nonpublic.</td>
</tr>
</tbody>
</table>
SECTION 5. THE NEED FOR A BETTER CFTC AND SEC REGULATORY SCHEME FOR DIGITAL ASSETS

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1. Introduction

The CFTC’s and the SEC’s authority over transactions in digital assets and derivatives involving them raises the questions of where the jurisdictional boundaries between the two agencies lie and how each agency’s authority can or should be best applied to foster the public interests in vibrant, reliable markets and investor protection. The application of their separate statutes and policies can materially affect the development of the markets in digital assets and the blockchain technology that underlies them, for better or worse. Sorting out the appropriate policies to advance market vibrancy and integrity is a work-in-progress and not a simple task.

The statutes are complex; myriad different types of digital assets potentially are covered; and the current laws and regulations were not crafted with such novel and varied assets in mind. Also, because the markets for these assets developed rapidly without clear regulatory guidance,
policymakers now must grapple with how these assets and the markets for them can be brought into regulatory compliance with the least harm to the markets’ many participants and to beneficial financial innovation.

2. Framing the Legal and Policy Analysis

(a) The Intersection of Securities and Non-Security Commodities Transactions

The main goals of futures and swaps regulation are to facilitate use of derivatives markets for price discovery and shifting of risk, to assure the integrity of derivatives prices and their convergence with prices in the underlying cash markets, and to protect market participants from fraud and manipulation. The predominant goals of securities regulation are to facilitate capital formation and capital flows in an efficient and fair environment, assure the integrity of market valuations, and protect investors from fraud and manipulation in securities investments.695 Despite those substantial differences in primary market focus and market regulation objectives, the boundary lines between what the CFTC regulates and what the SEC regulates can get blurred.

CFTC and SEC jurisdiction intersect in three principal ways:

When an interest underlying a derivative is a security.696 Securities-based derivatives initially generated debate over whether securities are covered by the CEA’s commodity definition—the settled answer is yes—and if so, which agency should regulate derivatives on

695 See generally Phillip M. Johnson & Thomas L. Hazen, Derivatives Regulation § 4.05 [9], at 1014 (Wolters Kluwer 2004).

696 The CEA uses the definition of “security” in the Securities Act and Exchange Act. See 7 U.S.C. § 1a(41). The CEA also defines other securities-related terms that are relevant for delineating how jurisdiction is allocated to the CFTC and SEC over security-based derivatives, including “security futures,” “security futures products,” “exempted securities,” and a “narrow-based security index.”
securities or related interests in securities. As explained in Section 2.4, the current statutory framework largely resolves jurisdictional issues in this area by giving the CFTC the authority to regulate certain securities-based derivatives (e.g., futures on Treasury securities or a broad-based index of equity securities), the SEC the authority to regulate others (e.g., options on securities or an index of securities), and both agencies the authority to regulate one segment together (security futures products). When a commodity’s classification as a security or a non-security is straightforward, the regulatory allocation scheme is relatively straightforward to apply. When it is not, as can be the case with certain digital assets, the determination as to which agency regulates derivatives on a particular token can be uncertain.

*When a non-security commodity or derivative is embedded in a security.* The CFTC can have jurisdiction with respect to a security that has embedded characteristics of a non-security commodity or derivative, such as when the value of a security is linked to the value of a non-security commodity. Certain “hybrid securities” linked to non-security commodities may qualify for relief from CEA derivatives regulation under existing exemptions (described below). However, hybrid digital assets that are securities on the basis that they are investment contracts—*i.e.*, by virtue of how they are first offered and marketed and not because they

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697 As explained in Section 5.4, after the CEA’s commodity definition was expanded in 1974 along with the establishment of the CFTC, there was initial debate over whether the amendments gave the CFTC exclusive jurisdiction over futures, options on futures, and options on securities. The current statutory framework reflects the resolution of those issues. When Dodd-Frank expanded the CEA’s reach to cover swaps in 2010, it divided oversight of swaps relating to securities between the SEC and CFTC.

698 Where the agencies allow regulated trading of derivatives on a digital asset, one can infer whether the asset is a security or a non-security commodity from the manner in which the derivative is permitted to trade. The fact that the futures exchanges list bitcoin futures as products the CFTC alone regulates and not as security futures, without SEC challenge during the very public new product review process that occurred, would seem to ratify bitcoin’s status as a non-security commodity.
represent equity ownership in an entity or the promise of debt repayment as a debt security—raise special policy considerations.

When a derivative has both securities and non-security commodities as underlying reference components. Although perhaps less common, CFTC and SEC jurisdictional interests also can overlap when a derivative has both securities and non-security commodities as underlying reference values. The statutory scheme acknowledges that this permutation could occur for derivatives classified as swaps, and resolves the issue by treating so-called “mixed swaps” as both swaps that the CFTC regulates and security-based swaps that the SEC regulates.699 Apart from this area of overlap, as between the two agencies, the CFTC alone regulates swaps and the SEC alone regulates security-based swaps.700

(b) Novel Characteristics of Digital Assets

The diverse terms and uses among digital assets, combined with the creativity of those developing such products, can pose unprecedented challenges for applying a jurisdictional analysis to products that involve some combination of securities characteristics with non-security commodity characteristics and/or derivatives characteristics. This is most notable for digital assets.

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699 A mixed swap is a swap that meets the security-based swap definition in CEA section 3(a)(68)(A), and which also is “based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(iii).” 7 U.S.C. § 1a(49)(D). CEA section 1a(49)(B)(x) excludes “security-based swaps” from the swap definition, “other than a security-based swap as described in subparagraph (D),” i.e., other than a mixed swap.

700 The SEC retains enforcement authority that it possessed prior to the enactment of Dodd-Frank Act over “security-based swap agreements,” which are defined as swap agreements (as defined in section 206A of the Gramm-Leach-Bliley Act) of which a material term is based on the price, yield, value or volatility of any security or any group or index of securities, including any interest therein, but does not include a security-based swap. See 15 U.S.C. § 78c(a)(78); 7 U.S.C. § 1a(47)(A)(v). Such security-based swap agreements may include, for example, swaps on broad-based security indices and U.S. Treasury securities that are subject to CFTC regulatory authority. See Product Definitions, 77 Fed. Reg. at 48,294. However, the SEC does not have regulatory authority with respect to such swaps.
assets where the securities characteristics may be temporary. The SEC staff has recognized that some digital assets—the digital coin ether being the example offered—might begin life as a security in the form of an investment contract but over time transform into a non-security commodity.\(^701\) The current legal framework does not anticipate this type of temporal permutation. The closest analogue would be when an index of securities may toggle between being classified as a narrow or a broad-based index, which affects the classification of certain securities-based derivatives (futures vs. security futures; swap vs. security-based swap) for purposes of applying CFTC and SEC jurisdiction.\(^702\) For example, a security-based index may evolve from a product under the CFTC’s exclusive jurisdiction to one subject to joint CFTC and SEC jurisdiction (or vice versa) as the index’s composition shifts over time.\(^703\) That

\(^701\) Hinman, supra note 54. The CFTC and SEC also can share jurisdiction with the states over cash market transactions in digital assets. Most states have laws governing virtual currency businesses. See infra Section 8 & Appendix; Cryptocurrency & Law: A Comprehensive Overview of 50 States’ Guidance and Regulations on Blockchain and Digital Currency, BITCOIN CENTER NEW YORK CITY (Mar. 6, 2018), https://bitcoincenternyc.com/bitcoin-news/bitcoin-blockchain-cryptocurrency-laws-50-states/. Other federal agencies such as the IRS and FinCEN have created additional regulatory considerations for market participants in the tax and money transmitter contexts, respectively. See I.R.S. News Release IR-2018-71, U.S. Internal Revenue Service (Mar. 23, 2018), https://www.irs.gov/newsroom/irs-reminds-taxpayers-to-report-virtual-currency-transactions (in which the IRS reminds taxpayers to report virtual currency transactions: “Taxpayers who do not properly report the income tax consequences of virtual currency transactions can be audited for those transactions and, when appropriate, can be liable for penalties and interest. In more extreme situations, taxpayers could be subject to criminal prosecution for failing to properly report the income tax consequences of virtual currency transactions.”); see also FIN-2013-G001, supra note 189.

\(^702\) The definitions of security future and security-based swap include, respectively, futures or swaps on a narrow-based security index. See 7 U.S.C. § 1a(44) (definition of security future); 15 U.S.C. § 78c(a)(68) (definition of security-based swap). In the Part 41 Rules for security futures products, CFTC Rule 41.14, 17 C.F.R. § 41.14, sets out tolerance period and transaction provisions for security futures on an index that ceases to be a narrow-based security index. The CEA definition of “narrow-based security index” in CFTC Rule 1.3, 17 C.F.R. § 1.3, as used in the definition of “security-based swap,” includes tolerance period and grace period concepts for swaps traded on exchanges or SEFs that become security-based swaps when the index has changed to a narrow-based security index.

\(^703\) This occurred, for example, with a futures contract offered by Eurex. In 2002, the CFTC granted no-action relief permitting Eurex to offer futures on a securities index in the United States, finding that the index met the statutory requirements for a broad-based securities index. See CFTC No-Action Letter No. 02-38 (Apr. 2, 2002), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrelettergeneral/documents/letter/02-38.pdf. In 2011, Eurex conducted an internal review and determined that the index had transitioned to a narrow-based securities index, which it brought to the attention of the SEC and CFTC. See Eurex Report, supra note 477, at 3.
circumstance, however, effectively involves the mechanical application of the statutory requirements to known securities. In contrast, the digital asset context involves the substantive determination of when the characteristics of the sale of a non-security commodity or derivative cease to involve an investment contract, so the transition or sharing of jurisdiction between the commissions would require new rules or rule interpretations.

(c) Cash Market Trading of Digital Assets

Each agency’s authority over cash market trading of commodities (under the broad CEA definition) should not intersect. The federal securities laws authorize the SEC, not the CFTC, to regulate initial offerings and secondary market trading of securities. As a general matter, the CFTC does not regulate cash commodity markets—it regulates derivatives markets. As one exception, the CFTC has regulatory authority over leveraged, marginned, or financed retail commodity transactions under CEA section 2(c)(2)(D),\textsuperscript{704} but that authority is expressly limited to transactions in commodities that are not securities.\textsuperscript{705} The CFTC also construes its anti-fraud and anti-manipulation enforcement authority (but not rulemaking authority) broadly to cover contracts for the sale of commodities in interstate commerce.\textsuperscript{706} CEA section 6(c)(1),\textsuperscript{707} which was added as part of the Dodd-Frank Act amendments to the CEA, as relevant here, broadly prohibits any person, directly or indirectly, from using or employing, or attempting to use or

\textsuperscript{704} 7 U.S.C. § 2(c)(2)(D). As explained in Section 2.2, transactions covered by this provision are regulated as or “as if” they are futures contracts, unless the transactions fit within an exemption. In practice, parties to such transactions try to operate within the “28 day actual delivery” exemption.

\textsuperscript{705} See 7 U.S.C. § 2(c)(2)(D)(ii)(II) (expressly providing that CEA section 2(c)(2)(D) does not apply to “any security”).

\textsuperscript{706} Of course the SEC does not regulate the non-security cash commodity markets, either. Participants in these markets are not obligated to meet any of the registration and reporting requirements or business conduct standards that derivatives and securities market participants must meet. See supra Section 2.3(f).

\textsuperscript{707} 7 U.S.C. § 9(c)(1).
employ, in connection with any contract of sale of any commodity in interstate commerce, any manipulative or deceptive device in contravention of any CFTC rule. CFTC Rule 180.1\textsuperscript{708} implements this statutory prohibition. However, CEA section 2(a)(1)(H)\textsuperscript{709} provides that the CFTC shall have no jurisdiction under the Dodd-Frank Act or any amendment to the CEA made by the Dodd-Frank Act with respect to any security other than a security-based swap.\textsuperscript{710} This would seem to exclude from the scope of CEA section 6(c)(1) and CFTC Rule 180.1 transactions in securities.\textsuperscript{711}

(d) Smart Contracts

Use of smart contracts as digitized representations of recognized derivatives contracts should not raise any unique issues of jurisdictional conflict between the CFTC and SEC over the derivatives.\textsuperscript{712} The terms and conditions defining the contract are relevant for analyzing the legal

\textsuperscript{708} 17 C.F.R. § 180.1. The CFTC’s construction of CEA section 6(c)(1) and Rule 180.1 was questioned in \textit{CFTC v. Monex Credit Co.}, 931 F.3d 966 (9th Cir. 2019), \textit{cert. denied sub nom. Monex Deposit Co. v. CFTC}, No. 19-933, 2020 WL 3492657 (June 29, 2020). The defendants argued, and the district court agreed, that section 6(c)(1) and Rule 180.1 apply only to fraud in connection with the manipulation of a market price and not in other contexts, such as in the solicitation of commodity transactions. The district court concluded that the CFTC’s construction did not comport with the legislative history of section 6(c)(1), which focused on market manipulation and did not suggest Congress intended the broad reach the CFTC ascribed to it. In reversing the district court, the Ninth Circuit held that section 6(c)(1) and Rule 180.1 applied to alleged fraud in the sale of leveraged retail commodity contracts, but the court declined to opine on the provisions’ application in other contexts. Other courts, too, have applied CFTC Rule 180.1 to fraud in connection with commodity derivatives transactions that did not involve allegations of market manipulation. \textit{See, e.g., CFTC v. S. Tr. Metals, Inc.}, 880 F.3d 1252, 1262 (11th Cir. 2018); \textit{CFTC v. Dupont}, No. 8:16-cv-03258, 2018 WL 3148532, at *8 (D.S.C. June 22, 2018) (slip op.); \textit{McDonnell I}, 287 F. Supp. 3d at 226–27, 229–30.

\textsuperscript{709} 7 U.S.C. § 2(a)(1)(H).

\textsuperscript{710} Presumably, this reservation of CFTC authority refers to mixed swaps, which are both swaps under the definition and security-based swaps. \textit{See} 7 U.S.C. §§ 1a(49)(B)(x), 1a(49)(D); \textit{supra} note 699 and accompanying text.

\textsuperscript{711} Given that Congress in the retail commodities transactions provision expressly excluded leveraged OTC transactions in securities from the CFTC’s jurisdiction, \textit{see supra} note 705, there would appear to be little or no basis to conclude that Congress intended for the CFTC to have any jurisdiction over non-leveraged cash securities transactions.

\textsuperscript{712} Likewise, the use of smart contracts to track and administer performance under deferred delivery commercial merchandizing transactions should not itself be dispositive of whether the contract is within the forward contract exclusion and thus outside the scope of regulation under the CEA as a future or swap.
classification of the derivative, regardless of the medium through which they are expressed. Representing derivatives through smart contracts that administer performance obligations under the contracts of course may raise other regulatory issues, but those are outside the scope of this analysis.

(e) Terminology Challenges

When discussing potential CFTC and SEC jurisdictional issues, regulators and others typically use the term “commodity” under its commonly understood meaning as shorthand to refer to commodities that are not securities. For clarity and precision, we use the term “non-security commodity” to cover commodities that are not securities, in light of the CEA commodity definition, as that definition covers securities. As explained in Section 2.3, though, there also are possible interpretations of the scope of the CEA’s commodity definition that, if accepted, would result in certain products falling outside the statutory definitions of both security and commodity. This issue to date principally affects the scope of the CFTC’s enforcement authority over cash market activities.

(f) Questions Guiding Analysis of CFTC and SEC Jurisdiction

Current law recognizes that issues of jurisdictional overlap can occur between the SEC and CFTC over novel derivative products, as they have in the past, and provides a mechanism (discussed below) for the two agencies to try to resolve them when they arise. Whether through that mechanism or otherwise, the following questions may be useful for evaluating whether transactions in or involving a particular digital asset are—or should be—within the regulatory purview of the CFTC alone, the SEC alone, both agencies together, or neither agency:

1. Is the digital asset a security?
2. Does the digital asset have characteristics of both a security and a non-security commodity?
3. Does the digital asset have the initial characteristics of a security only, with the potential to transform from a security to a non-security commodity (e.g., a digital asset initially offered as part of an investment contract but designed ultimately to be used as a medium of exchange)?

4. As a variation of item 3, if a digital asset is perceived to have characteristics of both a security and a non-security commodity from the outset, could the security characteristics cease in the future?

5. Does the digital asset have characteristics of both a security and a derivative related to a non-security commodity?

6. Is the digital asset an underlying interest for any contracts or transactions that are derivatives (futures, options on futures, options, swaps)?

3. **The Challenging Issues Applying the Statutory Schemes to Digital Assets**

The digitization of an asset principally functions as a technological wrapper for the particular unique bundle of property rights and interests each asset represents. The DAO token, the Munchee token, bitcoin, and a commodity-backed token are all digital assets, but have different features and functions. Some digital assets may be straightforward to classify as a security or a non-security commodity, such as tokens that are simply a form of electronic title for ownership of an underlying asset, say gold, where the token’s status should follow that of the underlying asset.

Other tokens can be more challenging to classify for appropriate regulatory treatment. In particular, the initial offering of digital assets for capital raising and their resale in secondary markets, when they are perceived to have attributes of both securities and non-security commodities, have brought confusion and uncertainty surrounding the interplay of the agencies’ jurisdictions. Tokens that are sold initially as a means to raise capital to build the platform in which the tokens will serve a utility function, e.g., as a medium of exchange for the issuer’s products and services, or as a store of value for investment, seemingly implicate both the CFTC’s and the SEC’s regulatory interests. If the SEC believes the initial or secondary market
transactions constitute the purchase or sale of a security under the tests set forth in *SEC v. W.J. Howey Co.*\textsuperscript{713} or *Gary Plastic Packaging v. Merrill Lynch, Pierce, Fenner & Smith Inc.*,\textsuperscript{714} the SEC could assert regulatory and enforcement authority to require compliance with the federal securities laws. If the CFTC believes they are non-security commodities, it could assert jurisdiction over cash market sales of the digital asset under its anti-fraud and anti-manipulation authority or possibly under its authority over certain retail commodity transactions, but competing assertions of jurisdiction over the same cash market commodity transactions by the SEC and CFTC would be at odds with the statutory allocation of jurisdiction between them, described above.

The clarity of the existing statutory scheme is strained when a digital asset might be considered a security because it is offered to raise capital for a business enterprise but also appears to replicate the structure and terms of a future, option, or swap on a non-security commodity. For example, if the token is designed to be backed by a store of gold at a future time, has its value largely pegged to the future price of gold, can be redeemed in the future for a pro-rata share of the gold or the cash equivalent, is a margined or leveraged transaction, and can be traded on margin in a secondary market, the initial transactions in the token might look like a vehicle to speculate on the future value of gold. Is it more appropriate from a regulatory perspective to treat those transactions as securities transactions regulated by the SEC, as derivatives transactions regulated by the CFTC, or as transactions regulated concurrently by both agencies? If those creating the tokens decide to resolve the question by expressly offering them as securities, seeking to rely on the CEA exemption for hybrid securities to avoid CFTC

\textsuperscript{713} 328 U.S. 293 (1946).

\textsuperscript{714} 756 F.2d 230 (2d Cir. 1985).
regulation, it is fair to ask whether that exemption was really intended to cover securities that economically replicate derivatives the CFTC otherwise would regulate. On the other hand, if the token represents title to gold, the circumstances of how the transactions are offered and the nature and intention of the parties to the transaction may support the conclusion that the transactions are most appropriately treated as commercial forward contracts that neither agency regulates.

Recognizing the regulatory uncertainty that results from reliance on the Howey test, SEC Commissioner Hester M. Peirce has recommended that the SEC establish a safe harbor.\textsuperscript{715} Commissioner Peirce succinctly explained the problem with the Howey test:

\begin{quote}
[T]he determination of whether an instrument is offered and sold as a security in the form of an investment contract requires a subjective weighing of the facts and circumstances. Such analysis, idiosyncratic by its very nature, does not produce clear guideposts for entrepreneurs and others to follow. The challenge of discerning a clear legal line is especially difficult with respect to new forms of business and novel technologies. Entrepreneurs may be forced to choose between unpalatable options: expending their limited capital on costly legal consultation and compliance or forgoing their pursuit of innovation due to fear of becoming subject to an enforcement action. A regulatory safe harbor could resolve this unhappy dilemma.\textsuperscript{716}
\end{quote}

She further summarized the impediments to blockchain and digital asset innovation caused by the SEC’s regulatory approach:

\begin{quote}
We have created a regulatory Catch 22. Would-be networks cannot get their tokens out into people’s hands because their tokens are potentially subject to the securities laws. However, would-be networks cannot mature into a functional or decentralized network that is not dependent upon a single person or group to carry out the essential managerial or entrepreneurial efforts unless the tokens are
\end{quote}


\textsuperscript{716} SEC Commissioner Peirce Statement on SEC Settlement with Unikrn, Inc., supra note 715.
distributed to and freely transferable among potential users, developers, and participants of the network. The securities laws cannot be ignored, but neither can we as securities regulators ignore the conundrum our laws create.\footnote{SEC Commissioner Peirce Safe Harbor Proposal, supra note 715.}

To facilitate participation in and the development of functional or decentralized networks, SEC Commissioner Peirce’s proposed safe harbor would provide network developers with a three-year grace exemption from the registration provisions (but not anti-fraud provisions) of the federal securities laws, so long as certain conditions are met. The proposed conditions would be that the offeror’s initial development team must:

- Intend for the network on which the token functions to reach network maturity—defined as either decentralization or token functionality—within three years of the date of the first token sale and undertake good faith and reasonable efforts to achieve that goal;
- Disclose key information on a freely accessible public website;
- Undertake good faith and reasonable efforts to create liquidity for users;
- File a notice of reliance; and
- Offer and sell the token for the purpose of facilitating access to, participation on, or the development of the network.\footnote{Id.}

To date, the SEC has not taken any action on Commissioner Peirce’s proposed safe harbor.

On the CFTC side, CFTC Chairman Heath Tarbert has informally suggested that the CFTC will not treat a digital asset as a commodity until it is determined not to be a security. In his remarks at the Yahoo! Finance All Markets Summit in October 2019 discussing Ethereum, Libra, and the treatment of forks, Chairman Tarbert explained that the legal analysis begins with the question of “[i]s it [a digital asset] a security, first and foremost,” and “if it isn’t a security, it
is most likely a commodity." He remarked that the CFTC worked with the SEC on Bitcoin and Ethereum and that the agencies agreed neither are securities. Chairman Tarbert further suggested that the CFTC may allow ether futures to trade on U.S. markets. He expressed the same view with respect to forks: “It stands to reason that similar assets should be treated similarly. If the underlying asset, the original digital asset, hasn’t been determined to be a security and is therefore a commodity, most likely the forked asset will be the same. Unless the fork itself raises some securities law issues under that classic Howey test.”

These principles, pursuant to which the CFTC apparently will defer to the SEC’s jurisdiction where the SEC views a transaction as a security under the Howey test, may limit potential friction between the agencies in regulatory actions but do not ultimately resolve the legal and jurisdictional overlap. The views of a CFTC Chairman, while consequential to the work of the agency during his or her term, are not binding on the Commission and have no force of law. In addition, the apparent premise that the CFTC would lack jurisdiction if a security is involved is not necessarily supported by the terms of the CEA or the federal securities laws. As explained in this Section (and Section 2), the CEA’s definition of “commodity” includes securities. The fact that a non-security commodity can be classified as a security interest in a

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719 CFTC Chairman Heath Tarbert has said ether, the world’s second-largest cryptocurrency by market capitalization, is a commodity, COINDESK (Oct. 10, 2019), https://www.coindesk.com/cftc-chairman-confirms-ether-cryptocurrency-is-a-commodity [hereinafter Coindesk article].

720 Id. Chairman Tarbert said: “We’ve been very clear on bitcoin: bitcoin is a commodity. We haven’t said anything about ether—until now. It is my view as chairman of the CFTC that ether is a commodity.” Id.; see also Heath P. Tarbert, Chairman, CFTC, Statement of Chairman Heath P. Tarbert in Support of Interpretive Guidance on Actual Delivery for Digital Assets n.3 (Mar. 24, 2020), https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement032420a (citing Heath P. Tarbert, Chairman, CFTC, Interview at Yahoo! Finance All Markets Summit (Oct. 10, 2019) [hereinafter Yahoo! Interview] (stating belief that current version of ether is a commodity)).

721 Coindesk article, supra note 719.
common enterprise under *Howey* based on how the transaction is structured and marketed does not necessarily oust the CEA’s application to the commodity or the transaction.

Several congressional bills have proposed legislation seeking to resolve the jurisdictional uncertainty between the CFTC and the SEC with respect to digital assets. In March 2020, U.S. Representative Paul A. Gosar of Arizona introduced the Crypto-Currency Act of 2020, which seeks to resolve jurisdictional boundaries by establishing three categories of digital assets—“crypto-commodities,” “crypto-currencies,” and “crypto-securities”—and dividing primary jurisdiction over them among the CFTC, FinCEN, and the SEC.\(^\text{722}\) It provides that the CFTC shall be the primary agency with the authority to regulate crypto-commodities; the Secretary of the Treasury, acting through the FinCEN, and the Comptroller of the Currency shall be the primary agencies with the authority to regulate cryptocurrencies (other than synthetic stablecoins); and the SEC shall be the primary agency with the authority to regulate crypto-securities and synthetic stablecoins.\(^\text{723}\)

How the primary jurisdiction of each agency would operate in practice is not clear, however, because any one digital asset would appear to fit within more than one of the three statutory product definitions (e.g., a cryptocurrency also could be a crypto-commodity); the bill defines the three categories as follows:

- “Crypto-commodity” means “economic goods or services, including derivatives, that—(A) have full or substantial fungibility; (B) the markets treat with no regard as to who produced the goods or services; and (C) rest on a blockchain or decentralized cryptographic ledger."


\(^{723}\) Id.
“Crypto-currency” means “representations of United States currency or synthetic derivatives resting on a blockchain or decentralized cryptographic ledger, including—
(A) such representations or synthetic derivatives that are reserve-backed digital assets that are fully collateralized in a correspondent banking account, such as stablecoins; and (B) synthetic derivatives that are—(i) determined by decentralized oracles or smart contracts; and (ii) collateralized by crypto-commodities, other crypto-currencies, or crypto-securities.”

“Crypto-security” means “all debt and equity that rest on a blockchain or decentralized cryptographic ledger,” except the term does not include a synthetic derivative that (i) is operated as, and is registered with the Department of the Treasury as, a money services business (as defined under 31 C.F.R. § 1010.100); and (ii) is operated in compliance with all applicable requirements of the Bank Secrecy Act and all other federal anti-money laundering, anti-terrorism, and screening requirements of the Office of Foreign Assets Control and FinCEN.

In September 2020, Representative K. Michael Conaway of Texas introduced the Digital Commodity Exchange Act of 2020 (DCEA), which is designed to fill the regulatory gaps that exist between the CFTC and the SEC. The DCEA creates a new statutory scheme within the CEA for transactions in a “digital commodity,” which the bill defines to be “any form of fungible intangible personal property that can be exclusively possessed and transferred person to person without necessary reliance on an intermediary, and which does not represent a financial interest in a company, partnership, or investment vehicle.” The DCEA principally addresses four areas:

(1) **Spot and margin exchange trading in digital commodities.** The DCEA provides for the voluntary registration with the CFTC of exchanges for the spot purchase and sale of digital commodities. The bill denominates such registered entities as Digital Commodity Exchanges (DCEs) and confers exclusive jurisdiction on the CFTC with respect to transactions subject to the rules of a DCE or any other CFTC registered entity. The DCEA requires that for an exchange to be approved for registration, it must demonstrate the ability to comply with many financial, governance, customer protection, and market protection requirements. It also authorizes the CFTC to promulgate and

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725 Id. § 2.
enforce rules governing margin trading on DCEs. This registration is entirely voluntary—an exchange must affirmatively opt to become CFTC regulated before the law will apply. The statutory scheme incentivizes regulation, however, by, among other things, preempting the application of state money transmitter laws for registered DCEs.

(2) **Off-exchange retail digital commodity transactions.** The DCEA amends the retail commodity transactions provision in CEA section 2(c)(2)(D) to exclude contracts of sale of digital commodities that (a) result in actual delivery within two days or such other period as the CFTC determines, or (b) are executed on or subject to the rules of a DCE.

(3) **Custody of digital commodities.** The DCEA provides for the CFTC designation of custodians of digital commodities as “Qualified Digital Commodity Custodians” if the CFTC finds that the custodian is subject to adequate supervision and appropriate regulation by a state, federal, or international banking regulator.

(4) **Sales of digital commodities acquired in securities offerings.** The DCEA does not change the application of the federal securities laws to the “presale” of digital commodities in connection with raising money to fund a digital commodity project. The DCEA, however, endeavors to establish a bright line for when a digital commodity that was “presold” as part of a securities offering may be lawfully resold by the owner. To this end, it confers exclusive jurisdiction on the CFTC “over any agreement, contract, or transaction involving a unit of a digital commodity, or any promise or right to a future unit of a digital commodity, obtained through a digital commodity presale and subject to the restrictions in section 4c(h)” (which the DCEA would add to the CEA).726

The DCEA would permit the sale or transfer of a digital commodity acquired in a securities offering in these instances:

- to another person who would have been eligible for the relevant securities offering;
- on a registered DCE;
- to utilize the digital commodity for its intended commercial purpose; or
- under a limited CFTC-provided public interest exemption.727

726 See id.

727 See id.
Under the DCEA, once a unit of a digital commodity is sold through a registered DCE, all trading restrictions on the asset are removed, and it becomes freely usable by any market participant for any purpose.\(^{728}\)

The regulatory uncertainty and ambiguity attending digital assets, unless and until addressed by legislation such as the DCEA, have the potential to frustrate enforcement of the laws. The agencies appear to have coordinated the use of their respective resources to combat perceived fraudulent activity in connection with cash market transactions in digital assets, such that in some circumstances only one agency has initiated action to protect potential victims and the public interest. In the absence of clear public statements to the contrary, however, their coordination does not necessarily mean that, where only one agency initiates an action, only that agency has determined that it has jurisdiction.\(^{729}\) When a digital asset straddles classification as a security or a non-security commodity, the risk that both the SEC and the CFTC could choose to assert their respective anti-fraud enforcement powers undermines the asserting agency’s jurisdictional position. If either agency initiates an enforcement action for suspected fraud in connection with cash market sales of digital assets, but the manner in which the digital asset is marketed to purchasers arguably brings it within the definition of a security as an investment

\(^{728}\) See id.

\(^{729}\) In 2018, Attorney General Jeff Sessions established a Cyber-Digital Task Force within the U.S. Department of Justice to evaluate the impact that recent advances in technology have had on law enforcement’s ability to keep U.S. citizens safe. The Task Force issued a comprehensive report later that year that identified particular threats confronting the United States, ranging from transnational criminal enterprises’ sophisticated cyber-enabled schemes to malign foreign influence operations to efforts to compromise critical infrastructure. The report also identified a number of emerging threats whose contours were still developing and recommended further examination of their potential impact. DOJ, REPORT OF THE ATTORNEY GENERAL’S CYBER-DIGITAL TASK FORCE 126 (July 2018), https://www.justice.gov/cyberreport. On October 20, 2020, the Task Force issued its second report detailing the enforcement framework for combating cyber-digital threats. The report included discussion of the CFTC and SEC enforcement efforts in the area but did not address the jurisdictional uncertainty between them. DOJ, REPORT OF THE ATTORNEY GENERAL’S CYBER-DIGITAL TASK FORCE (Oct. 2020), https://www.justice.gov/ag/page/file/1326061/download.
contract, sorting out the proper scope of each agency’s authority through the courts could frustrate the timely enforcement of either agency’s authority.730

From the perspective of creators and purveyors of such assets, the uncertainty could frustrate or overwhelm the commercial viability of the enterprise. The regulatory complexity and uncertainty are especially acute for digital assets that over time are deemed to morph from a security to a non-security commodity. Ether is the only example of an asset the SEC staff has identified that may have been a security when initially offered and later transformed into a non-security commodity. It bears noting, however, that as a practical matter, ether’s acceptance and use might not have happened if the securities law requirements for transfers of securities (e.g., requiring broker-dealers to act as intermediaries) had been observed. This implicates a key issue for the commercial practicality of the views of SEC staff: how will it be feasible for a digital asset that is intended to function as a medium of exchange to fulfill that function if its transfer from one owner to another must comply with restrictions on the purchase and sale of securities or can only be facilitated by persons that are registered (as appropriate to the roles they perform) as broker-dealers, exchanges, clearing agencies, or transfer agents? Even if, for example, the

730 There are instances in which the CFTC and SEC have brought parallel enforcement actions against the same exchange, but with each agency limiting its action to different products. As alleged in the agencies’ respective settlement orders in In re Plutus Financial, Inc. (d/b/a Abra) and Plutus Technologies Philippines Corp. (d/b/a Abra International), CFTC Docket No. 20-23, 2020 WL 4012173 (July 13, 2020), and In the Matter of Plutus Financial, Inc. (d/b/a Abra) and Plutus Technologies Philippines Corp., Admin. Proceeding No. 3-19873, 2020 WL 4091075 (July 13, 2020), a Philippines-based trading entity was sanctioned for entering into financial transactions with U.S. and non-U.S. customers who were not ECPs. The transactions allowed the customers to gain exposure to price movements of virtual and foreign currencies, stocks, and ETFs. The CFTC found the transactions based on virtual currencies (and currencies) to be swaps that violated CEA sections 2(e) and 4(d)(1) because the counterparty customers were non-ECPs and the trading entity was not registered as an FCM. The SEC found the transactions based on stocks and ETFs to be security-based swaps that violated Securities Act section 5(e) because the counterparty customers were non-ECPs, and violated section 6(l) of the Exchange Act because the transactions were not effected on a registered national securities exchange. Significantly, the agencies asserted jurisdiction over transactions between the non-U.S. Philippines trading entity and non-U.S. customers because an affiliated entity in the United States set the price for the swaps, established the hedging mechanism for the Philippines affiliate, and performed other managerial functions related to the contracts.
initial offering of the asset is made in compliance with securities private placement rules, the securities law resale restrictions effectively would seem to prevent the asset from being serviceable for purchasing goods and services, thereby blocking its evolution to non-security status and killing the enterprise.

Even assuming that the asset could reach a point to be considered transformed into a non-security commodity, there are major regulatory impediments that have yet to be addressed. For example, when and how is it to be determined that the transformation to a non-security commodity has occurred? How does the transformation affect the enforcement authority of each agency and the states and any private claims? With more experience, clearer standards may be established with respect to when a digital asset will be deemed a security or a non-security commodity, and a less complicated regulatory regime might emerge that establishes clear and commercially reasonable lines for the treatment of digital assets.

Digital assets that from inception are backed by a non-security commodity, but that do not confer on the holder any ownership rights in the commodity, also may raise interpretive jurisdictional issues. Such instruments may draw a comparison to commodity-based ETFs, suggesting they should be treated as securities, but commodity-based ETFs are intentionally offered as investments representing share ownership in fund vehicles. It is worth recalling that when commodity-based ETFs first emerged, they presented the novel issue of whether it was more appropriate to treat ETF shares as securities or as non-security commodities when their value as an investment derived solely from changes in the value of the non-security commodities that the ETFs passively held. The CFTC granted exemptions pursuant to its authority under CEA section 4(c) to permit options on such ETFs to trade as listed securities on markets regulated by the SEC and futures on the ETFs to trade as security futures it would jointly regulate with the
SEC, on the basis that the products would be appropriately regulated. The CFTC did not take a formal position as to whether the ETFs should be viewed as securities or non-security commodities.

ETFs have been around for years now, and commodity-based ETFs are commonly known as a type of security and today probably are covered under that element of the definition in the federal securities laws. Yet it does not follow that digital assets backed by non-redeemable commodity holdings and linked to price changes in such non-security commodities necessarily are securities. Tokens of that type should be evaluated based on their own merits, in terms of how they are structured, the manner in which they are offered, and the functions and features they possess. The issue is not simply whether such a token is a security or a non-security commodity. Linking the price of the token to the price of a non-security commodity evokes the implicit expectation that the token’s price will have some correlation to the prevailing price for the commodity. This raises questions regarding whether the token should be viewed as a form of cash-settled derivative on the commodity, and if so, whether the token fits within any of the CEA’s existing classifications for derivatives regulated by the CFTC. Alternatively, where the link is intended to provide pricing stability to facilitate acceptance of the token as a means of exchange to pay for goods or services, perhaps the currency-related function should define the token as a non-security commodity in its own right, and not as a derivative on the referenced commodity.

Securities with embedded derivatives elements are another area where CFTC and SEC jurisdiction can intersect. The existing landscape provides some clarity for hybrid securities that

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731 The definitions of “security” in Securities Act section 2(a)(1) and Exchange Act section 3(a)(10) include a “catchall” element covering any “instrument commonly known as a ‘security.’” 15 U.S.C. § 77b(a)(1); id. § 78c(a)(10).
remain securities, through exemptions from CFTC regulation available under CEA section 2(f) or under the CFTC Part 34 Rules. CEA section 2(f) provides one exemption for hybrid instruments that are “predominantly securities.” For an instrument to meet the predominance test, the purchaser must fully pay for the security, without any obligation to make additional payments such as margin or mark-to-market settlement, throughout the lifespan or at maturity of the security, and the hybrid security must not be marketed as a futures or options on futures contract subject to the CEA. The CFTC Part 34 Rules provide another exemption, which is limited to securities that are debt or equity securities and also imposes the “fully paid for” requirement and marketing restriction. In addition, the exemption assumes that the security has both commodity dependent and commodity independent components, and requires the value of the commodity dependent component(s) to be less than the value of the commodity independent component.

It is appropriate to question whether it makes sense to apply the more lenient terms of the CEA hybrid securities exemption to digital assets that may be securities on the basis of being an investment contract and that also have characteristics of derivatives the CFTC regulates. In practical terms, this issue may not arise, as the CEA exemption (and likewise the Part 34 exemption) would not be available for a digital asset where it is envisioned that the token will cease to be a security at some future time and continue life as a non-security commodity, because the exemption is predicated on the instrument retaining its security status at all times. But if an issuer were willing to do so, should it be allowed to keep the “security” label to claim the CEA exemption on the digital asset after the securities characteristics disappear? When the “entrepreneurial or managerial efforts of others” are difficult to quantify and the non-security

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732 The exemption also covers certain banking products, such as demand deposits or time deposits.
commodity and commodity derivatives characteristics dominate or may in the future dominate, it would seem there is a strong policy justification for CFTC jurisdiction. The commodity-based ETF precedent suggests that hybrid digital assets of this type should not be pigeonholed into the CEA section 2(f) exemption, but instead should be addressed through coordination between the two agencies and the CFTC’s exercise of its judgment regarding whether it is appropriate to exercise its exemptive authority under CEA section 4(c) to accommodate trading of derivatives on such digital assets.

Putting aside the foregoing issue, it is reasonable to foresee interest in offering debt or equity securities where one or more payment components are linked in whole or in part to the value of a virtual currency or other digital asset. In this hybrid security context, the issue, of course, is whether the digital asset is a non-security commodity. If it is, it will be important for the issuer to understand the terms of the hybrid security exemptions if it wants to qualify for relief from CEA regulation.

There are other interpretive issues that may impede development of the digital asset markets. For example, the definition of security in the ICA (and the IAA) is broader than the one used in the Securities Act, Exchange Act, and CEA, raising the prospect that a digital asset could be a non-security commodity under the CEA and yet be pulled into the realm of investment company regulation of a commodity fund holding the asset in its portfolio.

4. The History of Resolving Jurisdictional Issues between the SEC and CFTC

Issues of jurisdictional overlap between the SEC and CFTC are not new. The legal scheme today recognizes the value of cooperation between the two agencies, reflecting lessons learned from the history of resolving such issues.

In the earlier part of this history, jurisdictional questions between the CFTC and SEC over the application of their respective statutes to various financial products were debated in the
courts. Those controversies generally were resolved through negotiated outcomes between the agencies, some of which later were enacted into law. Shortly after passage of the Commodity Futures Trading Commission Act of 1974, which provided the CFTC with “exclusive jurisdiction” over futures on commodities in CEA section 2(a)(1) under a newly expanded “commodity” definition, the SEC asserted that the CEA amendments had not diminished its jurisdiction over transactions involving a security—even with respect to futures contracts that involved securities.\textsuperscript{733}

Not long thereafter, when the Chicago Board of Trade (CBOT) was preparing to list and trade a futures contract on Government National Mortgage Association (GNMA) certificates, the SEC warned that trading that contract might be illegal, notwithstanding the CFTC’s prior approval. The CBOT initiated trading anyway, and the SEC took no formal action against the exchange. In 1981, however, when the SEC granted permission to the Chicago Board Options Exchange (Cboe) to trade options on GNMA certificates, the CBOT sued the SEC, arguing that a GNMA certificate was a commodity under the CEA, and the CFTC therefore had exclusive jurisdiction. The CFTC and SEC, through their respective chairmen, Philip Johnson for the CFTC and John Shad for the SEC, negotiated a resolution in what is known as the “Shad-Johnson Accord” (“Accord”) that delineated the statutory applications to specific types of traded instruments. Because Congress had not yet enacted the Accord into law, the Seventh Circuit Court of Appeals did not consider it and instead held that GNMA certificates were commodities, that the CFTC had exclusive jurisdiction over GNMA options, and that the SEC had no power to authorize their trading on the Cboe.\textsuperscript{734} Later, following Congress’s enactment of the Accord into

\textsuperscript{733}JOHNSON & HAZEN, supra note 695, at § 4.05[8].

\textsuperscript{734}Bd. of Trade of Chi. v. SEC, 677 F.2d 1137 (7th Cir. 1982), vacated as moot, 459 U.S. 1026 (1982).
law as part of the Futures Trading Act of 1982.\textsuperscript{735} options on GNMA certificates were treated as options directly on securities over which the SEC exercised jurisdiction, but futures contracts and options on futures contracts on GNMA certificates (and more generally on exempted securities, as defined in the Exchange Act) were subject to CFTC jurisdiction.

A similar controversy arose in 1988 when three securities exchanges filed applications to permit exchange trading in what were called “stock index participation” instruments. These instruments were perceived to have many characteristics of futures contracts. Significantly, the CFTC took the position that the index participation instruments were not securities and therefore should be regulated by the CFTC as futures contracts. When the SEC granted the securities exchanges’ applications to list these products for trading, the CME challenged the SEC before the Seventh Circuit. That court found that the index participation instruments potentially could be classified as both securities and futures contracts, but concluded that based on the jurisdictional Accord, an instrument that can be classified as both a security and futures contract was subject to the exclusive jurisdiction of the CFTC.\textsuperscript{736} Consequently, the instruments could not trade on the securities exchanges without CFTC approval.

Additional jurisdictional controversies continued to arise into the early 1990s. Proposed legislation in 1991 sought to further delineate the jurisdiction between the CFTC and SEC over certain hybrid investment vehicles, including securities whose values were tied to the market price of another asset or commodity. The legislation ultimately did not include a jurisdictional


\textsuperscript{736} Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989).
allocation between the agencies. Rather, the 1992 amendments to the CEA gave the CFTC in new section 4(c)\textsuperscript{737} authority to exempt transactions from the requirements of the CEA.

One of the CFTC’s first uses of its authority under CEA section 4(c) related to the instruments that spawned the need for the authority—hybrid instruments. The CFTC crafted the Part 34 exemption (discussed above), covering hybrid instruments that are equity or debt securities or depository instruments with one or more commodity-dependent components that have payment features similar to commodity futures or commodity option contracts or combinations thereof. In the Commodity Futures Modernization Act of 2000 (CFMA), Congress added CEA section 2(f) to provide a statutory exclusion for hybrid securities that are predominantly securities (but on more lenient terms than set out in the CFTC exemption).

The CFMA also sought to resolve a jurisdictional controversy between the CFTC and SEC over the trading of futures on a single non-exempt security or a narrow-based security index. How to allocate jurisdiction over such products was one issue that the Accord left unresolved; the Futures Trading Act of 1982 banned trading of such products, but the ban was intended to be temporary. The CFMA established a structure for joint CFTC and SEC jurisdiction over those products, which is set out in CEA section 2(a)(1)(C).\textsuperscript{738}

Points of jurisdictional overlap do not always result in disputes, as the more recent history illustrates. The two agencies cooperated to work out an approach for handling commodity-based ETFs in 2008. A number of these vehicles are structured as trusts that passively hold commodities, with the objective that the share prices would track the prices of the underlying commodities. The registration statement for the first product of this type—a gold

\textsuperscript{737} 7 U.S.C. § 6(c).

\textsuperscript{738} Id. § 2(a)(1)(C).
ETF—was making slow progress through the SEC, as staff rightly anticipated that exchanges would want to list options and futures on the ETF shares, raising the issue of whether such derivatives should be regulated by the CFTC as commodity options and as futures, or by the SEC as options on securities and by the CFTC and SEC jointly as security futures. The exchanges in fact did pursue listing of such derivatives on shares of the gold ETF, which brought the issue before both agencies.

The CFTC and SEC entered into an MOU in March 2008 setting out an approach for addressing novel derivatives products that “may reflect elements of both securities and commodity futures or options, and may impact the regulatory mission of each agency.” Shortly thereafter, the CFTC exercised its exemptive authority under CEA section 4(c) to permit options on the ETF shares to be traded on national securities exchanges as options on securities and futures on such ETF shares to be traded on exchanges as security futures. In its orders, the CFTC did not take a position on whether the ETF shares should be considered a security or a non-security commodity, but instead determined that the exemption would be consistent with the public interest, in large part because the products would be subject to regulation by the SEC or, for the futures, jointly by the SEC and CFTC.


740 See, e.g., SPDR Exemption Order, 73 Fed. Reg. 31,981; CFTC Order Exempting the Trading and Clearing of Certain Products Related to SPDR Gold Trust Shares, 73 Fed. Reg. 21,917 (proposed Apr. 28, 2008) (permitting options on SPDR Gold Trust Shares to be listed by securities exchanges and cleared by Options Clearing Corporation as options on securities).
Following that cooperation, in a joint report in 2009, the CFTC and the SEC recommended legislation that would provide a process for expedited judicial review of jurisdictional matters regarding new products. The report grew out of a joint meeting of the two Commissions and 30 public panelist members, including industry experts and market participants. Among other issues, panelists commented about the past jurisdictional disagreements between the CFTC and SEC over particular products due to uncertainty as to their proper regulatory classifications: a securities product would be subject to SEC jurisdiction, and a derivatives product to CFTC jurisdiction. That uncertainty, in turn, occasionally caused lengthy delays in bringing new products to market, such as the gold ETF discussed above. Despite the Commissions’ entry into the 2008 MOU, panelists advocated a legislative solution to more clearly define the jurisdictional boundaries between the two agencies and establish procedures to promptly resolve jurisdictional issues.

In their joint report, the agencies concurred with panelists that legislation was necessary with respect to jurisdictional matters regarding novel products. Specifically, the joint report called for (i) a review process to ensure that the Commissions resolve any jurisdictional dispute against a firm timeline and (ii) legal certainty with respect to the agencies’ authority over

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products exempted by the other agency.\textsuperscript{743} Congress addressed the report’s recommendations in Dodd-Frank,\textsuperscript{744} enacting the first proposal in section 718 and the second in section 717.

As a more recent expression of cooperation, the CFTC and SEC entered into an MOU in July 2018 that updates the 2008 MOU.\textsuperscript{745} The new MOU is predicated on their joint acknowledgment that “enhanced coordination and cooperation concerning issues of common regulatory interest is necessary in order to foster market innovation and fair competition and to promote efficiency in regulatory oversight.”\textsuperscript{746}

5. **Statutory Process for Seeking Regulatory Clarity for Novel Derivative Products**

   Section 718 of Dodd-Frank establishes a procedure for the CFTC and SEC to determine the status of “novel derivative products” that might implicate the regulatory interests of both agencies. Under section 718(a)(1)(A), any person filing a proposal to list or trade a novel derivative product that may have elements of both securities and futures contracts, options on futures, or commodity options may concurrently provide notice and furnish a copy of such filing to the SEC and CFTC.\textsuperscript{747} The notice must state it has been made to both agencies. If no concurrent notice is made, section 718(a)(1)(B) provides, as an alternative, that if either Commission receives a proposal to list or trade a product and determines that the proposal involves a novel derivative product that may implicate the jurisdiction of the other, it must within

\begin{itemize}
\item \textsuperscript{743} Id. at 11.
\item \textsuperscript{744} Pub. L. No. 111-203, 124 Stat. 1376 (2010).
\item \textsuperscript{746} Id. at 1.
\item \textsuperscript{747} 15 U.S.C. § 8306(a)(1)(A).
\end{itemize}
five business days of making that determination notify and provide a copy of the proposal to the other Commission.\(^{748}\)

Not later than 21 days after receipt of a notice under Dodd-Frank section 718(a)(1), or upon its own initiative if no notice is received, the CFTC pursuant to section 718(a)(2) may request in writing that the SEC issue a determination as to whether a product is a “security,” as defined in Exchange Act section 3(a)(10).\(^{749}\) Similarly, the SEC, within 21 days after receipt of a notice under section 718(a)(1), or upon its own initiative if no such notice is received, may request in writing that the CFTC issue a determination as to whether a product is a futures contract, an option on futures, or a commodity option.\(^{750}\) In addition, the CFTC and SEC may request that the other agency issue an exemption with respect to a novel derivative product pursuant to their respective exemptive authorities under CEA section 4(c)\(^{751}\) and Exchange Act section 36.\(^{752}\)

Once a written request for a determination or exemption is made, the requested agency shall by order issue the requested determination and the reasons therefor, or grant an exemption or provide reasons for not granting an exemption, not later than 120 days after the date of receipt of such a request.\(^{753}\) Determinations by one agency that a novel derivative product is a security or a futures contract, option on futures, or commodity option (but not exemptions) are subject to

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\(^{748}\) Id. § 8306(a)(1)(B).

\(^{749}\) Id. § 78c(a)(10).

\(^{750}\) Id. § 8306(a)(2).

\(^{751}\) 7 U.S.C. § 6(c).

\(^{752}\) 15 U.S.C. § 78(mm).

\(^{753}\) Id. § 8306(a)(3).
judicial challenge by the other agency in the U.S. Court of Appeals for the District of Columbia Circuit.\textsuperscript{754} The court of appeals must review such a petition on an expedited basis and, in considering such a petition, must not give deference to, or any presumption in favor of, the views of either Commission.

Section 717 of Dodd-Frank amended the CEA and the Exchange Act to clarify that even if the CFTC or the SEC exempts a novel derivative product, the exempting Commission still retains jurisdiction over the product in certain cases. Specifically, Dodd-Frank section 717(a) amended CEA section 2(a)(1)(C)\textsuperscript{755} to provide that the CFTC has jurisdiction over a product that has been exempted by the SEC from the Exchange Act with the condition that the SEC exercise concurrent jurisdiction over the product. Similarly, Dodd-Frank section 717(b) added section 3B to the Exchange Act\textsuperscript{756} to provide that the securities laws govern as a security any agreement, contract, or transaction (or class thereof) that has been exempted by the CFTC from the CEA with the condition that the CFTC exercise concurrent jurisdiction over such agreement, contract, or transaction (or class thereof).

6. Potential Approaches to Resolving Jurisdictional Issues without New Legislation

The CFTC’s and SEC’s principal statutory tools to resolve jurisdictional questions without resorting to new legislation—section 718 of Dodd-Frank covering “novel derivative products” and exemptive authority under CEA section 4(c) and Exchange Act section 36—give the agencies extensive freedom to craft solutions.\textsuperscript{757} They confer authority to exempt any

\textsuperscript{754} Id. § 8306(b).


\textsuperscript{757} The SEC has additional and similar exemptive authority under the other statutes it administers, \textit{e.g.}, Securities Act section 28 and section 6(c) of the Investment Company Act of 1940.
product, transaction, or person, or any class of each, from any and all provisions of their statutes, unconditionally or conditionally, and retroactively, prospectively, or both. The freedom this allows, however, does not diminish the difficulty of exercising that exemptive authority to constrain power or effectively cede power to the other agency. Those decisions take time and great deliberation if it is difficult for either agency to reach a level of confidence that an alteration of the exercise of its power will not harm the interests of those whom the statutes are intended to protect. The examples of CFTC exemptive relief discussed above concerning hybrid securities and ETFs on commodities required an extensive period of review and careful agency attention before approval.

Digital assets present a more complex set of issues due to their varied characteristics and the capacity of some to change from securities to non-security commodities. But the exemptive or section 718 processes provide a potential context by which broader and more developed regulatory guidance can be provided to the public. To date, most of the guidance has come in the form of one-off enforcement settlements or court complaints that sometimes, given the complexity of the subject matter, can raise more questions than they answer, especially with respect to application of the announced principles or reasoning to transactions with features different from those that were the subject of the settlement or complaint.

Before determining a prudent use of exemptive authority, the agencies may need to develop a shared understanding of the different types of transactions and uses of digital assets and sort out their respective interests in each type. For example, for one of the problematic jurisdictional areas—a transaction like that described in the SEC’s order in In re Munchee LLC, in which a putative virtual currency (i.e., a putative commodity) underlies an investment contract but provides no equity interest in the enterprise—the agencies may need to consider their
respective interests at each stage of the issuing enterprise’s development. The SEC’s interest may be paramount and the CFTC’s remote at the outset, when an enterprise is offering the virtual currency for initial sale and promoting its potential appreciation in value over time in a secondary market, but the virtual currency has little if any active secondary market. In that instance, reliance on the SEC’s authority alone might be adequate to address the public interest and market integrity. However, in the event the virtual currency develops into an active secondary market, the CFTC’s interest might become paramount, and the SEC’s interest may wane because the sale of investment contracts will have concluded.

Sorting out the complex issues may require a regular internal deliberative process between the agencies’ staff. An important shared objective of both agencies would be to provide a means to inform the public of the agencies’ shared views of the law and the character of various types of transactions. A more formal public process, such as notice and comment rulemaking or some other means to receive comment from interested parties, also might be warranted. Restricting the exemptive process to non-public requests and communications from particular interested parties involved in the offering of a digital asset in certain instances might be inadequate to inform the agencies of all of the potential impacts of an exemption or regulatory approach.\footnote{See, e.g., 7 U.S.C. § 6(c)(1)(B) (not requiring public notice and opportunity for hearing for the CFTC and SEC’s joint exemption of a product from SEC regulation of security futures).}

An established process for resolving issues arising in the context of enforcement actions can be equally important to the development of consistent jurisdictional positions on which the public can rely. To the extent, for example, that the SEC considers a digital asset to be a security, it can be important that the CFTC both shares the SEC’s view and believes the transaction does
not involve CFTC jurisdiction over a non-security commodity or derivative. Again, an ongoing, structured internal process for analyzing and resolving these issues could be beneficial.

In the end, the difficult jurisdictional issues ultimately could require congressional legislation to resolve. But legislation would benefit from collaborative work by the agencies between themselves and in a public comment process to identify and start to resolve how this area of commerce can be best regulated for the benefit of market participants and the development of innovative financial products that improve commerce.
SECTION 6. FINCEN REGULATION*

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1. Scope

Cryptocurrencies offer a variety of benefits generally not available to users of other mediums of exchange, including anonymity, limited regulatory oversight, low transaction costs, and cross-border flexibility. These same benefits, however, expose cryptocurrencies to exploitation by money launderers and terrorist financiers, and the general absence of clarity regarding the AML and CFT laws and rules that govern cryptocurrency transactions exacerbates the potential for exploitation.759

* The authors of the 2020 updates to Section 6 would like to acknowledge Samuel B. Cutler, Associate, Sullivan & Cromwell LLP, for his contributions to updating this Section.

759 These and other vulnerabilities continue to be a subject of discussion. In June 2014, the FATF, an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering, terrorist financing, and other related threats, issued a report identifying the potential AML and CFT risks associated with virtual currencies. See FATF, VIRTUAL CURRENCIES: KEY DEFINITIONS AND POTENTIAL AML/CFT RISKS (2014), https://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-
The Bank Secrecy Act of 1970 (BSA) is the primary federal statute governing AML efforts outside of criminal prohibitions.\textsuperscript{760} Generally, the BSA applies to “financial institutions.” FinCEN, a bureau of the U.S. Department of the Treasury, has the authority to implement, administer, and enforce compliance with the BSA and associated regulations\textsuperscript{761} that are intended to detect and prevent money laundering.\textsuperscript{762} As part of this authority, FinCEN determines which persons are “financial institutions” under the BSA and has determined that certain persons not typically thought of as financial institutions, including casinos and MSBs, do constitute financial institutions for purposes of the BSA.\textsuperscript{763} Thus far, FinCEN has issued and interpreted regulations that apply to MSBs as relevant to digital asset businesses, including issuers, exchangers, and administrators of digital assets. Therefore, this Section focuses on AML requirements that apply to MSBs.

FinCEN’s regulatory definition of a MSB is particularly expansive and includes any person\textsuperscript{764} doing business as a dealer in foreign exchange, check casher, issuer or seller of money


\textsuperscript{761} This authority is by delegation from the Secretary of the Treasury. See Treasury Order 180-01 (Mar. 24, 2003).

\textsuperscript{762} 31 U.S.C. § 5318(h); Treasury Order 180-01 (Mar. 24, 2003).

\textsuperscript{763} See generally 31 C.F.R. ch. X.

\textsuperscript{764} FinCEN’s regulations define “person” as “an individual, a corporation, a partnership, a trust or estate, a joint stock company, an association, a syndicate, joint venture, or other unincorporated organization or group, an Indian
orders and traveler’s checks, money transmitter, provider or seller of prepaid access, and the U.S. Postal Service. Notably, the definition applies to a person, wherever located, doing business, whether or not an organized or licensed business concern, wholly or in substantial part within the United States, in one or more of the foregoing capacities. A money transmitter is any person that provides money transmission services, such as the “acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means.”

With respect to digital assets, FinCEN has issued guidance interpreting that the “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 can be used as currency makes a person a money transmitter under [FinCEN’s] regulations.” In its 2013 guidance on virtual currencies, FinCEN further asserted that an “exchanger” is “a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency,” and further defined an “administrator” as a “person engaged as a business in

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765 31 C.F.R. § 1010.100(ff).

766 Id.

767 Id. § 1010.100(ff)(5) (emphasis in original).

768 FIN-2013-G001, supra note 189, at 3 (emphasis added). The 2013 Guidance defines “convertible virtual currencies” as having an equivalent value in real currency or acting as a substitute for real currency. “Real currency” is defined as “the coin and paper money of the United States or of any other country that [i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance.” 31 C.F.R. § 1010.100(m).

769 In guidance issued in May 2019, FinCEN consolidated its 2013 guidance with other guidance and administrative rulings related to virtual currencies and applied them to common business models involving virtual currencies. See Application of FinCEN’s Regulations to Certain Business Models Involving Convertible Virtual Currencies, FIN-2019-G001 (May 9, 2019) [hereinafter FIN-2019-G001].
issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.”

Therefore, unless an exemption or exclusion applies, digital asset businesses that provide money transmission services are money transmitters subject to FinCEN regulation as MSBs. Although FinCEN’s interpretative guidance may not have the force and effect of law equivalent to a regulation, it does provide the agency’s views applicable to digital assets, as does its other guidance discussed below.

In its May 2019 guidance on virtual currencies, FinCEN asserted that the definition of a money transmitter applies regardless of the technology employed for the transmittal of value or the type of asset the person uses that substitutes for currency (e.g., whether physical or virtual). It also provided examples of how FinCEN’s money transmitter regulations apply to various business models involving transactions in virtual currency, including peer-to-peer exchangers, virtual currency wallets, virtual currency kiosks, decentralized applications, anonymity-enhanced virtual currency transactions, virtual currency payment processors, internet casinos, virtual currency trading platforms and decentralized exchanges, ICOs, virtual currency creators, and mining pools and cloud miners. Of particular interest, FinCEN asserted in the May 2019 guidance that money transmission may occur, unless exempt, when a person: (i) uses any representation of currency or fiat currency (i.e., legal tender) associated with the purchase or sale of commodities, securities, or futures contracts to engage in money transmission; (ii) issues

770 FIN-2013-G001, supra note 189, at 2; see also FIN-2019-G001, supra note 769, at 13.

771 31 C.F.R. §§ 1010.100(ff)(5)(ii), (8).

772 FIN-2013-G001, supra note 189; FIN-2019-G001, supra note 769.

773 FIN-2019-G001, supra note 769, at 3.

774 Id. at 14–28.
physical or digital tokens evidencing ownership of commodities, securities, or futures contracts that serve as value that substitutes for currency; or (iii) issues or employs commodities, securities, or futures contracts by themselves as value that substitutes for currency.\textsuperscript{775}

In this regard, FinCEN noted that the term MSB does not include: (i) a person registered with, and functionally regulated or examined by, the SEC or the CFTC, or (ii) a foreign financial agency that engages in financial activities that, if conducted in the United States, would require the foreign financial agency to be registered with the SEC or CFTC.\textsuperscript{776} As a result, in October 2019, the SEC, CFTC, and FinCEN issued a joint statement further clarifying the U.S. AML obligations that apply to digital assets for brokers and dealers of securities, futures commission merchants and introducing brokers of commodities, and MSBs, respectively.\textsuperscript{777}

2. Registration as a MSB

Generally, U.S. MSBs and non-U.S. MSBs that do business in the United States must register with FinCEN.\textsuperscript{778} Accordingly, absent an applicable exemption or exclusion, any digital asset business that qualifies as a MSB under FinCEN’s regulations, including issuers of digital assets, exchanges, and administrators, regardless of particular business model, must register with FinCEN.

\textsuperscript{775} Id. at 6–7.

\textsuperscript{776} Id. at 4.


\textsuperscript{778} See 31 C.F.R. § 1022.380(a). The jurisdictional reach of the BSA generally is understood to apply to financial institutions that are organized under U.S. law, operate within the United States, or provide financial products or services to U.S. residents. Accordingly, non-U.S. digital asset businesses that do not service U.S. residents typically would not be required to register as MSBs. Non-U.S. digital asset business that do service U.S. residents clearly are within the reach of the BSA, as evidenced by FinCEN’s recent enforcement action against BTC-E. See infra note 805 and accompanying text.
Once registered, a MSB (i) will be subject to examination by the IRS with respect to its AML/CFT compliance; (ii) may receive requests from FinCEN under section 314(a) of the USA PATRIOT Act of 2001 (PATRIOT Act) to provide specified information to law enforcement agencies across the country regarding accounts and transactions of persons that may be involved in terrorism or money laundering;779 and (iii) may share voluntarily information with other U.S. financial institutions under section 314(b) of the PATRIOT Act to combat potential money laundering and terrorist financing. As of February 2018, about 100 MSBs whose activities involve digital assets had registered with FinCEN, approximately one-third of which the IRS already had examined.780 By February 2019, those examinations “included a wide array of different types of virtual currency businesses, such as exchangers of currency, virtual currency trading platforms, administrators, virtual currency kiosk (or ATM) companies, crypto-precious metals dealers, and individual peer-to-peer exchangers.”781

The requirement to register with FinCEN is independent of the obligation a person or entity may have to become licensed as a money transmitter under state law. While many FinCEN-registered MSBs also are licensed as state money transmitters, and vice versa, FinCEN’s regulations are concerned with U.S. federal AML/CFT obligations, while state money transmission laws generally are targeted at achieving consumer protection goals, approval by a

779 31 C.F.R. §§ 1010.520, 1022.320(f). A secondary consequence of registration with FinCEN is that a MSB’s information is published in FinCEN’s online MSB database, which some state regulators use to identify MSBs that should be licensed under state money transmitter laws. However, not all FinCEN-registered MSBs must be licensed as state money transmitters, so this consequence is not necessarily a universal concern.


state authority, and compliance with other applicable state laws, including anti-money laundering. It therefore is possible that an entity may be required to register as a MSB with FinCEN but, due to differences with state law requirements, particularly with regard to differing obligations applicable to digital assets, may not be required to register as a MSB under particular state laws. If a person is required to register with FinCEN as a MSB, it does so by electronically filing a FinCEN Form 107 (Registration of Money Services Businesses) with FinCEN. A MSB’s owner or controlling person is responsible for completing the two-page form within 180 days of establishing the MSB.

A MSB must renew its Form 107 filing at least every two years but also must re-file its Form 107 with FinCEN when any of the following significant events occur:

- A MSB is registered under the laws of any U.S. state and experiences a change in ownership or control that requires the business to be re-registered under state law.
- There is a transfer of more than 10 percent of the voting power or equity interests of a MSB (other than a MSB that is required to report such transfers to the SEC).
- A MSB experiences a more than 50 percent increase in the number of its agents during any registration period.

The registration form must be filed not later than 180 days after a triggering change in ownership, transfer of voting power or equity interests, or increase in agents. FinCEN also expects MSBs to promptly file updated Form 107 filings if the MSB operates in a new MSB capacity (e.g., a check casher who begins selling money orders) or offers its products in a new

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782 A person who knowingly conducts, controls, manages, supervises, directs, or owns an unlicensed money transmitting business affecting interstate or foreign commerce, where punishable as a misdemeanor or felony under State law, may be exposed to potential federal criminal liability. 18 U.S.C. § 1960.


784 31 C.F.R. § 1022.380(b).
jurisdiction (e.g., a MSB expands its geographic footprint to offer money transmission in a U.S. state in which it previously did not do so) by using the BSA E-Filing System. 785 As a general observation, MSBs whose activities involve digital assets typically will be concerned with filing updates for new lines of business and new jurisdictions, because most digital assets do not implicate changes in the ownership structure of the MSB, and digital asset businesses tend not to implicate the agent model that is used in retail MSB settings.

3. Anti-Money Laundering Program

FinCEN requires MSBs (including digital asset businesses that are money transmitters under FinCEN’s regulations) to develop, implement, and maintain an effective, risk-based AML program that is reasonably designed to prevent the MSB from being used to facilitate money laundering and the financing of terrorist activities. 786 Given the risk-based nature of the AML regime, the precise expectations for any given MSB will vary based on the nature of the financial activity involved. However, generally an adequate AML program for a MSB will address or include the following:

- collecting and verifying customer identifying information; 787
- appropriate internal controls; 788


787 Although there is no customer identification rule for individuals or customer due diligence rule for verifying beneficial ownership of legal entities generally applicable to MSBs, FinCEN encourages MSBs to adopt policies and procedures that incorporate proper identification of all persons conducting financial transactions with the MSB. See FinCEN, Money Laundering Prevention: A Money Services Business Guide, at 11–12, https://www.fincen.gov/sites/default/files/shared/mlp_en_prevention_guide.pdf.

788 31 C.F.R. § 1022.210(d)(1).
• designation of a BSA/AML compliance officer;\textsuperscript{789}
• employee AML training;\textsuperscript{790}
• independent review of the AML compliance program;\textsuperscript{791}
• monitoring and reporting suspicious activity by filing SARs with FinCEN, which generally is triggered at a $2,000 threshold for MSBs;\textsuperscript{792}
• subject to dollar thresholds, filing Currency Transaction Reports\textsuperscript{793} and Currency and Other Monetary Instrument Reports with the U.S. government;\textsuperscript{794}
• maintaining required records;\textsuperscript{795}
• responding to certain law enforcement requests;\textsuperscript{796} and
• Developing a written risk assessment, among other procedures, protocols, tools, and systems.

The aforementioned recordkeeping requirements include obligations (subject to certain exceptions) for funds transfers of $3,000 or more. Specifically, nonbank financial institutions, such as MSBs, that accept any such funds transfer must obtain and retain certain information concerning the person placing the order and the recipient (Transfer Rule),\textsuperscript{797} and transmittor and

\textsuperscript{789} Id. § 1022.210(d)(2).
\textsuperscript{790} Id. § 1022.210(d)(3).
\textsuperscript{791} Id. § 1022.210(d)(4).
\textsuperscript{792} Id. § 1022.320.
\textsuperscript{793} Id. §§ 1022.310, 1022.311, 1010.311.
\textsuperscript{794} Id. § 1010.340.
\textsuperscript{795} See, e.g., id. §§ 1010.410, 1010.415, 1022.410, 1022.420.
\textsuperscript{796} 31 C.F.R. §§ 1022.520, 1010.520. Banks, broker-dealers, mutual funds, futures commission merchants, and introducing brokers also are subject to other, more extensive AML requirements, such as with respect to customer due diligence and beneficial ownership identification. See Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398 (May 11, 2016) (to be codified at 31 C.F.R. pts. 1010, 1020, 1023, 1024, 1026) (adopting due diligence requirements for banks, broker-dealers, mutual funds, and futures commission merchants).
\textsuperscript{797} 31 C.F.R. § 1010.410(e).
intermediary financial institutions must include in the order specified information regarding the sender and recipient so that such information is included in the order as it travels from financial institution to financial institution (Travel Rule). Under the Transfer Rule, if a fund transmitter or recipient is not an established customer, which frequently may be the case with MSBs, the nonbank financial institution must undertake additional steps aimed at obtaining, verifying, and retaining information regarding the identity of the customer. Based on the operational and technological standards of digital assets transferred on the blockchain, as well as questions regarding whether the exchange of virtual currency should be viewed as a funds transfer, it is difficult for such MSBs to comply fully with the Transfer Rule and Travel Rule.

The Travel Rule and analogous international standards, in particular, have been a recent focus of international attention, with FATF adopting an interpretive note in June 2019 confirming that countries should apply provisions similar to FinCEN’s Travel Rule (FATF Recommendation 16) to virtual asset services providers. Based on this multinational standard, virtual assets and virtual asset service providers (VASPs) operating in global jurisdictions are beginning to develop standards that can meet FATF Recommendation 16. In the United States, FinCEN has confirmed that the Travel Rule is the most commonly cited violation by the IRS against MSBs engaged in virtual currency money transmission.

798 Id. § 1010.410(f).
799 Id. §§ 1010.410(e)(2)–(3).
4. **Know-Your-Customer Requirements**

As noted, although there is no customer identification rule for individuals or customer due diligence rule for verifying beneficial owners of legal entities generally applicable to MSBs, MSBs, in particular circumstances, are required to obtain and verify the identity of their customers and maintain certain records. At a minimum, this means that a MSB must collect sufficient information regarding a customer to meet the MSB’s recordkeeping and reporting obligations, including the accurate and complete submission of a SAR, Currency Transaction Report, Report of International Transportation of Currency or Monetary Instruments, or Report of Foreign Bank and Financial Accounts, when required. In practice, however, a MSB may need to collect additional information from a customer when it is opening an account with the MSB in order to make a risk assessment regarding the customer and to enable it to understand the customer sufficiently to carry out the MSB’s reporting obligations. The nature and extent of the information collected should be consistent with the risk of the MSB’s activities.

5. **Enforcement**

Failure to comply with applicable BSA requirements has resulted in substantial consequences for persons engaged in digital asset businesses. In May 2015, Ripple, which facilitated transfers of cryptocurrency and provided cryptocurrency exchange transaction services, agreed to pay FinCEN a civil money penalty of $700,000 to settle potential liability in connection with violations of the BSA—failing to register with FinCEN as a MSB, maintain an  

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802 See, e.g., 31 C.F.R. §§ 1010.410, 1022.310, 1022.311, 1010.311.
appropriate AML program, and file required SARs.\textsuperscript{803} The DOJ also imposed on Ripple a $450,000 forfeiture.\textsuperscript{804}

In July 2017, FinCEN, again in coordination with the DOJ, assessed more than $110 million in civil money penalties against BTC-E a/k/a Canton Business Corporation, a virtual currency trading platform based outside the United States.\textsuperscript{805} The charges, based on the company’s transactions with U.S. customers, included failing to register with FinCEN as a MSB, maintain an appropriate AML program, file required SARs, and retain records related to funds transfers.

Most recently, FinCEN brought an enforcement action in April 2019 against Eric Powers, an individual, which resulted in a civil money penalty of $35,350 for his willful violation of the BSA’s registration, program, and reporting requirements.\textsuperscript{806} Mr. Powers acted as a peer-to-peer virtual currency exchanger, which qualified him as a money transmitter and financial institution from December 6, 2012 through September 24, 2014.\textsuperscript{807} This is the first time FinCEN assessed civil money penalties against a peer-to-peer virtual currency exchanger. In commentary, Director Blanco reminded market participants that “obligations under BSA apply to money transmitters


\textsuperscript{807} See 31 C.F.R. §§ 1010.100(ff)(5), (t).
regardless of their size.” 808 The United States Attorney for the District of Maryland also imposed a forfeiture of $123,192.14 and 237.53575 bitcoin to the United States. 809

Another approach the U.S. Department of the Treasury has used to address the money laundering risk posed by non-U.S. virtual currency providers is its authority under section 311 of the PATRIOT Act to impose special measures, including the authority to identify the provider as a financial institution of primary money laundering concern. In 2013, FinCEN issued a notice of finding under section 311 with respect to now-defunct Liberty Reserve S.A., a web-based money transfer system registered in Costa Rica, thereby eliminating its access to the U.S. financial system. 810


SECTION 7. INTERNATIONAL REGULATION OF DIGITAL ASSETS AND BLOCKCHAIN TECHNOLOGY*

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The global nature of blockchain technologies and cryptocurrencies presents unique regulatory challenges. Most cryptocurrencies and other blockchain applications traverse international boundaries, thus creating challenges associated with how to—and who should—regulate them. For this reason, a number of international organizations and regulatory bodies, both within and across continents, have endeavored to issue guidance and regulations in these areas. Individual countries, too, have sought to do so, often using the guidance of larger international organizations as a springboard, and sometimes even adopting it wholesale. In such a dynamic environment, individual countries often look to one another to take the lead—with European and Asian nations frequently at the helm—and then use their peer countries’ approaches as frameworks for evaluating how best to regulate within their own borders. This

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Section focuses on the applicable regulations in Europe and Asia, and in individual countries of interest.

1. **European Initiatives**

   Both individual European countries and European institutions have issued a number of statements, guidance, and regulations potentially applicable to cryptocurrencies, blockchain, and ICOs. In November 2017, for example, ESMA\(^\text{811}\) issued a statement reminding firms involved in ICOs to “give careful consideration as to whether their activities constitute regulated activities,” and if so, to comply with applicable EU legislation.\(^\text{812}\) Where the coins or tokens at issue in an ICO qualify as “financial instruments,” as defined in the MiFID II, firms likely are conducting regulated investment activities, such as placing, dealing in, or advising on financial instruments or offering transferable securities to the public.\(^\text{813}\) In that instance, a number of rules and regulations may apply, including MiFID II, the Prospectus Directive, and the AIFMD, and the Fourth Anti-Money Laundering Directive (“4AMLD”) and Fifth Anti-Money Laundering Directive (“5AMLD”) also may apply. The 5AMLD drove much of the legislation and regulation regarding cryptocurrency throughout Europe in 2019 and 2020. Most recently, EU members approved the Sixth Anti-Money Laundering Directive (“6AMLD”), set to go into full effect in

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\(^\text{811}\) ESMA is an independent EU authority that “contributes to safeguarding the stability of the European Union’s financial system by enhancing the protection of investors and promoting stable and orderly financial markets.” *Who We Are*, ESMA, https://www.esma.europa.eu/about-esma/who-we-are. Although independent, ESMA is accountable to the European Parliament’s Economic and Monetary Affairs Committee, as well as the Council of the European Union and the European Commission, and works closely with other European supervisory authorities. *Id.*


\(^\text{813}\) ESMA Statement 1, *supra* note 812.
mid-2021. The 6AMLD implements additional monitoring requirements and generally expands the scope of covered entities.

The EMIR\textsuperscript{814} similarly governs market clearing activities.\textsuperscript{815} Blockchain technologies may be used for clearing, and thus may be subject to EMIR requirements in certain instances. With respect to licensing, cryptocurrency exchanges seeking to offer services in the EU also may seek either a payment institution or an electronic money institution license (or work in partnership with entities that have such licenses).\textsuperscript{816}

In late 2019, the EU urged the European Central Bank to consider developing a digital currency, likely in part in response to Facebook’s stablecoin project, Libra.\textsuperscript{817} The Council of the EU noted in a joint statement with the Commission on “Stablecoins” that the European Central Bank should consider such an initiative in part to ease entry into cross-border digital currency markets.\textsuperscript{818} In early 2020, the European Central Bank confirmed that it is working on a central


bank digital currency, as are a significant majority of other central banks surveyed by BIS.  

(a) MiFID II

MiFID II is a European Directive that regulates firms that provide services to clients linked to “financial instruments” and the venues in which those instruments trade in the European Union. Broadly speaking, MiFID II “aims to create a single market for investment services and activities and to ensure a high degree of harmonised protection for investors in financial instruments.” Firms that provide investment services in relation to financial instruments, as defined in MiFID II, in turn must comply with MiFID II requirements.

MiFID II defines “financial instruments” as transferable securities, money-market instruments, units in collective investment undertakings, and certain options, futures, forward rate agreements, and swaps, among other items. ESMA has stated that where firms provide services in relation to financial instruments, including ICOs involving a coin or token that qualifies as a financial instrument, the process by which the coin or token is created, distributed, or traded likely involves MiFID II-regulated activities, and thus must comply with MiFID II requirements. Whether the coin or token qualifies as a financial instrument depends on its characteristics and nature, and whether certain safe harbors may apply.

819 Speech by Yves Mersch, supra note 818.

820 MiFID II, FCA (last updated May 28, 2020), https://www.fca.org.uk/markets/mifid-ii. MiFID II revised MiFID to improve financial market functioning and strengthen investor protection in the wake of the financial crisis. Id.

821 ESMA Statement 1, supra note 812, at 2.

822 Id.


824 ESMA Statement 1, supra note 812.
(b) The Prospectus Directive

If an ICO is structured such that the coins or tokens at issue constitute a “transferable security,” the issuer of the ICO must publish a prospectus, which is subject to the approval of the relevant Competent Authority.\(^{825}\) The Prospectus Directive, in turn, “requires publication of a prospectus before the offer of transferable securities to the public or the admission to trading of such securities on a regulated market situated or operating within a Member State, unless certain exclusions or exemptions apply.”\(^{826}\) Prospectuses must contain all material information necessary for investors to make an informed assessment of the facts, presented in an analyzable and comprehensible form.\(^{827}\) If an ICO does not qualify as a securities offering, however, “there are [] no minimum disclosure standards on the type, structure and quality of information provided as part of an ICO process, except for those stipulated in general consumer protection legislation.”\(^{828}\)

(c) The Alternative Investment Fund Managers Directive

The AIFMD includes rules for the authorization, ongoing operation, and transparency in AIF markets in the EU and requires AIF managers to comply with capital, operational, and organizational rules and transparency requirements.\(^{829}\) An ICO may qualify as an AIF, and thus

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\(^{825}\) Id. at 2. Each EU member state has a designated Competent Authority for implementing the Directive. Different European countries have different Competent Authorities.

\(^{826}\) Id. at 1.

\(^{827}\) Id. at 1–2.

\(^{828}\) EFSIR 2018, supra note 816, at 79.

\(^{829}\) See ESMA Statement 1, supra note 812, at 2.
be subject to AIFMD requirements, if used to raise capital from a number of investors for investment in accordance with a defined investment policy.\(^{830}\)

(d) **Anti-Money Laundering and Terrorist Financing**

In December 2017, the European Parliament and the EU Council reached an agreement on proposed amendments to the 4AMLD to “bring more transparency to improve the prevention of money laundering and to cut off terrorist financing,”\(^{831}\) approved in April 2018.\(^{832}\) These amendments (known as the 5AMLD), which member states were required to implement by January 2020,\(^{833}\) seek to “put cryptocurrency exchanges and custodial wallet providers within the scope of money laundering supervision” and aim to provide “less anonymity and more traceability, through better customer identification, and strong due diligence.”\(^{834}\) The amendments bring custodial wallet providers and virtual exchange platforms within the EU’s AML remit and require them to put in place policies and procedures to “detect, prevent and report money laundering and terrorist financing,”\(^{835}\) including performing identity checks on

\(^{830}\) *Id.*


\(^{835}\) Miseviciute, *supra* note 831. The amendments cover only providers engaged in exchanging virtual currencies and fiat currencies (cryptocurrency exchanges) and custodian wallet providers, however; “virtual-to-virtual” exchanges are not included. *Id.*
their customers and customers’ beneficial owners (where applicable), reporting suspicious transactions, and registering with relevant authorities.\footnote{Conheady, supra note 833.}

The 6AMLD went into effect on December 3, 2020 for member states, and regulated entities must implement relevant regulations by June 3, 2021.\footnote{Directive 2018/1673 of the European Parliament and of the Council of 23 October 2018 on combating money laundering by criminal law, 2018 O.J. (L 284) 22.} 6AMLD promises sweeping changes, including an extension of liability and sanctions to legal persons (such as corporate entities), in addition to individuals, and an expansion of criminal liability to those who aid and abet, incite, or attempt money laundering offenses. It also clarifies what conduct constitutes a money laundering offense and strengthens and harmonizes measures applicable to cryptocurrencies.\footnote{Id. at 27–28.} Finally, the hallmark of 6AMLD is the principle of dual criminality, allowing multiple member states to prosecute cross-border offenses.

\textbf{(e) EMIR}

EMIR provides that certain classes of OTC derivatives transactions must be cleared through CCPs\footnote{CCPs are corporate entities that reduce counterparty, operational, settlement, market, legal, and default risk for traders. \textit{See} Andrew Bloomenthal, \textit{Central Counterparty Clearing House—CCP}, INVESTOPEDIA (last updated Aug. 5, 2019), https://www.investopedia.com/terms/c/ccph.asp. CCPs help to facilitate trading in European derivatives and equities markets by protecting trading firms against default from electronically matched buyers and sellers whose creditworthiness is unknown. \textit{Id.}} and that risk mitigation techniques must be applied to other OTC transactions.\footnote{Id.} In some instances, blockchain technologies may be used to clear derivatives transactions, including OTC derivatives transactions. Where the underlying OTC derivatives transactions are subject to CCP clearing obligations, the blockchain network used for clearing

\footnote{DLT SECURITIES MARKETS REPORT, supra note 815, at 13.}
must comply with EMIR requirements; that is, either the blockchain network itself must meet EMIR’s CCP definition (and obtain a CCP authorization) or an existing CCP must join the network.\textsuperscript{841}

EMIR requires a number of risk mitigation techniques even for OTC derivatives transactions not cleared by CCPs, though it does not prescribe the technology to be used for those techniques.\textsuperscript{842} Accordingly, blockchain technology could be used for non-centrally cleared OTC derivatives as well. In that instance, the blockchain technology would need to accommodate EMIR’s risk mitigation requirements.\textsuperscript{843} However, not all clearing activities that may involve blockchain technology are subject to EMIR regulation. Spot transactions, for example, “are not in scope of the clearing obligation under EMIR,”\textsuperscript{844} so use of blockchain technology to clear spot transactions could fall outside the scope of EMIR regulation, provided that CCPs are not involved in the clearing.\textsuperscript{844}

2. \textbf{Individual European Country Regulations}

As a board member of the German Central Bank (Bundesbank) suggested in January 2018, cryptocurrency regulation can be achieved only through international cooperation, given the “obviously limited” regulatory power of individual nation states in light of the cross-border features of cryptocurrencies.\textsuperscript{845} Regulations pertaining specifically to blockchain and

\textsuperscript{841} \textit{Id.} at 14.

\textsuperscript{842} \textit{Id.}

\textsuperscript{843} \textit{Id.}

\textsuperscript{844} \textit{Id.}

cryptocurrencies remain in their infancy or nonexistent in many European countries, and in many instances, European nations—much like the United States—continue to examine the feasibility of regulating these new technologies under existing laws that pre-date them while also contemplating new laws and regulations tailored to address them.846

Nevertheless, in addition to (and in many instances in conjunction with) EU regulations and directives,847 a number of individual European jurisdictions have jumped on the cryptocurrency and blockchain bandwagon. Most European nations have at minimum examined how cryptocurrencies, ICOs, and blockchain technologies fit within their existing regulatory frameworks and whether new regulation in those spheres is necessary. In particular, many European countries have examined and issued guidance regarding whether a particular token or coin constitutes a “security,” whether certain ICOs constitute “securities offerings,” and how certain blockchain and cryptocurrency transactions fit (or do not fit) within, and thus are or are not subject to, existing securities laws and regulations—often taking a case-by-case approach.848

846 For example, the Danish Financial Supervisory Authority (DFSA) has stated that “[c]ryptocurrencies that are only usable as a means of payment, remain unregulated in the financial legislation in Denmark.” See Statement: ICO, DANISH FIN. SUPERVISORY AUTH. (Nov. 13, 2017), https://www.dfsa.dk/News/Press-releases/2018/ico-statement-131117. That said, the DFSA has cautioned businesses to carefully consider whether their ICO and cryptocurrency activities fall within the scope of Danish financial regulations because certain cryptocurrencies increasingly resemble financial instruments, and the DFSA determines on a case-by-case basis whether ICOs and cryptocurrencies are subject to these regulations. Id.


848 The Dutch Authority for the Financial Markets, for example, has stated that certain ICOs and cryptocurrencies with structures similar to securities fall within the Dutch Financial Supervision Act and thus are subject to Dutch financial regulations. See Initial Coin Offerings (ICO’s): Serious Risks, DUTCH AUTH. FOR FIN. MKTS., https://www.afm.nl/en/professionals/onderwerpen/ico. It assesses each case on an individual basis to determine whether the Financial Supervision Act applies. Id.
A number of European countries also have issued advisories to warn citizens of the risks associated with investments in cryptocurrencies and ICOs, as discussed in further detail in the selected country-specific analyses below.

(a) The United Kingdom

The UK FCA, an independent financial regulator and EU Competent Authority in the UK, issued a statement addressing certain aspects of cryptocurrencies in April 2018.

According to that statement and related publications, neither the FCA nor the Bank of England currently regulates cryptocurrencies unless they constitute a part of other regulated products or

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849 See generally Regulators’ Statements on Initial Coin Offerings, OICV-IOSCO (last visited Mar. 7, 2019), http://www.iosco.org/publications/?subsection=ico-statements. Sweden’s Financial Supervisory Authority issued a five-point warning in November 2017 regarding risks associated with ICOs, for example, emphasizing (1) ICOs are unregulated and not subject to the Financial Supervisory Authority’s supervision; (2) issuers are not required to sell a new digital asset for real market value or allow investors to evaluate the asset; (3) there is no guaranteed access to a secondary market; (4) ICOs have no information requirements—that is, issuers of ICOs are not required to provide all material information; and (5) the risk of investment fraud. See Press Release, Swedish Fin. Supervisory Auth., Warning for Risks with Initial Coin Offerings (ICO) (Nov. 7, 2017), https://translate.google.com/translate?hl=en&sl=auto&tl=en&u=https%3A%2F%2Fwww.fi.se%2Fsv%2Fpublicerat%2Fnyheter%2F2017%2Fvarning-for-risker-med-initial-coin-offerings%2F&sandbox=1.

850 Concerns regarding money laundering, terrorist financing, and other types of fraud and scams have prompted several countries to take action in these areas. For example, Belgium’s Minister of Justice voiced support for strict new cryptocurrency legislation in light of cryptocurrency’s popularity with cybercriminals, scammers, and terrorist groups, and the Belgian Ministry of Justice is working in cooperation with experts from the Central Office for Seizure and Confiscation and the Board of Procurators General on procedural solutions to facilitate the seizure of digital assets following the Belgian government’s seizure of large numbers of bitcoins in two drug trafficking cases. See Elena Platonova, Belgium May Tighten Cryptocurrency Regulation, COINFOX (Apr. 17, 2017), http://www.coinfox.info/news/6959-belgium-may-tighten-cryptocurrency-regulation. In September 2018, Belgium’s Financial Services and Markets Authority (FSMA) issued an updated consumer warning against cryptocurrency trading platforms, listing more than two dozen platforms in which it has identified signs of fraud. See Warning Against New Cryptocurrency Trading Platforms, FSMA (Sept. 4, 2018), https://www.fsma.be/en/warnings/warning-against-new-cryptocurrency-trading-platforms; see also List of Companies Operating Unlawfully in Belgium, FSMA (last visited Mar. 7, 2019), https://www.fsma.be/en/warnings/companies-operating-unlawfully-in-belgium?field_type_of_fraude_tid_i18n=10595&submit=Apply.

851 See Cryptocurrency Derivatives: FCA statement on the requirement for firms offering cryptocurrency derivatives to be authorised, FCA (Apr. 6, 2018), https://www.fca.org.uk/news/statements/cryptocurrency-derivatives [hereinafter Cryptocurrency Derivatives]. The FCA, a financial regulatory body in the UK that regulates some 49,000 financial services firms and financial markets in the UK and serves as the prudential regulator for more than 18,000 of them, is an independent public body funded entirely by the firms it regulates. See About the FCA, FCA (last updated Sept. 24, 2020), https://www.fca.org.uk/about/the-fca. Established in April 2013 to take over the Financial Services Authority’s responsibility, the FCA is accountable to the UK Treasury (responsible for the UK’s financial system) and Parliament. Id.
services, and the FCA does not consider cryptocurrencies to be “currencies” or “commodities” for purposes of regulation under MiFID II.\(^{852}\)

By contrast, because cryptocurrency derivatives are “capable of being financial instruments” under MiFID II, the FCA has determined that firms conducting business in cryptocurrency derivatives in the UK must comply with both applicable FCA rules and relevant provisions in EU regulations.\(^{853}\) By extension, the FCA has deemed it likely that “dealing in, arranging transactions in, advising on or providing other services that amount to regulated activities in relation to derivatives that reference either cryptocurrencies or tokens issued through an [ICO],” such as cryptocurrency futures, cryptocurrency CFDs, and cryptocurrency options, “will require authorisation by the FCA.”\(^{854}\) Offering products or services requiring FCA authorization without obtaining that authorization constitutes a criminal offense in the UK and may subject a firm to enforcement action.\(^{855}\) Further, the FCA recently announced that effective January 6, 2021, it will ban the sale of cryptocurrency derivatives, including products that track prices of cryptoassets, to retail investors.\(^{856}\) Accordingly, it would behoove firms providing services in connection with these cryptocurrency-based products to obtain appropriate authorization by the FCA and, to the extent offered for sale to retail investors, cease such sales, lest they risk potential criminal prosecution. The UK’s withdrawal from the EU complicates


\(^{853}\) Cryptocurrency Derivatives, supra note 851.

\(^{854}\) Id.

\(^{855}\) Id.

matters, but according to the FCA, EU law will continue to apply during the transition period, until December 31, 2020.\footnote{\textit{The EU withdrawal transition period}, FCA (last updated Dec. 9, 2020), https://www.fca.org.uk/brexit/eu-withdrawal-transition-period.} What else happens after 2020 remains unclear, but it seems likely that the EU requirements may continue to apply in some form, whether through new UK rules or otherwise, and the UK and EU have indicated that they intend to reach agreement on their future, post-2020 relationship.

\textbf{(1) FCA Consumer Warnings}

The FCA has issued consumer warnings in relation to cryptocurrencies, including one regarding ICOs\footnote{\textit{Initial Coin Offerings: Consumer warning about the risks of Initial Coin Offerings (\textit{“ICO}s\textquotedblright)}, FCA (last updated Feb. 2, 2019), https://www.fca.org.uk/news/statements/initial-coin-offerings [hereinafter \textit{Initial Coin Offerings}]. The FCA describes ICOs as “a digital way of raising funds from the public using a virtual currency, also known as cryptocurrency.” \textit{Id}.} and another regarding cryptocurrency CFDs.\footnote{\textit{Consumer Warning about the risks of investing in cryptocurrency CFDs}, FCA (last updated July 3, 2019), https://www.fca.org.uk/news/news-stories/consumer-warning-about-risks-investing-cryptocurrency-cfds.} With respect to ICOs, the FCA acknowledges that ICOs “vary widely in design” and deems them “very high-risk, speculative investments.”\footnote{\textit{Id}, supra note 858.} The FCA warns that only experienced investors should invest in ICOs, and those who do so should be “prepared to lose [their] entire stake.”\footnote{\textit{Id}.} The FCA has identified a number of risks associated with ICOs, including: (1) the fact that most ICOs are not regulated by the FCA, and many are based overseas; (2) ICOs offer little or no investor protection, and investors are “extremely unlikely” to have access to UK regulatory protections, such as the Financial Services Compensation Scheme or the Financial Ombudsman Service; (3) price volatility; (4) potential for fraud; (5) inadequate documentation, because instead of a regulated
prospectus, ICOs usually provide only a “white paper,” which may be “unbalanced, incomplete or misleading;” and (6) ICOs often are in an early development stage, such that their business models are “experimental,” and “[t]here is a good chance of losing your whole stake.”

The FCA does not regulate ICOs collectively; rather, “[w]hether an ICO falls within the FCA’s regulatory boundaries or not can only be decided case by case,” and “[m]any ICOs will fall outside the regulated space.” That said, depending on their structure, some ICOs may involve FCA-regulated investments, such that firms involved in them may be subject to FCA regulations. Similarly, some ICOs may parallel initial public offerings, private placement of securities, crowdfunding, or collective investment schemes, and some tokens may constitute transferable securities under MiFID II, thereby subjecting those ICOs to FCA oversight.

The FCA’s consumer warning about cryptocurrency CFDs calls these products “extremely high-risk” and “speculative,” given that cryptocurrencies are “not issued or backed by a central bank or government” and “have experienced significant price volatility in the past year which, in combination with leverage, places [investors] at risk of suffering significant losses and potentially losing more than [they] have invested.” Specific risks associated with investment in cryptocurrency CFDs include: (1) price volatility; (2) leverage, which multiplies

862 Id.
863 Id.
864 Id.
865 Id.; see MiFID II Art. 4(1)(44).
866 Consumer Warning about the Risks of Investing in Cryptocurrency CFDs, supra note 859. The FCA defines CFDs as “complex financial instruments” that permit speculation on the price of an asset and often are offered through online platforms. Id. CFDs typically are offered with “leverage,” meaning that an investor must put down only a portion of the investment’s total value. Id. Leverage multiplies the impact of price changes on both profits and losses, meaning that money loss can occur “very rapidly.” Id. Cryptocurrency CFDs, in turn, permit speculation on price changes in cryptocurrencies like Bitcoin or Ethereum. Id.
losses and profits and could result in an investor “owing money to the firm;” (3) charges and funding costs; and (4) lack of price transparency—that is, greater risk that investors will not receive a “fair and accurate price” for the underlying cryptocurrency. The consumer warning goes on to state that the FCA does regulate CFDs, including cryptocurrency CFDs, so investors are subject to protections offered by the UK financial services regulatory framework, including requirements that firms offering cryptocurrency CFDs must be authorized and supervised by the FCA; individual complaints may be referred to the Financial Ombudsman Service; and eligible customers have access to the Financial Services Compensation Scheme. These protections, however, will not compensate investors for losses associated with trading.

(2) FCA Discussion Paper on Distributed Ledger Technology and Cryptoassets Taskforce Report

In April 2017, the FCA published a discussion paper on DLT to “start a dialogue on the potential for future development of DLT” in FCA-regulated markets, including the “balance of risk and opportunities” in relation to DLT. The paper acknowledges that the FCA generally takes a “technology neutral” approach to regulating financial services—that is, “not to regulate specific technology types, only the activities they facilitate and the firms carrying out these activities,” so as to “accommodate innovation but avoid arbitrage and unfair competition”—and endeavors to examine “whether there is anything distinctive about DLT” that would require a

866 [Note: Text not numbered properly.]

867 Id.

868 Id.

869 FCA, DP17/3, DISCUSSION PAPER ON DISTRIBUTED LEDGER TECHNOLOGY 5 (2017), https://www.fca.org.uk/publication/discussion/dp17-03.pdf. The discussion paper describes DLT as “a set of technological solutions that enables a single, sequenced, standardised and cryptographically-secured record of activity to be safely distributed to, and acted upon by, a network of varied participants,” in contrast to a “traditional centralised ledger system, owned and operated by a single trusted entity.” Id. at 10. Blockchain, in turn, is a “type of DLT where records are collated into ‘blocks’ and linked using a cryptographic signature.” Id.
different approach. The FCA noted that in some instances, DLT may not fit within FCA requirements, such that the FCA may “need to consider whether [its] rules prevent or restrict sensible development that would benefit consumers and hence whether changes may be needed.” The FCA concluded that it currently does “not see a clear need to consider changes to [its] regulatory framework for DLT solutions to be implemented,” but noted that it continues to work actively with other regulators and standard setting bodies, including ESMA, IOSCO, and the Financial Stability Board, given the cross-border applications of DLT. The FCA discussion paper also posed a series of questions, including those addressing regulatory reporting requirements, smart contracts, and how best to manage security, operational, and other risks associated with DLT, and invited comments from users and providers of DLT, committing to review those responses and determine next steps.

In December 2017, the FCA published a feedback statement in response to the comments it received on the discussion paper. The feedback generally supported the notion that the FCA’s current rules “are flexible enough to accommodate applications of various technologies, including the use of DLT by regulated firms,” and “[n]early all respondents generally agreed there are no substantial barriers to adopting DLT under [the FCA’s] regulatory rules and no changes to specific rules were proposed,” although “some respondents doubted the compatibility

870 *Id.* at 5, 7.

871 *Id.* at 7.

872 *Id.* at 8.

873 *Id.* at 9, 12–25, Annex 1.

874 *DLT Feedback Statement, supra* note 852.
of permissionless networks with [the FCA’s] regulatory regime.”875 Most respondents “strongly supported continued direct engagement by the FCA and other financial services regulators to foster innovation and ensure appropriate regulatory safeguards are in place,” and all “urged [the FCA] to collaborate even more proactively with other national and international regulatory bodies and industry associations,” given the “global nature of DLT.”876

In response to these and other comments from the industry, the FCA committed to continue monitoring developments in the DLT-related markets, keep its rules and guidance “under review” in light of such developments, and continue to work collaboratively with other national and international regulatory bodies—although the FCA did not identify a “need to propose specific changes [to its rules and guidance] at this juncture.”877 In 2014, the FCA also established an innovation hub, which includes a regulatory “sandbox” that allows firms to test new products, services, and business models—including those related to cryptocurrencies and DLT—in a live market environment while simultaneously ensuring that appropriate safeguards are in place.878

More recently, in March 2018, the UK formed a Cryptoassets Taskforce with the FCA, the UK Treasury, and the Bank of England, which published an October 2018 report evaluating the policy and regulatory implications of DLT and cryptoassets, as well as the opportunities and

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875 Id. at 4–5.

876 Id. at 5.

877 Id. at 6; see id. at 26.

risks they present. The Taskforce concluded that cryptoassets “have no intrinsic value and investors should therefore be prepared to lose all the value they have put in.” The report identified numerous risks associated with cryptoassets, including harm to consumers and market integrity, use for illegal activities, and potential future threats to financial stability. The report committed the Taskforce to a number of actions to mitigate these risks, including consulting to (1) clarify which cryptoassets do and do not fall within existing regulations; (2) determine whether regulations should be extended to cover cryptoassets with features similar to other types of investments but that currently fall outside the regulatory regime; (3) evaluate a potential prohibition on the sale of certain cryptoasset-based derivatives to retail consumers; (4) address how regulations can meaningfully address risks posed by exchange tokens and related exchanges and wallet providers; and (5) implement and exceed 5AMLD regulations.

(3) 2019–2020 Updates: FCA Guidance and Regulations

In 2019, the FCA released more comprehensive guidance detailing its regulatory oversight of digital assets. The FCA guidance divided digital assets into three primary categories: security tokens, e-money tokens, and unregulated tokens (including utility tokens and...

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880 Cryptoasset Taskforce Publishes Report on UK Approach to Cryptoassets, supra note 879.

881 CRYPTOASSETS TASKFORCE: FINAL REPORT, supra note 879.

882 Id.

exchange tokens). By definition, the last category is not regulated and includes tokens that do not meet the definitions of the first two categories, whereas the first two categories fall within the FCA’s regulatory power. The FCA noted that Bitcoin and similar cryptoassets are “exchange tokens,” and thus fall outside its regulatory authority. Stablecoins generally are viewed as “utility tokens” and are not regulated by the FCA unless a specific type of stablecoin also fits into the e-money category. However, as noted below, the FCA was granted authority to oversee the AML regime for digital assets, which applies to exchange tokens like Bitcoin, and the UK Treasury Department recently announced that it is in the process of drafting proposals to regulate private stablecoins and researching CBDCs as a cash alternative.

In early 2020, as a result of the implementation of the 5AMLD and FATF’s international standards on AML/CTF, the UK Treasury granted the FCA additional regulatory powers to enforce AML standards. The Money Laundering and Terrorist Financing (Amendment) Regulations 2019 include in their scope “cryptoasset businesses”—that is: (1) cryptoasset exchanges (e.g., traditional crypto exchanges, teller machines, peer-to-peer providers, and ICOs)

884 Id. at 13–14.

885 Id. at 10.


and (2) wallet custodians.\textsuperscript{888} New cryptoasset businesses must register with the FCA to start transacting, while businesses existing as of January 10, 2020, must register with the FCA by January 10, 2021.\textsuperscript{889} Further, cryptoasset businesses must undertake “customer due diligence” before transacting with an entity if they are establishing a business relationship with that entity or conduct occasional transactions exceeding 1,000 euros.\textsuperscript{890} This requires that a cryptoasset business, like other relevant persons, identify the customer’s identity, verify that identity, and identify any beneficial owner, among other information.\textsuperscript{891} Relevant persons also are required to conduct “enhanced customer due diligence” when a customer is “identified as one where there is a high risk of [money laundering or terrorist financing].”\textsuperscript{892} Records and documents obtained from due diligence are required to be kept for at least five years from the date the occasional transaction is completed or the business relationship has come to an end.\textsuperscript{893} Moreover, all relevant persons must take steps to “identify and assess the risks of money laundering and terrorist financing” and provide this assessment to the “supervisory authority” (for cryptoasset businesses, the FCA) upon request.\textsuperscript{894}


\textsuperscript{889} Id.

\textsuperscript{890} See The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, SI 2007/2133, pt. 3, ch. 1, reg. 27 (Eng.).

\textsuperscript{891} Id. reg. 28.

\textsuperscript{892} Id. ch. 2, reg. 33.

\textsuperscript{893} Id. pt. 4, reg. 40.

\textsuperscript{894} Id. pt. 2, ch. 2, reg. 18.
(b) Switzerland

In September 2017, the Swiss FINMA\textsuperscript{895} published guidance setting out its position on ICOs.\textsuperscript{896} Therein, FINMA acknowledged the recent “marked increase” in ICOs in Switzerland and noted that the structure of ICOs “varies markedly from offering to offering,” such that “[t]here is no catch-all definition.”\textsuperscript{897} FINMA also noted that ICOs “are currently not governed by any specific regulation, either globally or in Switzerland,” but given the purpose and characteristics of ICOs, “various links to current regulatory law may exist depending on the structure of the services provided,” including in the areas of AML and terrorist financing, banking laws, provisions on securities trading (such that a licensing requirement to operate as a securities dealer may exist where tokens qualify as securities), and collective investment schemes.\textsuperscript{898} Accordingly, “the likelihood arises that the scope of application of at least one of the financial market laws may encompass certain types of ICO model,” and “[w]here financial market legislation has been breached or circumvented, enforcement proceedings will be initiated.”\textsuperscript{899} FINMA also issued a warning to potential investors, highlighting that because ICOs

\textsuperscript{895} FINMA is the independent financial-markets regulator in Switzerland charged with supervising banks, insurance companies, exchanges, securities dealers, collective investment schemes, and their asset managers and fund management companies. It is institutionally independent from Switzerland’s political authorities, such that neither Swiss Parliament nor the government may direct how it carries out its regulatory duties. It remains subject to parliamentary scrutiny and must account to parliamentary commissions overseeing its work, however. FINMA is financed by the fees and levies it charges for its supervisory work and is responsible for ensuring the effective functioning of Switzerland’s financial markets. See FINMA—\textit{an independent supervisory authority}, FINMA (last visited Mar. 7, 2019), https://www.finma.ch/en/finma/finma-an-overview/.


\textsuperscript{897} Id. at 2.

\textsuperscript{898} Id. at 2–3.

\textsuperscript{899} Id. at 3.
often are in early development stages, “a number of uncertainties [exist] regarding the financial
and implementation aspects involved,” and “FINMA cannot rule out that ICO activities may be
fraudulent,” given the “increased fraudulent activities by providers of fake cryptocurrencies.”900

In February 2018, FINMA released ICO guidelines to provide market participants with
information regarding the supervisory and regulatory framework for ICOs.901 FINMA again
acknowledged that the “wide variety of types of token and ICO set-ups” renders it impossible to
generalize legal guidance; instead, “[c]ircumstances must be considered holistically in each
individual case,” and FINMA will base its assessment on the “underlying economic purpose of
an ICO,” particularly when indications of attempts to circumvent existing regulations are
present.902 This will include assessing the transferability and economic function and purpose of
the tokens—that is, whether the tokens at issue constitute one or more of three types of tokens:
(1) “payment tokens” (which FINMA deems “synonymous with cryptocurrencies”) intended to
be used as a means of payment for acquiring goods or services or as a means of money or value
transfer; (2) “utility tokens” intended to provide digital access to an application or service via a
blockchain-based infrastructure; or (3) “asset tokens” representing assets like a debt or equity
claim on the issuer (analogous to equities, bonds, or derivatives), as well as tokens enabling
physical assets to be traded via blockchain.903 “Hybrid tokens”—a combination of tokens that

900 Id. at 3–4; see also Press Release, FINMA, FINMA Closes Down Coin Providers and Issues Warning about Fake

901 FINMA GUIDELINES, supra note 58, at 1.

902 Id. at 2.

903 Id. at 3.
fall into more than one category—also exist; in those instances, the applicable requirements are cumulative, and the token could be deemed both a security and a means of payment.\footnote{Id.; see also supra Section 1.2(b).}

In assessing whether tokens qualify as securities, FINMA will base its assessment on Swiss law definitions. Under the Swiss Financial Market Infrastructure Act, “securities” are “standardised certificated or uncertificated securities, derivatives, and intermediated securities” that are “suitable for mass standardised trading”—that is, they are “publicly offered for sale in the same structure and denomination or are placed with more than 20 clients, insofar as they have not been created especially for individual counterparties.”\footnote{FINMA GUIDELINES, supra note 58, at 4.} Under this definition, FINMA will not treat payment tokens as securities, given that they are designed to act as a means of payment.\footnote{Id. If, however, new case law or legislation classified payment tokens as securities, FINMA “would accordingly revise its practice.” Id.} Similarly, utility tokens will not be treated as securities if their “sole purpose is to confer digital access rights to an application or service” and the token can be used in that manner at the point of issue, because in that instance, the token’s “underlying function” is to grant access rights, and the connection with capital markets—a “typical feature of securities”—is absent.\footnote{Id. at 5.} That said, if a utility token has an “investment purpose” at the point of issue, FINMA will treat it as a security (in the same manner as asset tokens).\footnote{Id.} Finally, FINMA will treat asset tokens as securities under the Swiss Financial Market Infrastructure Act, provided that they represent an “uncertificated security” or a derivative (whose value depends on an underlying asset) and the
tokens are standardized and suitable for mass standardized trading.\footnote{Id.} If, under these guidelines, FINMA concludes that ICO tokens constitute securities, they will be subject to Swiss securities regulation.\footnote{Id.} Further, to the extent that tokens can be transferred on a blockchain infrastructure—at either the time of the ICO or at a later date—the provisions of Switzerland’s AML Act will apply.\footnote{Id. at 6. The AML Act governs anyone providing payment services or issuing or managing a means of payment. Id. AML Act regulations do not apply to utility tokens if the purpose of issuing the tokens is to provide access rights to a non-financial application of blockchain technology. Id. at 7.}

In late November 2018, the Swiss Federal Council brought into force an amendment to the Swiss Banking Act designed to “promote innovation (fintech).”\footnote{Press Release, The Federal Council, Switz. Gov’t, Federal Council Adopts Implementing Provisions for Fintech Authorisation (Nov. 30, 2018), https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-73186.html.} Pursuant to that amendment, starting on January 1, 2019, companies that “operate beyond the core activities characteristic of banks”—including cryptocurrency- and blockchain-related firms—“will be able to accept public funds of up to a maximum of CHF 100 million on a professional basis subject to simplified requirements,” provided that they receive special authorization (that is, a license) and “neither invest nor pay interest on these funds.”\footnote{Id.} In December 2018, FINMA published guidelines regarding how interested companies may apply for the new FinTech license and what information they must provide, including: a description of the proposed business activity, geographical scope, and clientele; information about the persons responsible for the
administration and management of the business; a business plan and budget; and policies regarding risk management, internal controls, and AML.\textsuperscript{914}

In 2019, FINMA released stablecoin guidelines, as an update to its earlier ICO guidelines.\textsuperscript{915} This guidance noted that while Swiss law does not have any specific provisions to regulate stablecoins, they would be treated the same as any other blockchain-based tokens. The qualities of stablecoins, however, can influence which financial laws apply. For example, if a token is linked to a specific fiat currency (such that a person has a “redemption claim” for a specified amount of that fiat currency), it likely would be categorized as a deposit under the banking laws.\textsuperscript{916} Facebook inquired about Libra, and FINMA indicated that the Facebook stablecoin system likely would fall under financial market infrastructure regulations, requiring a payment system license.\textsuperscript{917}

FINMA took further steps in 2019 and 2020 when it adopted AML regulations affecting digital assets. As in the UK, FINMA requires due diligence of customers in various scenarios, which includes collecting the name, account number, and addresses of the client and any


\textsuperscript{916} SUPPLEMENT TO THE GUIDELINES, supra note 915, at 2.

\textsuperscript{917} FINMA publishes ‘stable coin’ guidelines, supra note 915.
beneficiaries. In 2020, FINMA also proposed lowering the threshold for unidentified transactions from CHF 5,000 to CHF 1,000 (roughly $1,200).

(c) France

In January 2018, the French Minister of the Economy created a working group headed by the former deputy governor of France’s central bank, tasked with developing cryptocurrency regulation.820 Shortly thereafter, in a March 2018 report, the Bank of France proposed to ban insurance companies, banks, and trust companies from “taking part in deposits and loans in crypto-assets” and prohibit all marketing of cryptoasset savings products to the public, emphasizing the need for regulations to combat money laundering and terrorism financing.821 The Bank of France does not consider cryptocurrencies to constitute money or legal tender,822 but they may qualify as “intangible movable property” under French civil law.823

With respect to blockchain, the French government passed a statute authorizing the use of DLT for the issuance of mini-bonds and the recording of trades. The statute defines DLT and recognizes it as a recording tool for use in transferring and authenticating ownership titles in the

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822 Id.

mini-bond context. In the ICO context, the AMF has divided cryptocurrency tokens into two categories: (1) utility tokens, which grant a right of use to the holder by allowing the holder to use the technology and/or services distributed by the ICO promoter; and (2) security tokens, which offer financial or decisional prerogatives and are intended to grant their holders financial rights or voting rights. Because certain cryptoasset derivatives can qualify as financial contracts (depending on their structure), the AMF has concluded that they are subject to regulations applicable to the offer of financial instruments, including relevant Monetary and Financial Code rules concerning approval, good conduct, and the ban on advertising derivatives. The AMF plans to create a “visa” system through which it will approve and legitimate ICOs that abide by certain rules and other best practices. This will enable legitimate ICOs to more easily interact with third parties like banks and accounting firms.

Further, in 2019, the French Parliament adopted the Action Plan for Business Growth and

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928 See Martinet, supra note 920.

929 Id.
Transformation (“PACTE”), which created a new regime for digital assets. PACTE delineates categories of “digital asset service providers.” Two service provider types—those who have custody of digital assets or wallets and those who allow purchase of digital assets in legal tender—must register with the AMF, given their heightened risk of money laundering. Other digital asset service providers may opt-in to formally register as a digital asset service provider and must follow various requirements if they do so. Benefits of registering may include increased visibility and the perception of trustworthiness. ICOs are regulated under this provision as well, in an entirely opt-in regime. ICOs may apply to the AMF for a “visa,” provided that they meet the obligations and conditions of the PACTE. On January 13, 2020, the first ICO “visa” was approved under PACTE.

In 2020, France became the first European country to successfully test a CBDC, the e-

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932 CODE MONÉTAIRE ET FINANCIER [MONETARY AND FINANCIAL CODE] art. L54-10-5-I (Fr.).

933 Id. art. L54-10-5 (Fr.).

934 Id. art. L552-1 (Fr.).

935 Id.

The Bank of France will continue to test the use of the CBDC with applicants from the banking and financial industry. Notably, in March 2020, the French Commerce Court ruled that cryptocurrencies are money.

(d) Germany

Germany’s BaFin has stated that the country’s existing regulatory framework applicable to other financial services also applies to blockchain technologies, emphasizing that it is not the technology itself that needs regulation, but rather its application in different contexts within the financial sector. BaFin has classified all virtual currencies as “financial instruments” under the German Banking Act, which in turn provides that financial instruments include “securities . . . money market instruments, foreign exchange units of account, and derivatives.”


938 Id.


940 BaFin is Germany’s autonomous financial regulatory authority that falls under the supervision of the Federal Ministry of Finance. See About BaFin, BAFIN (last visited Mar. 7, 2019), https://www.bafin.de/dok/7859472. BaFin authorizes what financial entities may conduct banking business in Germany and monitors their conduct, seeking to ensure the transparency and integrity of the financial market and the protection of investors. See Functions & history, BAFIN (last updated Jan. 29, 2020), https://www.bafin.de/dok/7859558. BaFin oversees banks, financial services institutions, insurance undertakings, pension funds, domestic investment funds, and asset management companies. See id.


942 Id.

943 See Virtual Currency (VC), BAFIN (last updated Dec. 11, 2017), https://www.bafin.de/dok/8054452 [hereinafter Virtual Currency (VC)].

944 Kreditwesengesetz [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 6, § 1(11), no. 1 (Ger.), https://www.bafin.de/dok/7859046. In contrast, virtual currencies are not considered legal tender, currencies, foreign notes or coins, or e-money in Germany. See Virtual Currency (VC), supra note 943.
Similarly, in March 2018, BaFin issued an advisory letter stating that it will assess on a case-by-case basis whether an ICO token constitutes: (a) a “financial instrument” within the meaning of the German Securities Trading Act or MiFID II; (b) a “security” within the meaning of the German Securities Prospectus Act; or (c) a “capital investment” within the meaning of the German Capital Investment Act.945 Pursuant to that advisory, the classification of a token does not depend on whether it is a unit of account under the German Banking Act,946 and not all tokens are automatically deemed units of account under that Act.947 BaFin also established that a token can be classified as a “security” even if it cannot be physically represented by a certificate or global note, provided that each “holder of the token can be documented, for example by means of distributed ledger or blockchain technology.”948

Like other European countries, Germany formally incorporated the requirements of the 5AMLD in December 2019. Germany has defined “cryptoassets” as a new type of financial instrument, which has the qualities of being (1) a digital representation of value, which (2) has never been issued or guaranteed by a central bank or public body, (3) does not have legal status of currency or money, but (4) on the basis of an agreement or practice (i) is accepted by natural or legal persons, (ii) as a means of exchange or payment, or (iii) serves investment purposes, and

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946 Id. Units of account are not deemed financial instruments pursuant to the German Securities Trading Act or MiFID II, and thus are treated differently under this legislation than under the German Banking Act. Id.

947 Id.

948 Id.
(5) can be transferred, stored, and traded by electronic means.\textsuperscript{949} BaFin released guidance on this topic on March 2, 2020 and noted that, as a result of this action, many service providers offering exchanges of virtual currencies into legal tender, vice versa, or into other cryptoassets would be covered by the AML law.\textsuperscript{950} Additionally, custody of those cryptoassets (sometimes called crypto banking) is a new financial service that requires licensing by BaFin, if done “on a commercial basis.”\textsuperscript{951} More than 40 banks have applied to be licensed to conduct crypto custody.\textsuperscript{952}

(e) Austria

Austria’s FMA similarly has published guidelines on how regulations may apply to blockchain technologies, depending on their structure and use.\textsuperscript{953} These include the following:

- Under the **Austrian Banking Act**, if an activity conducted on a commercial basis includes the receipt of funds from other parties for the purpose of management or deposits, then the activity constitutes a banking transaction and requires a license from the FMA. Certain blockchain cryptocurrency transactions likely fall within this classification.

- Austria’s **Alternative Investment Fund Managers Act** provides that if a company collects capital from a number of investors that subsequently is invested in virtual currencies according to a defined investment strategy and the profit is passed on to

\textsuperscript{949} Guidance notice – guidelines concerning the statutory definition of crypto custody business (section 1 (1a) sentence 2 no. 6 of the German Banking Act (Kreditwesengesetz – KWG)), BAFin (Mar. 3, 2020), https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Merkblatt/mb_200302_kryptoverwahrgeschaeft_en.html.

\textsuperscript{950} Id.

\textsuperscript{951} Id.


the investors, the company meets the definition of an alternative investment fund and must hold a license.

- Austria’s **Capital Markets Act** provides that if a company publicly offers investments or securities in virtual currencies, or in companies investing in virtual currencies, then the company must publish a prospectus in accordance with the Act.

- Austria’s **Payment Services Act** provides that if an online platform used for purchasing virtual currencies also processes payments in euros, the platform may be required to hold a license.\(^{954}\)

- Austria’s **Financial Markets Anti-Money Laundering Act**, which is Austria’s implementation of the 5AMLD, provides that those offering certain services, including issuing and selling of virtual currencies, transfer of virtual currencies, trading and exchange platforms, and custodial wallets, are required to register with the FMA.\(^{955}\) All of these entities are subject to due diligence and reporting requirements. Failure to register could lead to a €200,000 fine.

The FMA determines whether Austrian regulations apply to various business models on a case-by-case basis.\(^{956}\)

With respect to ICOs, the FMA has provided the following guidance:

- **Austrian Banking Act**: If capital is raised with legal currency (not virtual currency) and is to be invested by the ICO organizer, this constitutes a deposit-taking activity and requires a license under the Act. Even if capital is raised with virtual currency, the activity still may fall within the Act’s parameters and require a license, depending on the ICO structure. Further, if the coins or tokens are structured as securities or financial instruments, then their custody and administration on behalf of other parties falls within the Act’s scope and requires a license.

- **Securities Supervision Act**: If an ICO offers rights comparable to those offered by securities—for example, voting rights, shares in profits, tradability, interest

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\(^{956}\) See Licensing, supra note 954.
payments—the coins and tokens may constitute “financial instruments” and require a license.

- **Capital Markets Act**: If coins or tokens grant holders certain proprietary rights—for example, rights to a claim, membership rights or conditional rights, dividends, repayment—against the ICO organizer, they may qualify as investments within the scope of the Act, thus requiring organizers to publish a prospectus pursuant to the Act.

- **E-Money Act and Payment Services Act**: Whether an ICO falls within the scope of these acts is evaluated on a case-by-case basis and depends in part upon whether (1) the ICO results in the payment of “money” (a legal means of payment), and (2) the token may be used by every holder and therefore is transferable (as opposed to personalized for each user).

- **Alternative Investment Fund Managers Act**: If a company collects capital from a number of investors that is then invested in virtual currencies according to a defined investment strategy, and the profit is passed on to the investors, that transaction qualifies as an alternative investment fund, and the company must hold a license.957

- **Financial Markets Anti-Money Laundering Act**: If a company issues virtual currencies, it must register with the FMA and is subject to the AML/CFT regime.958

Previously, when an activity fell within the scope of an Austrian regulation and required a license, Austria’s Financial Markets Anti-Money Laundering Act’s due diligence obligations applied.959 However, since the implementation of 5AMLD, it appears that a wide range of services (including ICOs, exchanges, and custodians) must comply with due diligence and reporting requirements under the current AML/CFT regime.960

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958 Inclusion of virtual currencies in the prevention of money laundering, *supra* note 955.


960 Inclusion of virtual currencies in the prevention of money laundering, *supra* note 955.
(f) Slovenia

Slovenia seeks to become a leader in blockchain development in the EU\(^{961}\) and was one of the earliest European countries to revise certain of its existing laws to address cryptocurrencies. Slovenia has updated its AML law to explicitly reference cryptocurrencies, defining all crypto-exchanges and brokers engaged in trading cryptocurrencies as financial institutions.\(^{962}\) In light of that amendment, crypto-exchanges and cryptocurrency brokers must follow transparency rules and compliance procedures applicable to other financial institutions.\(^{963}\)

(g) Malta

Malta, like Slovenia, has updated its existing laws to accommodate blockchain and cryptocurrency technologies. The country seeks to attract blockchain companies and in June 2018 approved three bills towards that end:

- The **Digital Innovation Authority Bill** establishes an authority responsible for promoting and regulating companies using blockchain. The authority will certify legitimate blockchain companies and provide legal certainty to users who wish to make use of a blockchain platform.

- The **Technology Arrangements and Services Bill** deals primarily with processes associated with setting up exchanges and other companies operating in the blockchain market. It also addresses the possibility of Technology Service Provider registration and certification of Technology Arrangements, possibly granting legal personality to Technology Arrangements.

- The **Virtual Financial Assets Bill** focuses on the regulatory framework applicable to ICOs and regulation of certain service providers involved in activities related to


\(^{963}\) *Id.*
ICOs. It also outlines the regulatory framework that will apply to cryptocurrency exchanges.964

The MFSA965 has proposed a “financial instrument test” to determine whether a DLT asset should be classified as an “asset” under the recently approved Virtual Financial Assets Bill or as a “financial instrument” under section C of MiFID Annex 1.966 This test applies to issuers of ICOs conducted in or from within Malta, as a means of determining whether their activities fall within the context of applicable European Commission or Maltese regulations.967 The test includes twelve checklists, “the first of which focuses on [virtual tokens] under the [Virtual Financial Assets Bill] while the remaining focus on the various financial instruments under MiFID.”968 The MFSA already has different definitions of virtual assets for purposes of the test, all of which are found in the consultation paper for the “financial instrument test.”969


965 The MFSA is the Maltese financial regulator responsible for functions previously carried out by the Central Bank of Malta, the Malta Stock Exchange, and the Malta Financial Services Centre. See About Us, MFSA (last visited Mar. 7, 2019), https://www.mfsa.mt/about-us/. The MFSA is a fully autonomous public institution and reports to Parliament on an annual basis. Id. Some of the MFSA’s key functions include: regulating and supervising the conduct of the financial services industry in Malta; consumer and investor protection; issuing licenses to businesses involved in banking, investments, insurance, pensions, and stock brokerage; inspections of licensed financial services businesses; publication of guidance notes and directives to the financial services industry; and proposing the improvement of existing legislation or creation of new legislation. See id.


967 Id.

968 Id. at 4.

969 Id. at 2–3.
3. **Asian and Australian Regulations**

The contemporary regulatory landscape of cryptocurrencies in Asia and Australia is nascent and fluid. Nevertheless, in the past few years, five governments with jurisdiction over major cryptocurrency markets—Japan, South Korea, Australia, Singapore, and China—have begun to crystallize their respective regulatory stances.

As each country summary in this Section will explain, each of the Asian or Australian government’s regulatory postures conceptually falls into one of two categories: (1) proactive regulation, which results in a more detailed regulatory scheme; or (2) less nuanced regulation to remain consistent with policy interests in permitting, or prohibiting, the growth of the virtual currency market. Japan, South Korea, and Australia fall within the first category, whereas Singapore and China fall within the second. Each government primarily regulates cryptocurrency exchanges and ICOs within its borders by first deciding whether to permit these practices and, if so, by deciding what regulatory standards virtual currency market participants must meet to operate. Each government has adopted a position in rough accordance with its overall regulatory posture, although regulation is in a state of flux. Asian governments also have regulated cryptocurrencies by affording (or withholding) the status of legal payment, permitting (or banning) mining, and levying various forms of taxes.

Each of these governments also has taken a position on when and to what extent its regulatory posture impacts foreign parties and cross-border transactions. No clear regional trend has emerged, with the five countries split along two broader questions: whether foreign parties can participate in their markets, and to what extent their regulations apply to those parties. Moreover, no larger regulatory body has been established to coordinate regulation at a regional level in Asia. As a result, national regulatory regimes remain largely particularized to the issues facing each individual jurisdiction, with less regulatory attention on cross-border effects.
(a) **Japan**

Of all the countries in Asia, and arguably globally, Japan has the deepest and most turbulent history with cryptocurrencies. The world’s first cryptocurrency exchange was established in Japan in 2010 (it was shut down shortly thereafter because of fraudulent activity), and the founder of Bitcoin is widely believed to be a Japanese citizen, although his or her identity remains a mystery. Japan also has been the site of the world’s two largest cryptocurrency heists. In February 2014, Mt. Gox, a massive cryptocurrency exchange that then accounted for roughly 70% of global cryptocurrency trading, was hacked. Over $450 million (based on bitcoin’s trading price at the time) was stolen; at peak bitcoin prices, those coins were worth more than $10 billion. Then, in January 2018, hackers infiltrated Coincheck, another Japanese cryptocurrency exchange, and stole roughly $500 million (based on the value of the coins at the time). Despite these incidents, Japan has become the world’s largest cryptocurrency market—roughly 55% of all bitcoin traded daily is denominated in yen.

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973 In the Mt. Gox hack, roughly 850,000 coins were stolen, then valued at over $450 million. At bitcoin’s peak price of $19,783.21, logged on December 17, 2017, the total value of these stolen coins was roughly $17 billion.


Japan’s legal embrace of cryptocurrency began in 2017, after both China and South Korea restricted cryptocurrency exchanges and ICOs. Shortly thereafter, Japan passed an amendment to the Payment Services Act that had two primary regulatory implications: first, it recognized virtual currency as a legal form of payment, and second, it allowed for legal operation of cryptocurrency exchanges once prospective exchanges meet minimum guidelines and register with the FSA. These requirements apply in equal force to domestic and international exchange providers, although foreign registrants need not establish a company in Japan to qualify. Although Reuters announced the amendment as Japan’s acceptance of cryptocurrencies as legal tender, this view was mistaken as a matter of law. Nevertheless, more retail outlets have begun accepting cryptocurrencies as a form of payment; estimates vary from 5,000 to 20,000. Moreover, in the fourth quarter of 2017, the FSA approved the registration of Japan’s 16 major exchanges. In April 2018, a self-regulatory body—the Japan Virtual Currency Exchange Industry Association—was founded to strengthen the regulatory framework surrounding cryptocurrency exchanges. It joins a growing Japanese community of


977 See Payment Services Act, Act No. 59 of 2009, amended by Act No. 62 of 2016 (Japan).


self-regulating associations including the Japan Blockchain Association and the Japan Cryptocurrency Business Association, which similarly were designed to raise standards within Japan’s emerging cryptocurrency industry. In April 2020, the FSA officially certified the Japan Virtual and Crypto Assets Exchange Association (JVCEA), which was renamed the Japan Crypto Asset Trading Business Association, as a self-regulatory organization under the Financial Instruments and Exchange Act (FIEA).982

Despite this generally permissive regulatory treatment, Japan has a stringent regulatory posture in other areas. For example, Japan taxes cryptocurrency at a high rate; Japan treats cryptocurrencies as income-generating assets, and thus taxes income generated through cryptocurrency trading by as much as 55% (under the miscellaneous income tax), depending on the asset holder’s income. Exchanges, however, are not subject to Japan’s consumption tax.983

In May 2018, the FSA released a five-point agenda on its regulatory intentions going forward. First, it plans to institute strict security standards to ensure that exchanges can defend against hacks. Second, it will require exchanges to implement strict KYC processes for AML and CFT. Third, it will require separate management of corporate and consumer assets and will require protections to prevent employee trading on consumer assets. Fourth, it will restrict cryptocurrencies that afford complete anonymity to the consumer. Finally, it will require that exchange programs organize in accordance with Japanese corporate law and will monitor them to ensure separations between shareholders and management, and between internal asset

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983 Ishida et al., supra note 978.
manager and developer roles.  

In March 2019, the FSA submitted further amendments to both the Payment Services Act and the FIEA related to the purchase and sale of cryptocurrencies. These were passed by the legislature on May 1, 2019, and implementation commenced on May 31, 2020. The changes are significant and represent Japan’s softening approach towards cryptocurrency. Many countries in Asia, including Japan, China, and South Korea, proposed or implemented bans on ICOs, but Japan laid out a framework for eventual legalization. The 2019 amendments, however, classify ICOs and Security Token Offerings (STOs) as Type II securities. ICOs thus are legal, but issuers must follow the regulatory process for an offering of any other type of security—including the creation of a prospectus and handling by companies licensed under the FIEA.

Further, the changes to the laws replaced all references to “virtual currency” with “crypto asset,” added further grounds to refuse registration as an exchange service provider, and required that crypto exchanges keep customer assets in “cold wallets and equivalents” separate from their


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own. The changes also expanded the businesses that need to register with the FSA to include crypto custodians—those holding cryptoassets for customers—even if those businesses do not function as an exchange. Further, the changes criminalized several unfair practices regarding cryptoasset spot and derivatives transactions, including the dissemination of rumors and market manipulation.

Japan also started to seriously consider creating its own CBDC in 2020, as a response to both China’s parallel effort and Facebook’s Libra project. The global coronavirus pandemic has added fuel to calls to create a CBDC, but as of July 2020, Japan appeared to be in the research stage, having commenced preliminary experiments with a CBDC without concrete plans to issue a digital currency.

(b) South Korea

South Korea’s regulatory posture towards cryptocurrencies has oscillated considerably in recent years, but like Japan, South Korea generally has moved towards legitimizing cryptocurrencies by focusing on targeted regulations in an otherwise permissive regulatory environment. South Korea originally approached cryptocurrencies with a comparatively cautious

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988 See Amendment to Payment Services Act and Financial Instruments and Exchange Act, supra note 985, at art. 1. The FSA views the law as requiring cold wallet separation. Regulatory Approaches to Cryptoassets: Japan, supra note 987.

989 See Amendment to Payment Services Act and Financial Instruments and Exchange Act, supra note 985, at art. 2.

990 Id.


992 Id.

approach. That posture was driven in part by the rapid increase in bitcoin’s value, as well as the “kimchi premium,” a speculative phenomenon in which cryptocurrency coins (including bitcoin) trade in South Korea at significant (i.e., up to 50%) mark-ups over the global trading price for that coin. In part because of these premiums, South Korea witnessed several illegal arbitrage schemes, for which the government indicted nearly two dozen perpetrators in December 2017. Despite South Korea’s ongoing regulatory uncertainty regarding cryptocurrencies, it is the third largest global market for cryptocurrencies (after the United States and Japan). Moreover, South Korea aimed to have 8,000 stores accepting cryptocurrencies as payment by the end of the 2018 calendar year.

To reduce speculation in late 2017, the government repeatedly warned that cryptocurrencies were not legal tender and not insured by the central bank. In September 2017, the Financial Services Commission (FSC) proposed a ban on all ICOs. Although the ban never became law, the lack of regulatory clarity around ICOs chilled their adoption. Later that year, government leaders proposed a ban on all anonymous trading. These statements fueled


speculation that the government might move to ban cryptocurrencies entirely; in response, a petition signed by more than 200,000 persons was sent to the government, leading to a public assurance that an outright ban would not take place.\footnote{Evelyn Cheng, \textit{More than 200,000 sign petition in South Korea to stop government’s crackdown on bitcoin ‘happy dream’}, CNBC (Jan. 16, 2018, 9:00 AM), https://www.cnbc.com/2018/01/16/over-200000-sign-petition-in-south-korea-to-stop-bitcoin-regulation.html.} In January 2018, South Korea released guidelines for the industry that increased AML and KYC standards and banned anonymous trading on domestic exchanges and foreigners and minors from trading on any exchange.\footnote{Kim et al., \textit{supra} note 995.} Later in January, the government announced that it would tax cryptocurrency exchanges at the corporate rate, which is 24.2% of corporate income.\footnote{Ramirez, \textit{supra} note 999.}

Before further legislation started to provide some regulatory clarity, Korean operators began to self-regulate. In May 2018, the Korean Blockchain Association—a self-regulatory industry association that includes South Korea’s 14 largest virtual currency exchanges—released a set of self-regulatory measures it would apply to its membership.\footnote{Son Ji-hyoung, \textit{Association affirms 12 cryptocurrency exchanges’ security standards}, THE KOREA HERALD (July 11, 2018, 6:29 PM), http://www.koreaherald.com/view.php?ud=20180711000695.} The guidelines recommended separate management of customer and exchange assets, a process to flag and review abnormal transactions, enhanced client protection systems, minimum capital reserves, and the publishing of regular audit and finance reports, among other items. In July, the Korean Blockchain Association announced that its major exchanges had met these minimums.\footnote{\textit{Id.}}

By mid-2018, South Korea’s regulatory posture has become more permissive, notwithstanding the country’s largest hack (of roughly $70 million on two exchanges) in June.
2018.\textsuperscript{1005} Later that month, the National Assembly announced its plans to pass comprehensive cryptocurrency regulation in the near future. The proposal focuses on AML and KYC provisions and would require exchanges to register with the FSC Financial Intelligence Unit.\textsuperscript{1006} Moreover, in July 2018, the FSC established the Financial Innovation Bureau to supervise and regulate all financial innovation in South Korea, including cryptocurrencies.\textsuperscript{1007} These decisions follow the National Assembly’s announcement in May 2018 that it would propose legislation to lift the ban on ICOs.\textsuperscript{1008}

In March 2020, South Korea passed a reform bill for cryptocurrency, providing a comprehensive framework for the regulation of digital assets and crypto exchanges.\textsuperscript{1009} The legislation includes AML and CFT coverage for virtual asset service providers, \textit{i.e.}, those who do business in buying, selling, exchanging, transferring, storing, or managing virtual assets. Additional licensing and registration requirements are noteworthy aspects of the reform bill. Service providers must register with the government and secure a certificate from the Korean Internet and Security Agency.\textsuperscript{1010} Additionally, virtual asset service providers must partner with

\begin{footnotesize}
\begin{enumerate}
\item Kim et al., \textit{supra} note 995.
\item Danny Crichton, \textit{South Korea passes one of the world’s first comprehensive cryptocurrency laws}, \textit{TECH CRUNCH} (Mar. 5, 2020, 11:07 AM), https://techcrunch.com/2020/03/05/south-korea-passes-one-of-the-worlds-first-comprehensive-cryptocurrency-laws/.
\end{enumerate}
\end{footnotesize}
a bank, thus tying digital transactions to an identifiable bank account. This law will take effect in March 2021, one year from its promulgation, and more details on the implementation and scope of the law likely will be given when regulations (called Presidential Decrees) are issued.

Two more developments warrant attention. First, the Bank of Korea launched its CBDC testing program, which should conclude by the end of 2022. Second, South Korea’s June 2020 announcement that it would impose a new cryptocurrency tax brought swift backlash from economists. This announcement stated that the government will tax income from cryptocurrency transactions (like capital gains) at 20% on all income over 2.5 million won, starting on October 1, 2021.

(c) Australia

Australia has taken a generally permissive regulatory posture towards cryptocurrencies but has done so cautiously in certain areas (e.g., tax, AML, and CFT laws) and recently has increased the stringency of relevant regulatory regimes affecting cryptocurrency products.

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1011 Id.

1012 Teukjeong geumyunggeoraejeongboui bogo min iyong deunge gwanhan beomnyul ilbugaejeongbeomnyuran (daean) [Amendment to the Act on Reporting and Use of Specific Financial Transaction Information (alternative)], Bill No. 24776, Mar. 5, 2020, ch. 4 (S. Kor.), http://likms.assembly.go.kr/bill/billDetail.do?billId=PRC_S1W9V1R1K2Y5J1A5K3V1Z0L4X1H3W9; see Felipe Erazo, Mandatory KYC verification may contradict privacy laws in South Korea, COINTELEGRAPH (Sept. 25, 2010), https://cointelegraph.com/news/mandatory-kyc-verification-may-contradict-privacy-laws-in-south-korea.


1014 Lee Min-hyang, South Korea’s move to tax cryptocurrency faces backlash, THE KOREA TIMES (June 21, 2020, 7:36 PM), http://www.koreatimes.co.kr/www/biz/2020/06/602_291560.html.

Australia also was the first country to provide a gold-backed digital asset, through the Perth Mint. Historically, Australia had taken a somewhat restrictive tax posture towards cryptocurrencies. Although standard capital gains and income taxes apply, from 2014 until mid-2017, Australia effectively double-taxed cryptocurrencies by applying its goods and services tax to both digital currency purchases and to products purchased in digital currencies. Other than this special treatment, Australia historically has treated cryptocurrencies under preexisting regulatory regimes where possible. For example, cryptocurrency exchanges must receive an Australian Financial Services License if the exchange provides financial services or deals in financial products. Similarly, ICO providers must comply with ASIC regulations issued in September 2017, which provide guidance for ICO regulation based on the underlying transaction taking place on the platform (e.g., managed investment schemes must follow the Corporations Act; share offers must follow Australian public corporations law; financial service provision requires the appropriate license).

However, Australia has passed and increasingly enforced more stringent quality controls on cryptocurrency exchanges and ICOs. In April 2018, the Australian Transaction Reports and Analysis Centre mandated that all exchanges with a business operation located in Australia register and meet its AML and CFT compliance and reporting obligations pursuant to the Anti-Money Laundering and Counter-Terrorism Financing Act of 2006. That law requires regulated

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1017 Treasury Laws Amendment Act 2017 (Cth) s 1 (Austl.).

1018 See Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) (Austl.).

entities to establish their customers’ identities, monitor activity, and report suspicious activity to the Centre, among a host of other requirements to ensure the security of financial transactions in Australia. The regulation surfaced in an environment of growing concern around Australia’s AML and CFT laws following the widely reported Commonwealth Bank scandal. In June 2018, a year-long investigation into Commonwealth Bank of Australia, Australia’s largest bank, ended with a $534 million fine for the bank’s AML and CFT violations. Stringency regarding ICOs similarly has grown. In May 2018, ASIC prohibited multiple ICOs from moving forward because of their deceptive and misleading practices. The agency noted that this provision of Australian law applies to ICOs irrespective of whether they are dealing in a financial product.

As a general matter, Australian cryptocurrency regulations apply to any operator, foreign or domestic, with a location in Australia. Notably, ASIC’s ICO guidelines also soon may be applied to foreign operators seeking to access the Australian market, even if the provider does not have a location in Australia. In April 2018, ASIC Commissioner John Price noted that “[w]e will highlight that Australian corporate and consumer law might apply—even if the ICO is created and offered from overseas.” It does not appear that this has become official policy, however.

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(d) Singapore

Singapore generally has embraced cryptocurrencies and sought to create a permissive environment for their operation largely to attract foreign operators to its market. As a result, Singapore has moved at a far slower pace to design cryptocurrency-specific legislation; as late as October 2017, the MAS managing director went so far as to state that “as of now, I see no basis for wanting to regulate cryptocurrencies.”1024 Following this philosophy, Singapore consistently has adopted a guiding principle of choosing to regulate cryptocurrencies within preexisting regulatory frameworks whenever possible, and to look case-by-case to determine whether an individual cryptocurrency transaction is subject to regulation. That philosophy has its roots in the earliest periods of cryptocurrency adoption in Singapore; in 2014, the MAS already had been on record stating that it would not regulate cryptocurrencies unless they fell within the ambit of a previously regulated financial instrument.1025

As a practical matter, most regulation of cryptocurrencies occurs when the underlying product is treated as a security by the MAS. For example, when an ICO seeks to raise debt or equity, the offering is regulated as a security under Singaporean securities law.1026 Similarly, an exchange platform facilitating secondary trading of cryptocurrency securities must be a MAS-approved exchange or market operator.1027


1026 Id., at 4–5, 7–8.

1027 Li Fei Quek et al., Regulating Cryptocurrency Exchanges in Singapore, CNPLAW (May 9, 2018), https://www.cnplaw.com/regulating-cryptocurrency-exchanges-in-singapore/.
In 2019, Singapore formally codified such a regime in its Payment Services Act, which clarifies that digital payment token services (including exchanges and “any service of dealing in digital payment tokens”) must be licensed with the MAS and are thus subject to AML, CFT, and KYC requirements set out by the MAS.1028 In June 2020, MAS brought its first enforcement action under the Payment Services Act, against an individual who used fraudulent fund transfers to buy Bitcoin without a license.1029 Finally, capital gains made on cryptocurrency investments are not taxed in Singapore, which has no capital gains tax; income and sales taxes, however, do apply equally to cryptocurrencies.

Singapore treats cross-border cryptocurrency flow under a similar regulatory philosophy. Foreign-operated exchanges must obtain the proper licensing to facilitate cryptocurrency trading when the underlying cryptocurrency asset is classified as a security. By offering clarity, Singapore has sought to attract foreign ICO operators fleeing more stringent regulatory regimes (e.g., China and India) or cautiously permissive regulatory regimes where guidelines are in a state of flux. The strategy has had some desired effect: recently, Singapore became the third largest market for ICOs since 2014, ahead of every other market in Asia.1030


(e) China

Despite its historical importance to the international cryptocurrency market, China recently has taken a restrictive regulatory posture towards cryptocurrencies. At its height, China arguably represented the industry’s most consequential market—over 95% of bitcoin’s daily trading volume was in renminbi, and over 50% of major mining pools were based in China.\textsuperscript{1031}

Starting in 2017, however, China significantly restricted its private cryptocurrency industry. First, it banned domestic ICOs in September 2017.\textsuperscript{1032} Later that month, it banned all domestic cryptocurrency exchanges, though it did not ban OTC and peer-to-peer trading, nor did it effectively prevent foreign-operated exchanges from interfacing with Chinese consumers. In January 2018, China’s Leading Group on Internet Financial Risks Remediation (the leading internet finance regulatory body in China) ordered all local governments to “actively guide” companies in their regions to exit the cryptocurrency mining industry.\textsuperscript{1033} In February, the government blocked access to and banned foreign exchanges to sever the loophole that domestic traders had used to avoid the September 2017 domestic exchange ban. The government also suggested it would increase enforcement on “exchange-like” cryptocurrency service providers.\textsuperscript{1034}

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\textsuperscript{1033} Gabriel Wildau, China Moves to Shutter Bitcoin Mines, FIN. TIMES (Jan. 9, 2018), https://www.ft.com/content/adfe7858-f4f9-11e7-88f7-5465a6ce1a00.
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\textsuperscript{1034} See Clark & Chen, supra note 1032.
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However, the Chinese government’s actions have sent mixed messages. While continuing to treat cryptocurrencies strictly, China has embraced the concept of a government-sanctioned virtual currency that uses blockchain. In March 2018, the Central Bank of China announced its intention to create a sovereign digital currency and suggested that it could accept any virtual currency that had a stabilizing effect on the economy.\textsuperscript{1035} Moreover, China increased its investment in blockchain technology—including a commitment to fostering the technology in China’s most recent five-year plan—and encouraged private sector innovation.\textsuperscript{1036} Finally, in May 2018, an editorial in a state-owned newspaper made the case for moving towards a cautiously permissive regulatory approach, in which cryptocurrency exchanges and ICOs would be legal but more heavily regulated.\textsuperscript{1037}

In 2019, President Xi Jinping made public statements endorsing blockchain technology.\textsuperscript{1038} Shortly thereafter, China’s National Development and Reform Commission removed the mining of cryptocurrency from a list of activities set for elimination.\textsuperscript{1039} Moreover, in May 2020, China’s legislature passed a law that protected cryptocurrency inheritance


\textsuperscript{1036} Jane Li, \textit{China wants to be a front runner in blockchain technology even if the ban on bitcoin remains}, S. CHINA MORNING POST (Mar. 7, 2018, 9:33 PM), https://www.scmp.com/business/china-business/article/2136188/beijing-sIGNALS-IT-WANTS-BECOME-FRONT-RUNNER-BLOCKCHAIN.

\textsuperscript{1037} Xiao Xin, \textit{Improved regulation makes more sense than just saying no to bitcoin in China}, GLOB. TIMES (May 30, 2018), http://www.globaltimes.cn/content/1104753.shtml.


\textsuperscript{1039} China leaves bitcoin mining out of list of restricted activities, ALJAZEERA (Nov. 7, 2019), https://www.aljazeera.com/ajimpact/china-leaves-bitcoin-mining-list-restricted-activities-191107145910691.html.
And in July 2020, the Supreme Court and National Development and Reform Commission published their opinions in a joint document, including the provision of clearer legal standards and preventing against infringements.\(^\text{1041}\) China also began testing its CBDC in mid-2020.\(^\text{1042}\)

Together these changes and pronouncements suggest China’s active exploration of more permissive cryptocurrency regulation. This tension with the overall regulatory posture has led some commentators to speculate that China’s hostility towards cryptocurrencies lies not in its resistance to their innovative potential, but instead reflects the Communist Party’s reluctance to cede control in its financial markets to privately operated and hard-to-control cryptocurrency platforms.\(^\text{1043}\)

4. **Global Guidance**

A number of transcontinental bodies also have published statements, guidance, and position papers regarding cryptocurrencies and blockchain technologies. Although many of these organizations have endeavored to embrace these new technologies, others have cast doubt on their safety and long-term viability.

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\(^{1041}\) *Id.*


\(^{1043}\) See Clark & Chen, *supra* note 1032.
(a) IOSCO

IOSCO\textsuperscript{1044} published a lengthy report on FinTech in February 2017, which defines and discusses a multitude of DLT and blockchain technology applications and potential associated risks, challenges, and benefits.\textsuperscript{1045} The report also highlights key regulatory developments in the area and acknowledges that IOSCO and other international organizations “are observing the developments of DLT under their respective objectives.”\textsuperscript{1046}

In January 2018, the IOSCO Board issued a press release advising investors to “be very careful in deciding whether to invest in ICOs” and highlighting the “clear risks” associated with them, deeming ICOs “highly speculative investments in which investors are putting their entire invested capital at risk.”\textsuperscript{1047} The IOSCO Board has acknowledged that ICOs are “not standardized, and their legal and regulatory status is likely to depend on the circumstances of the individual ICO.”\textsuperscript{1048} The IOSCO Board also established an ICO Consultation Network as a resource for IOSCO members, through which members may discuss their experiences and bring concerns, including cross-border issues, to the attention of regulators.\textsuperscript{1049}

Similarly, in May 2018, IOSCO issued a press release in relation to the organization’s

\textsuperscript{1044} About IOSCO, IOSCO (last visited Mar. 7, 2019), http://www.iosco.org/about/?subsection=about_iosco (IOSCO “develops, implements and promotes adherence to internationally recognized standards for securities regulation,” and its membership regulates more than 95% of securities markets globally in more than 115 jurisdictions).


\textsuperscript{1046} Id. at 64.


\textsuperscript{1048} Id.

\textsuperscript{1049} Id.
annual conference, where the IOSCO Board agreed to develop a Support Framework addressing domestic and cross-border issues related to ICOs, and to create a FinTech Network to serve as a collaborative forum for discussion of regulatory issues and emerging FinTech risks.

In collaboration with other international bodies, IOSCO reported to the G20 at the July 2018 G20 summit that at present, cryptoasset platforms, like cryptoassets more generally, do not pose global financial stability risks, but they “raise other significant concerns, including consumer and investor protection, market integrity and money laundering/terrorism financing, among others.” IOSCO emphasized the importance of coordination among financial regulators in different jurisdictions in the cryptoasset space.

In 2019, IOSCO further examined issues and risks associated with the operations of cryptoasset trading platforms (CTPs) that fall or should fall within security regulators’ auspices. It noted that there are several key considerations, including access to CTPs, safeguarding assets, conflicts of interests, operations, and market integrity, and noted how typical securities regulation should apply to these platforms.


1051 Id.


1054 Id.

(b) G20, FSB, BCBS, CPMI, BIS, and FATF

Several other international organizations have worked collaboratively with IOSCO and the G20 to address issues related to cryptocurrencies and blockchain. At the conclusion of their March 2018 summit, the G20 members issued a statement on cryptoassets, acknowledging cryptoassets’ potential to “improve the efficiency and inclusiveness of the financial system and the economy more broadly” but cautioning that they do “raise issues with respect to consumer and investor protection, market integrity, tax evasion, money laundering and terrorist financing,” “lack the key attributes of sovereign currencies,” and “could have financial stability implications.” In its March 2018 statement, the G20 also committed to apply the FATF standards to cryptoassets and called on international standard-setting bodies, including the FSB, the CPMI, the FATF, and IOSCO to report back to the G20 in July 2018 and continue monitoring cryptoassets and associated risks and assess multilateral responses as

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1057 *What do we do*, FATF (last visited Nov. 13, 2020), https://www.fatf-gafi.org/about/whatwedo/ (the FATF is an inter-governmental body established to set standards and “promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system”).

1058 *About the FSB*, FSB (last visited Mar. 7, 2019), http://www.fsb.org/about/ (established in April 2009 as the successor to the Financial Stability Forum, the FSB is an “international body that monitors and makes recommendations about the global financial system” to “promote[] financial stability” by “coordinating national financial authorities and international standard-setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies”).

1059 *Committee on Payments and Market Infrastructures (CPMI)—overview*, BIS (last visited Nov. 13, 2020), https://www.bis.org/cpmi/ (CPMI, a committee of the BIS, “promotes, monitors and makes recommendations about the safety and efficiency of payment, clearing, settlement and related arrangements” and “serves as a forum for central bank cooperation in related oversight, policy and operational matters”); *About BIS—overview*, BIS (last visited Dec. 23, 2020), https://www.bis.org/about/index.htm?m=1%7C1 (established in 1930 and based in Basel, Switzerland, the BIS is owned by 63 central banks across the globe and serves as a bank for other central banks).
necessary.\textsuperscript{1060}

In response to the March G20 statement, the FSB published a July 2018 report on its work and the work of other international organizations related to cryptoassets.\textsuperscript{1061} According to that report, in the first quarter of 2018, the FSB examined potential financial stability implications from cryptoassets and concluded that cryptoassets “do not pose a material risk to global financial stability at this time,” though the FSB supports “vigilant monitoring in light of the speed of developments and data gaps.”\textsuperscript{1062} To that end, the FSB worked collaboratively with the CPMI on a framework for monitoring financial stability risks related to cryptoassets, which the FSB Plenary approved in June 2018.\textsuperscript{1063}

The FSB’s July 2018 G20 report also details the BCBS\textsuperscript{1064} efforts in the cryptocurrency space. The BCBS focuses on regulating and supervising banks globally to enhance financial stability, and its current initiatives in the cryptoasset context include: “(i) quantifying the materiality of banks’ direct and indirect exposures to crypto-assets; (ii) clarifying the prudential

\textsuperscript{1060} Communiqué, supra note 1056; Communiqué Annex, supra note 1056.

\textsuperscript{1061} See FSB CRYPTO-ASSETS REPORT TO G20, supra note 1053.

\textsuperscript{1062} Id. at 1. This is in accord with an earlier report the FSB published in June 2017 regarding regulatory issues in FinTech that warrant authorities’ attention. See FSB, FINANCIAL STABILITY IMPLICATIONS FROM FINTECH (2017), http://www.fsb.org/wp-content/uploads/R270617.pdf. Therein, the FSB considered the number of digital currencies “relatively small,” and as such, concluded that “they do not currently pose a systemic risk,” further stating that “given the difficulties of a [digital currency] ever accounting for a significant proportion of transactions in a jurisdiction, the likelihood of a [digital currency] ever becoming systematically important is judged to be low.” Id. at 52. If one or more digital currencies were to achieve “widespread adoption,” however, the FSB acknowledged that financial stability issues could arise, such as challenges related to enforcing [KYC] and [AML] rules and overseeing a particular digital currency given its “international, borderless nature.” Id. at 52–53.

\textsuperscript{1063} See FSB CRYPTO-ASSETS REPORT TO G20, supra note 1053, at 1, 8.

\textsuperscript{1064} The Basel Committee – Overview, BIS (last visited Dec. 23, 2020), https://www.bis.org/bcbs/ (BCBS is a BIS committee responsible for prudential regulation of banks; it has 45 member central banks and bank supervisors from 28 jurisdictions).
treatment of banks’ exposures to crypto-assets; and (iii) monitoring developments related to crypto-assets/FinTech and assessing their implications for banks and supervisors.”

For its part, the CPMI has a mandate to promote safety and efficiency in payment, clearing, and settlement arrangements and has acknowledged the need to closely monitor digital currencies and DLT. Since the issuance of its 2015 report on digital currencies, the CPMI has continued to monitor developments, and to develop frameworks and reports to assist central banks.

Separately, in June 2018, the BIS (of which the CPMI and the BCBS are member committees) issued its annual economic report and expressed skepticism about cryptocurrencies, concluding that cryptocurrencies “raise a host of issues” and are a “poor substitute for the solid institutional backing of money.” The BIS did acknowledge that the technology underlying cryptocurrencies (blockchain and DLT) “could have promise in other applications, such as the simplification of administrative processes in the settlement of financial transactions,” however.

The FATF made a separate submission to the G20 in July 2018. In the submission, the FATF pledged to prioritize fostering improvements in regulation and supervision of virtual

1065 FSB CRYPTO-ASSETS REPORT TO G20, supra note 1053, at 6–7.

1066 Id. at 3.


1069 ANNUAL ECONOMIC REPORT, supra note 1068, at 91.
currencies and cryptoassets, outlined a comprehensive approach to combat increased use of virtual currencies and cryptoassets for money laundering and terrorist financing, and committed to examine how existing FATF standards may apply to virtual currencies and cryptoassets.\footnote{FATF, FATF REPORT TO THE G20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS 1–4 (2018), \url{http://www.fatf-gafi.org/media/fatf/documents/reports/FATF-Report-G20-FM-CBG-July-2018.pdf.}}

In response to these developments, at the conclusion of its July 2018 meeting, the G20 reiterated its commitment to implementing FATF standards and further requested that the FATF clarify how its standards apply to cryptoassets.\footnote{\textit{Communiqué}, UN ENVIRONMENT (July 21–22, 2018), \url{http://unepinquiry.org/wp-content/uploads/2018/07/Communique_FMCBG_Meeting_July_2018.pdf.}} It also encouraged additional future updates from the FSB and other organizations regarding further work in monitoring potential risks of cryptoassets and responses thereto.\footnote{\textit{Id.}} The G20 further acknowledged the “significant benefits” that technologies underlying cryptoassets can deliver to the financial system and larger economy, while again cautioning that they may “raise issues with respect to consumer and investor protection, market integrity, tax evasion, money laundering and terrorist financing.”\footnote{\textit{Id.}} The G20 nonetheless concluded that as of July 2018, cryptoassets “do not at this point pose a global financial stability risk,” but pledged to “remain vigilant” in monitoring the issue.\footnote{\textit{Id.}}

In October 2018, the FSB published an additional report for G20 detailing potential cryptocurrency risks,\footnote{See FSB, CRYPTO-ASSETS: POTENTIAL CHANNELS FOR FUTURE FINANCIAL STABILITY IMPLICATIONS (2018), \url{http://www.fsb.org/wp-content/uploads/P101018.pdf.}} and during its November 30-December 1, 2018 meeting, the G20 signed
a declaration committing to regulate crypto-assets for AML and CFT “in line with FATF standards” and “consider other responses as needed.”

Discussions relating to cryptocurrency continued into 2019. As in 2018, the FSB report to the G20 in May 2019 detailed the works in progress of the FSB, BCBS, CPMI, BIS, IOSCO, FATF, and Organisation for Economic Co-operation and Development (OECD). Much of that report revolved around regulatory developments and the role to be played by financial institutions with respect to cryptocurrencies, risk assessments, and further development of regulations. For example, the FATF worked on detailing the AML/CTF recommendations (“Recommendation 15”) it adopted in 2018. In June 2019, the FATF released an interpretive note to Recommendation 15, including requiring licensing obligations, monitoring by government agencies, and applying a risk-based regulatory approach to virtual asset service providers.

The statement by leaders at the G20 reiterated that countries need to remain vigilant with respect to risks and requested further proposals on multilateral responses by standard setting bodies like the FATF and FSB. In response, the FSB prepared a report on stablecoins, which could change assessments about cryptoassets and their impact on stability.

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statement, countries from the G20 agreed not to allow commencement of stablecoins like Libra until sufficient regulations are put in place to mitigate risks. Finally, while the G20 summit in 2020 was delayed, the FATF also submitted a report on stablecoins.

In sum, the inherently global, cross-border nature of emerging blockchain technologies and cryptocurrencies renders their monitoring and regulation inherently challenging, in a manner perhaps unparalleled in history. Accordingly, numerous regulators and larger organizations, both within and among countries and continents, continue to work collaboratively to examine how best to govern these areas in a manner that both protects investors and fosters continued innovation.


SECTION 8. STATE LAW CONSIDERATIONS

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1. New York State Department of Financial Services’ BitLicense

   On June 24, 2015, the DFS adopted an extensive set of regulations on virtual currency businesses in New York State. Under the regulations, any person that is a resident of, or located in, or has a place of business or is conducting business in New York, and is engaged in a “virtual currency business activity” is required to obtain a license from the DFS. Licensed virtual currency businesses must have in place certain compliance policies; meet capital requirements set by the DFS on a case-by-case basis; meet prescribed customer protection and asset custody standards; keep certain required books and records; be subject to DFS examinations; have implemented AML and cybersecurity programs; have a business continuity and disaster recovery program in place; and establish and maintain a customer complaints process.¹⁰⁸³

(a) **BitLicense Applicability**

A three-step analysis helps determine if a business must be licensed under the DFS’s BitLicense regulations. The first step is to determine whether the business’s product or service involves a “virtual currency.” DFS Rule 200.2(p) defines “virtual currency” to include “any type of digital unit that is used as a medium of exchange or a form of digitally stored value.”\(^{1084}\) The regulations further explain that “Virtual Currency shall be broadly construed to include digital units of exchange that (i) have a centralized repository or administrator; (ii) are decentralized and have no centralized repository or administrator; or (iii) may be created or obtained by computing or manufacturing effort.”\(^{1085}\) The definition of virtual currency explicitly excludes:

1. digital units that (i) are used solely within online gaming platforms, (ii) have no market or application outside of those gaming platforms, (iii) cannot be converted into, or redeemed for, Fiat Currency or Virtual Currency, and (iv) may or may not be redeemable for real-world goods, services, discounts, or purchases.

2. digital units that can be redeemed for goods, services, discounts, or purchases as part of a customer affinity or rewards program with the issuer and/or other designated merchants or can be redeemed for digital units in another customer affinity or rewards program, but cannot be converted into, or redeemed for, Fiat Currency or Virtual Currency; or

3. digital units used as part of Prepaid Cards.\(^{1086}\)

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\(^{1084}\) *Id.* § 200.2(p).

\(^{1085}\) *Id.*

\(^{1086}\) *Id.* The regulations define a “Prepaid Card” to mean an electronic payment device that:

1. is usable at a single merchant or an affiliated group of merchants that share the same name, mark, or logo, or is usable at multiple, unaffiliated merchants or service providers;
2. is issued in and for a specified amount of Fiat Currency;
3. can be reloaded in and for only Fiat Currency, if at all;
4. is issued and/or reloaded on a prepaid basis for the future purchase or delivery of goods or services;
5. is honored upon presentation; and
6. can be redeemed in and for only Fiat Currency, if at all.

If the business involves a virtual currency, the second step in the analysis is whether the business is engaged in a “virtual currency business activity.” The regulations define the term “virtual currency business activity” as the conduct of any one of the following types of activities involving New York or a New York Resident:

(1) receiving Virtual Currency for Transmission or Transmitting Virtual Currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of Virtual Currency;

(2) storing, holding, or maintaining custody or control of Virtual Currency on behalf of others;

(3) buying and selling Virtual Currency as a customer business;

(4) performing Exchange Services\(^{1087}\) as a customer business; or

(5) controlling, administering, or issuing a Virtual Currency.\(^{1088}\)

The development and dissemination of software in and of itself does not constitute a virtual currency business activity.\(^{1089}\)

If a business is found to be engaged in a virtual currency business activity, the final analysis is whether any of the exemptions apply. Exemptions are available to (1) persons that are chartered under the New York Banking Law and are approved by the superintendent to engage in Virtual Currency Business Activity; and (2) Merchants and consumers that utilize Virtual Currency solely for the purchase or sale of goods or services or for investment purposes.\(^{1090}\)

\(^{1087}\) “Exchange Service” means “the conversion or exchange of Fiat Currency or other value into Virtual Currency, the conversion or exchange of Virtual Currency into Fiat Currency or other value, or the conversion or exchange of one form of Virtual Currency into another form of Virtual Currency.” \textit{Id.} § 200.2(d).

\(^{1088}\) \textit{Id.} § 200.2(q).

\(^{1089}\) \textit{Id.}

\(^{1090}\) \textit{Id.} § 200.3(c).
(b) Application Requirements

In addition to the payment of a nonrefundable $5,000 fee, a license application must include, among other things, (1) information about the licensee and its affiliates, including business descriptions, a projected customer base, and specific marketing targets; (2) detailed biographical information, an independent investigatory agency background report, and a set of completed fingerprints for each principal of the licensee; (3) a current financial statement for the licensee and each principal; (4) details of the licensee’s banking arrangements and insurance policies; (5) a copy of written policies and procedures related to the DFS BitLicense regulations; and (6) an explanation of the methodology used to calculate the applicable virtual currency’s value in fiat currency. The regulations establish a 90-day application review period, subject to extensions at the discretion of the superintendent of DFS.

To the extent that an applicant cannot satisfy all of the regulatory requirements, the regulations permit the superintendent of DFS, in his or her sole discretion, to grant a “conditional license” to such an applicant. Although a conditional license is potentially available, a number of virtual currency businesses, particularly smaller firms and start-up ventures, left New York rather than undergo the BitLicense application process that requires significant expenses in time and money.

On June 24, 2020, DFS proposed a framework for conditional BitLicenses. DFS

1091 Id. §§ 200.4–200.5.
1092 Id. § 200.6(b).
1093 Id. § 200.4(c).
1095 N.Y. State Dep’t of Fin. Servs, Request for Comments on a Proposed Framework for a Conditional BitLicense (June 24, 2020),
intends to allow businesses to work in collaboration with an authorized holder of a BitLicense or limited purpose trust company.\textsuperscript{1096} The framework targets startups, growth-stage companies, established New York companies not yet conducting any virtual currency business activity, and established virtual currency companies now operating outside of New York, with the expectation that the conditional licensee eventually will seek a full BitLicense.\textsuperscript{1097} Under the proposed framework, the conditional license applicant would engage with an authorized entity for various services and support relating to structure, capital, systems, and personnel.\textsuperscript{1098} Applicants must contact DFS to indicate their interest in the conditional license and must submit their agreement with an authorized BitLicensee or trust charter and other documentation required based on the type of business and risks presented.\textsuperscript{1099} If approved, the conditional licensee may engage in any virtual currency business activity.\textsuperscript{1100} Public comments on the proposed framework ended on August 10, 2020.\textsuperscript{1101} A final rule had not been published as of August 24, 2020.

As of August 24, 2020, a search of the DFS’s database listed nineteen BitLicense holders: Bitflyer; Bitpay, Inc.; BitStamp USA, Inc.; Circle Internet Financial, Inc.; Coinbase, Inc.; Coinsource; Cottonwood Vending; Eris Clearing, LLC; Genesis Global Trading, Inc.; LibertyX/Moon Inc.; NYDIG Execution LLC; Robinhood Crypto; Seed Digital Commodity Market, LLC; SoFi Digital Assets; Square, Inc.; Tagomi Trading; Xapo, Inc.; Ripple affiliate

\textsuperscript{1096} Id.

\textsuperscript{1097} Id.

\textsuperscript{1098} Id.

\textsuperscript{1099} Id.

\textsuperscript{1100} Id.

\textsuperscript{1101} Id.

XRP II, LLC;\textsuperscript{1102} and Zero Hash LLC. In addition, the DFS has granted limited purpose trust company banking charters under the New York Banking Law to Gemini Trust Company and Paxos Trust Company, formerly known as itBit Trust Company.

To increase transparency in the application process, DFS published a notice to applicants on June 24, 2020 providing additional details on the license procedures.\textsuperscript{1103} First, DFS will limit substantive review to applications that are complete.\textsuperscript{1104} All required documents must be submitted, and the checklist on the application website must be completed, before DFS will review an application.\textsuperscript{1105} Second, DFS will limit the number of deficiency letters by reserving the right to deny applications, without notice, after the third deficiency letter.\textsuperscript{1106}

\textbf{(c) Ongoing Compliance Obligations}

A BitLicense licensee is subject to DFS examination and ongoing compliance obligations. Each licensee must have a compliance program that ensures compliance with the BitLicense regulations and applicable federal and state laws and regulations.\textsuperscript{1107} The compliance program must be reviewed and approved by the licensee’s board of directors and overseen by a designated compliance officer.\textsuperscript{1108} The regulations impose capital and custody requirements on

\textsuperscript{1102} On May 5, 2015, FinCEN, along with the U.S. Attorney’s Office for the Northern District of California, assessed a $700,000 civil money penalty against XRP II, LLC and its parent company Ripple Labs Inc. The former willfully violated the Bank Secrecy Act by failing to implement an effective AML program and to report suspicious activity related to several financial transactions. See FinCEN Press Release, supra note 803.


\textsuperscript{1104} Id.

\textsuperscript{1105} Id.

\textsuperscript{1106} Id.

\textsuperscript{1107} Id. § 200.7.

\textsuperscript{1108} Id.
licensees (capital requirements may be satisfied in the form of cash and virtual currency); the amount of capital required is left to the superintendent’s discretion based on a list of outlined factors.\textsuperscript{1109} Additionally, the regulations require (1) books and records similar to those in place for most financial firms; (2) licensees to deliver quarterly and audited annual financial reports to the superintendent; (3) superintendent approval for certain changes to the business or in control of the licensee; (4) advertising, marketing, and consumer protection measures, including enumerated disclosures to customers of material risks and the delivery of confirmation receipts to customers after each transaction; and (5) a customer complaints process.\textsuperscript{1110}

The regulations also incorporate strict AML and cybersecurity requirements for licensees, though certain relief is available to licensees that are subject to federal AML requirements. In a June 3, 2015 speech, then-DFS Superintendent Benjamin Lawsky noted that there was a significant overlap between the rules dealing with AML issues and existing FinCEN regulations.\textsuperscript{1111} As a result, FinCEN registrants that already file SARs in compliance with

\textsuperscript{1109} Id. § 200.8(a). The factors DFS considers when determining minimum capital requirements include:

- the composition of the Licensee’s total assets, including the position, size, liquidity, risk exposure, and price volatility of each type of asset;
- the composition of the Licensee’s total liabilities, including the size and repayment timing of each type of liability;
- the actual and expected volume of the Licensee’s Virtual Currency Business Activity;
- whether the Licensee is already licensed or regulated by the superintendent under the Financial Services Law, Banking Law, or Insurance Law, or otherwise subject to such laws as a provider of a financial product or service, and whether the Licensee is in good standing in such capacity;
- the amount of leverage employed by the Licensee;
- the liquidity position of the Licensee;
- the financial protection that the Licensee provides for its customers through its trust account or bond;
- the types of entities to be serviced by the Licensee; and
- the types of products or services to be offered by the Licensee.

\textsuperscript{1110} Id. §§ 200.10–12, 200.14, 200.18–20. A licensee must disclose terms and conditions, as well as material risks, to customers. The regulations enumerate the minimum material risk disclosures that must be provided to customers.

\textsuperscript{1111} Superintendent Lawsky’s Remarks at the BITS Emerging Payments Forum (June 3, 2015).
FinCEN regulations do not need to duplicate their work by filing SARs with the DFS.\textsuperscript{1112}

The regulations also require a licensee to establish and maintain a written anti-fraud policy that identifies fraud-related risk areas, including market manipulation, and incorporates effective procedures and controls to protect against such risks.\textsuperscript{1113} The policy must allocate responsibility for monitoring these risks and provide for periodic policy evaluations and revisions.\textsuperscript{1114} After adopting the BitLicense regulations, the DFS provided guidance on the anti-fraud policy mandate, requiring that a licensee submit a report to the Department “immediately upon the discovery of any wrongdoing.”\textsuperscript{1115} Within 48 hours of submitting the report, the licensee must provide a “further report” of material developments relating to the original events, including a statement of (1) the actions taken or proposed to be taken with respect to such developments; and (2) any changes in the licensee’s operations that have been put in place or are planned in order to avoid repetition of similar events.\textsuperscript{1116} A licensee must maintain records of each incident of wrongdoing.\textsuperscript{1117}

\textbf{(1) Limited Exemptions}

The DFS’s BitLicense regulations provide exemptions from the licensing requirement

\begin{itemize}
\item \textsuperscript{1112} Id.
\item \textsuperscript{1113} N.Y. COMP. CODES R. & REGS. tit. 23, § 200.19(g).
\item \textsuperscript{1114} Id.
\item \textsuperscript{1115} N.Y. State Dep’t of Fin. Servs., Letter From Maria T. Vullo, Superintendent of Fin. Servs., to All Virtual Currency Business Entities Licensed under 23 NYCRR Part 200 or Chartered as Limited Purpose Trust Companies under the New York Banking Law on Guidance on Prevention of Market Manipulation and Other Wrongful Activity (Feb. 7, 2018), https://www.dfs.ny.gov/system/files/documents/2020/03/il180207.pdf [hereinafter NYS DFS Guidance]. The guidance applies both to persons that hold a BitLicense and to those chartered as a limited purpose trust company under the New York Banking Law.
\item \textsuperscript{1116} Id.
\item \textsuperscript{1117} Id.
\end{itemize}
only for entities “chartered under the New York Banking Law” and “merchants and consumers using virtual currency solely for the purchase of goods or services or for investment purposes.” As a result, a global investment bank headquartered in Manhattan that is a regulated national bank with the Treasury Department’s Office of the Comptroller of the Currency, a registered broker-dealer with the SEC and FINRA member, or an FCM registered with the CFTC and NFA member still would be required to obtain a BitLicense if it wanted to allow its New York customers to hold virtual currency in accounts with it. In addition, because the exemption is only for entities chartered under the New York Banking Law, money transmitters licensed by the DFS are not exempt from the BitLicense license requirement, nor are BitLicense registrants exempt from the money transmitter license requirement. In addition, the DFS BitLicense regime does not provide for any reciprocity for persons similarly registered in other states.

(2) A Lack of Market Conduct Standards

Although the DFS’s BitLicense regulations explicitly include virtual currency “exchangers,” the regulations do not expressly articulate standards relating to market conduct generally, or conduct related to fraud or market manipulation, such as front-running, wash trading, or spoofing. This lack of market conduct standards was one of the reasons the SEC cited for rejecting the Bats/Winklevoss Bitcoin Trust ETF application. Although the SEC acknowledged that the Gemini Exchange was regulated by the DFS, it observed that DFS regulations do not require virtual currency businesses registered with it to have the kinds of

1118 N.Y. COMP. CODES R. & REGS. tit. 23, § 200.3(c).

Digital and Digitized Assets: Federal and State Jurisdictional Issues (December 2020)
ABA IDPPS Jurisdiction Working Group

safeguards national securities exchanges are required to have, which are “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.”

The DFS has attempted to address the regulations’ failure to set standards for market conduct by issuing guidance in February 2018. The guidance requires BitLicense holders and limited purpose trust companies (“VC Entities”) “to implement measures designed to effectively detect, prevent, and respond to fraud, attempted fraud, and similar wrongdoing.” The guidance elaborates that “market manipulation is a form of wrongdoing about which VC Entities must be especially vigilant.” VC Entities are directed to implement written policies identifying the risks of fraud the entity faces given its business model, put in place procedures and controls against the identified risks, allocate responsibility for monitoring risks, and periodically evaluate the effectiveness of the controls and monitoring mechanisms.

2. **New York Limited Purpose Trust Charter**

   In New York, virtual currency businesses are exempt from the DFS’s BitLicense requirements if they are chartered under the New York Banking Law, most commonly as a

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1120 Winklevoss Order, *supra* note 617, at 34 (quoting 15 U.S.C. § 78f(b)(5)).

1121 NYS DFS Guidance, *supra* note 1115.

1122 *Id.* at 1.

1123 *Id.*

1124 *Id.* at 2.
limited purpose trust company, and are approved by the superintendent to engage in Virtual Currency Business Activity.\footnote{1125} Before the DFS implemented its BitLicense regime, a firm could obtain a limited purpose trust company charter from the DFS to immediately commence its virtual currency operations.\footnote{1126} However, in March 2014, the DFS indicated that any virtual currency exchange licensed under the New York Banking Law would be expected to meet the substantive requirements of the BitLicense when finalized.\footnote{1127}

Limited purpose trust companies are entities chartered under the bank and trust company provisions of the New York Banking Law. A limited purpose trust company is subject to many of the same requirements that apply to a bank operating under a New York State banking charter.\footnote{1128} Under New York law, a trust company has general powers available to banks and trust companies, including:

- the power to discount, purchase, and negotiate promissory notes, drafts, bills of exchange, and other written obligations for the payment of money;
- the power to purchase accounts receivable;
- the power to borrow and lend money on a secured or unsecured basis;
- the power to buy and sell exchange, coin, and bullion;
- the power to receive deposits of money, personal property, and securities; and
- the power to exercise all other incidental powers that are necessary to carry on the business of banking.\footnote{1129}

\footnote{1125} N.Y. COMP. CODES R. & REGS. tit. 23, § 200.3(c).
\footnote{1127} Id.
\footnote{1129} N.Y. BANKING LAW § 96 (McKinney).
While a limited purpose trust company, unlike a trust company, is not allowed to make loans or take deposits, it still can serve as the custodian of customer funds. In practice, most limited purpose trust companies typically engage in activities such as employee benefit trust, personal trust, corporate trust, transfer agency, securities clearance, investment management, and custodial services. Because of the limited nature of its activities, however, a limited purpose trust company is not eligible for FDIC deposit insurance. At the same time, limited purpose trust companies can indirectly provide FDIC insurance to their clients by holding the deposits at an FDIC-insured institution.

(a) Similarities to DFS BitLicense Regulations

Like the BitLicense regulations, the regulations require an entity chartered as a New York limited purpose trust company to obtain approval from the DFS when there is a change in the general character of the company’s business or a change in its corporate structure or control. Under the limited purpose trust charter, an entity must comply with similar regulatory compliance requirements as required by the BitLicense, including AML requirements; Office of Foreign Assets Control of the U.S. Treasury Department requirements; cybersecurity

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1131 Id.

1132 Id.

1133 Shadab, supra note 1128.

1134 NYS DFS Trust Co. Org., supra note 1130.


1136 Id.
requirements and programs;\textsuperscript{1137} anti-fraud requirements;\textsuperscript{1138} disclosure requirements;\textsuperscript{1139} and reporting requirements.\textsuperscript{1140}

(b) Key Differences between the Limited Purpose Trust Charter and the DFS BitLicense Regime

Unlike the BitLicense regime, the limited purpose trust charter does not have uniform application processes and fees.\textsuperscript{1141} Fees vary based on the type and purpose of the applicant. Because the limited purpose trust charter does not have a conditional license like that of the BitLicense regime, all limited purpose trust company applicants must be ready to comply with the full set of requirements when applying with the DFS.

Additionally, the limited purpose trust charter provides chartered entities with powers generally associated with trustees and other fiduciaries that the BitLicense regime does not provide to its licensees.\textsuperscript{1142} Activities specifically identified in the statute as activities that New York trust companies may conduct with respect to their fiduciary accounts include:

- the power to accept deposits exclusively in a fiduciary capacity, including in the capacity to receive and disburse money, to transfer, register, and countersign evidences of indebtedness or other securities, and to act as attorney-in-fact or agent;\textsuperscript{1143} and

\textsuperscript{1137} Id. §§ 500.00, 500.03 (including the cybersecurity requirement for a written disaster recovery and business continuity plan).

\textsuperscript{1138} NYS DFS Guidance, supra note 1115.

\textsuperscript{1139} See, e.g., N.Y. COMP. CODES R. & REGS. tit. 3, § 13.2.

\textsuperscript{1140} See, e.g., id. § 24.1.


\textsuperscript{1142} N.Y. BANKING LAW § 100 (McKinney).

\textsuperscript{1143} Id. § 96.
• the power to accept appointment as receiver, trustee, or committee of the property or estate of any person in insolvency or bankruptcy proceedings.\textsuperscript{1144}

While BitLicense capital requirements only mandate the maintenance of sufficient capital (with no set minimum), the limited purpose trust charter sets a minimum of $2,000,000 in Tier 1 capital for the initial capitalization of chartered entities.\textsuperscript{1145} Limited purpose trust companies must maintain their Tier 1 capital at a level no less than 0.25\% of discretionary assets.\textsuperscript{1146}

3. Adoption of Virtual Currency Token Listing Framework under DFS Guidance

On June 24, 2020, DFS published guidance enabling BitLicensees and virtual currency trust companies to offer and use new coins in a “timely and prudent manner.”\textsuperscript{1147} Previously, these entities required DFS approval to use virtual currencies other than those listed in their initial application.\textsuperscript{1148} The guidance allows entities to self-certify the use of new coins and “Greenlisted” coins without DFS approval.\textsuperscript{1149} No privacy coins or gambling coins may be self-certified.\textsuperscript{1150} In order to self-certify new coins, the entity must have a policy in place that meets the various requirements DFS specifies in the guidance.\textsuperscript{1151} Notable requirements include:

\textsuperscript{1144} \textit{Id.} \S\ 100.

\textsuperscript{1145} NYS DFS Trust Co. Org., \textit{supra} note 1130 (“Tier 1 capital will consist of permanent core capital elements (common stockholders’ equity, noncumulative perpetual preferred stock, a limited amount of cumulative preferred stock, and minority interest in the equity of consolidated subsidiaries) less goodwill and other intangible assets that are required to be deducted.”).

\textsuperscript{1146} \textit{Id.}

\textsuperscript{1147} \textit{Guidance Regarding Adoption or Listing of Virtual Currencies}, N.Y. STATE DEP’T OF FIN. SERVS (June 24, 2020), https://www.dfs.ny.gov/apps_and_licensing/virtual_currency_businesses/gn/adoption_listing_vc.

\textsuperscript{1148} \textit{Id.}

\textsuperscript{1149} \textit{Id.}

\textsuperscript{1150} \textit{Id.}

\textsuperscript{1151} \textit{Id.}
• Annual review of the coin-listing policy by the board of directors or equivalent authority of the entity;

• Prior written approval of DFS for any changes to the coin-listing policy;

• Thorough due diligence processes to ensure that the coin is created or issued by a legitimate and reputable entity or entities for lawful and legitimate purposes;

• Assessment of legal, market, security, and regulatory risks posed by a new coin; and

• Ongoing monitoring and periodic reevaluation of the coin tailored to the risk level of the particular coin.\textsuperscript{1152}

In addition to the self-certification process, DFS released its process for Greenlisting coins for wider use.\textsuperscript{1153} If a coin has been approved for use by three unrelated entities, DFS will announce that the coin is being considered for Greenlisting on the DFS website.\textsuperscript{1154} After a six-month waiting period, entities will be able to use the Greenlisted coin without individual DFS approval.\textsuperscript{1155} The entity must have monitoring policies in place for use of the Greenlisted coin.\textsuperscript{1156} Coins may be Greenlisted for custody and listing. The following coins have been approved for both: Binance USD, Bitcoin, Bitcoin Cash, Ethereum, Gemini Dollar, Litecoin, Pax Gold, and Paxos Standard.\textsuperscript{1157} A complete and updated list may be found on the DFS website.

4. New York Attorney General Virtual Markets Integrity Initiative

On April 17, 2018, following the adoption of the BitLicense regulations, former New York Attorney General Eric T. Schneiderman sent letters to 13 major virtual currency businesses

\textsuperscript{1152} \textit{Id.}

\textsuperscript{1153} \textit{Id.}

\textsuperscript{1154} \textit{Id.}

\textsuperscript{1155} \textit{Id.}

\textsuperscript{1156} \textit{Id.}

as part of the Virtual Markets Integrity Initiative, which was “a fact-finding inquiry into the policies and practices of platforms used by consumers to trade virtual or ‘crypto’ currencies like bitcoin and [E]ther.” The letters included a questionnaire that requested the recipients “to disclose information falling within six major topic areas, including (1) Ownership and Control, (2) Basic Operation and Fees, (3) Trading Policies and Procedures, (4) Outages and Other Suspensions of Trading, (5) Internal Controls, and (6) Privacy and Money Laundering.” In addition to virtual currency businesses that operate under the BitLicense or New York limited purpose trust charter, virtual currency businesses that did not operate in New York also received Schneiderman’s request. One such recipient, California-based cryptocurrency exchange Kraken, publicly stated that it would not respond to the request because it no longer operates in New York.

5. State Securities Regulation of Virtual Currencies and Initial Coin Offerings

Most states currently lack comprehensive statutes that address the regulation of virtual currency businesses, the offer and sale of virtual currencies, or both. While many states have imposed regulations to address the virtual currency context, such as money transmitter regulations on offerors of virtual currency, most states have not focused on the issuance of novel virtual currencies or tokens through ICOs.

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1159 Id.

1160 Id.


1162 See Appendix for 50-state survey of virtual currency regulation.
(a) The Uniform Law Commission Attempts to Establish a Uniform Framework

Recognizing the importance of creating a uniform virtual currency framework at the state level, the ULC attempted to bridge the regulatory gap between states at its annual conference in July 2017. The ULC adopted and recommended for enactment in all states a Uniform Regulation of Virtual Currency Businesses Act (URVCBA). The URVCBA aims to form a common statutory framework for states to regulate virtual currency-related activity. Once an entity is deemed to be engaging in regulated activity, the URVCBA imposes many of the same requirements as the DFS’s BitLicense regime. Under the URVCBA, an entity must apply for a license and be approved following a thorough review of the applicant’s policies, procedures, and background. Once licensed, an entity is subject to examinations and recordkeeping requirements and must maintain compliance programs and procedures, including information security and operational security, business continuity, disaster recovery, anti-fraud, AML, and prevention of terrorist financing programs.

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1165 A few key differences are that the URVCBA provides for (i) a de minimis threshold under which licensure is not required (URVCBA § 103(b)(8)), (ii) reciprocity if licensed in another state under that state’s version of the URVCBA (URVCBA § 204), and (iii) an exemption from the licensure requirements for all banks, not just banks chartered in that state (URVCBA § 103(b)(2)).

1166 URVCBA Article 2 Licensure.

1167 Id. Article 3 Examination; Examination Fees; Disclosure of Information Obtained During Examination.

1168 Id. § 302.

1169 Id. § 601.
The Uniform Supplemental Commercial Law for the Uniform Regulation of Virtual-Currency Businesses Act (the “Supplemental Act”) is a follow-up to the URVCBA. The Supplemental Act incorporates Article 8 of the Uniform Commercial Code into the agreement made between a virtual currency licensee or registrant and users. To date, seven states (California, Connecticut, Hawaii, Nebraska, Nevada, Oklahoma, and Rhode Island) have introduced the bill, or the Supplemental Act, on their floors. On June 13, 2020, Louisiana became the first state to adopt licensing requirements based on URVCBA.

(b) State Regulation of ICOs

ICOs’ unique characteristics create a gray area for federal and state legislators. The SEC has been clear that it considers the majority of ICOs to be securities offerings and expects the issuers of ICOs to comply fully with federal securities laws. In addition, states have begun to bring their own actions against issuers of ICOs under state law, for fraudulent securities offerings. In 2018, nine states’ securities regulatory bodies had issued at least one summary cease and desist order, with Texas issuing eight orders. In May 2018, the North American Securities Administrators Association announced “Operation Cryptosweep,” a coordinated series of sweeps by multiple state and provincial regulators across the United States and Canada to check and halt false securities offerings and raise public awareness of the risks associated with ICOs and cryptocurrency-related investment products. The effort netted more than 70 inquiries and investigations, and 35 pending or completed enforcement actions centered on ICOs.

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or virtual currencies.\textsuperscript{1172}

Currently, Wyoming is the only state that has enacted a statute to address the regulation of ICOs. In March 2018, Wyoming Governor Matt Mead signed into law Wyoming House Bill 70, known as the “Utility Token Bill.”\textsuperscript{1173} The bill designates certain virtual currencies as “utility tokens” that offer access to a future service or product.\textsuperscript{1174} As such, utility tokens are considered a means of exchange for these products or services or a type of a discount coupon, rather than an investment. The bill allows virtual currency companies to qualify their offerings as utility tokens and exempts them from state security laws if the tokens and their issuers meet the following requirements:

1. The token is not marketed by its developers as an investment opportunity;
2. The token is able to be exchanged for goods and services; and
3. Developers have not agreed to repurchase the tokens.\textsuperscript{1175}

The Utility Token Bill gives companies freedom to act broadly in the virtual currency sphere—as issuers, exchanges, and wallet providers—without meeting the licensing requirements of other laws.

\textsuperscript{1172} Id.
\textsuperscript{1173} WYO. STAT. ANN. § 17-4-206 (West).
\textsuperscript{1174} Id.
\textsuperscript{1175} Id.
APPENDIX: 50-STATE VIRTUAL CURRENCY REGULATION SURVEY (AS OF OCTOBER 8, 2020)

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2020 UPDATES TO APPENDIX

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This Cryptocurrency Regulation Survey is a summary chart that briefly identifies what legislative or regulatory steps, if any, a state has taken with respect to the licensing or regulation of cryptocurrency. It does not identify every cryptocurrency activity that may be subject to licensure in a particular state.

This Survey provides information on laws, regulations, and guidance that already exist as well as proposed state bills or regulations that contemplate some sort of cryptocurrency regulation. It is intended to address state efforts aimed at requiring (or not requiring) licensing or otherwise regulating cryptocurrency businesses. It does not cover every state law that discusses or addresses cryptocurrency, such as, for example, statutes or regulations (enacted or proposed) concerning tax treatment of cryptocurrency, requesting studies of cryptocurrency, regulatory sandboxes, state securities law implications, or the treatment of cryptocurrency under abandoned property laws. It also does not discuss every state enforcement action that has addressed cryptocurrencies, though it notes any of particular importance.

This Survey uses the term “cryptocurrency” as a generally applicable term intended to include other, similar currencies addressed in state regulatory regimes, such as virtual currency or digital currency.
**Standalone Cryptocurrency Regulation**

| Louisiana | In June 2020, Louisiana enacted the “Virtual Currency Businesses Act,” which imposes a licensing requirement. “Virtual currency” is defined as “a digital representation of value that is used as a medium of exchange, unit of account, or store of value, and that is not legal tender, whether or not denominated in legal tender.” A license is required for engaging in “virtual currency business activity,” which includes:  
1. Exchanging, transferring, or storing virtual currency or engaging in virtual currency administration, whether directly or through an agreement with a virtual currency control services vendor;  
2. Holding electronic precious metals or electronic certificates representing interests in precious metals on behalf of another person or issuing shares or electronic certificates representing interests in precious metals;  
3. Exchanging one or more digital representations of value used within one or more online games, game platforms, or family of games for either of the following:  
   i. Virtual currency offered by or on behalf of the same publisher from which the original digital representation of value was received;  
   ii. Legal tender or bank credit outside the online game, game platform, or family of games offered by or on behalf of the same publisher from which the original digital representation of value was received.  
A license is not needed for persons using virtual currency as payment for the purchase or sale of goods or services for personal use or whose volume of virtual currency business does not exceed $35,000 annually.  

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**Notes:**

1176 In this chart, the summary analysis of whether a license is required assumes the business is engaging in the relevant licensable activity, if any, involving only cryptocurrency. If the business engages in the same activity involving fiat currency (e.g., fiat currency is exchanged for cryptocurrency), the licensing determination likely would differ. For example, states that are listed as “no” may require a money transmitter license where the entity is receiving and transmitting fiat currency (or sovereign currency) in connection with a cryptocurrency transaction or exchange. A further analysis would be needed.
New York

New York Department of Financial Services (DFS) promulgated rules that require licensing for any entity engaging in the following:

- Receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of virtual currency;
- Storing, holding, or maintaining custody or control of virtual currency on behalf of others;
- Buying and selling virtual currency as a customer business;
- Performing exchange services as a customer business;
- Controlling, administering, or issuing a virtual currency.

23 NYCRR, Part 200.

On June 24, 2020, DFS proposed a conditional licensing framework for virtual currency business entities so that these entities can offer virtual currency services while their BitLicense is being reviewed. Under the proposed framework, an applicant seeking to engage in virtual currency business activity in New York under a conditional license would collaborate and engage with an authorized VC Entity for various services and support, such as those relating to structure, capital, systems, personnel, or any other support needed.

<table>
<thead>
<tr>
<th>Guidance on Cryptocurrency Through Existing Legal Frameworks</th>
<th>Is License Required?</th>
</tr>
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<tbody>
<tr>
<td><strong>Alabama</strong></td>
<td>Effective August 1, 2017, Alabama repealed its Sale of Checks Act and replaced it with a Monetary Transmission Act. Under the new law, a license is required to, <em>inter alia</em>, receive monetary value for transmission, and <em>monetary value</em> is defined as a “medium of exchange, including virtual or fiat currencies, whether or not redeemable in money.” Ala. Code § 8-7A-2(8).</td>
</tr>
<tr>
<td><strong>Alaska</strong></td>
<td>The Division of Banking and Securities of the Department of Commerce, Community, and Economic Development appears to require licensed money transmitters or applicants for a money transmitter license to enter into a “Limited License Agreement” if they will provide transmission services for cryptocurrency or incorporate cryptocurrency into their transmission services for fiat currencies. These agreements state that a money transmitter license does not permit the licensee to transmit cryptocurrency, and the licensee may not state or imply that it is licensed to transmit cryptocurrency. Moreover, a licensee must disclose the following statement whenever it discloses that it holds a money transmission license: “Please note that this license does not cover the transmission of virtual currency.” The license agreement states that the Division is unable under state law to license an entity to transmit cryptocurrency.</td>
</tr>
</tbody>
</table>
cryptocurrency, but the indication is that the Division will not prevent such transmission if the licensee has entered into the Limited License Agreement.

| Arkansas | In July 2018, the Arkansas Securities Department (Department) issued a no-action letter for CEX.IO, which is “an online virtual currency exchange allowing buyers and sellers of Bitcoin and other virtual currencies to trade with one another over the Internet.” The letter simply concludes it is agreeing with the company that a license is not required, but it does not provide further detail on the regulator’s rationale. Notably, the letter attaches the request from the company, and the request notes that several other states also provided the company with a no action position. In March 2020, the Department issued two additional no-action letters. In the first letter, the Department confirmed an entity did not need a license to offer Bitcoin kiosks where those kiosks dispensed only the entity’s own supply of cryptocurrency. In the second letter, the Department confirmed an entity did not need a license to sell Bitcoin from its own inventory where the customer paid a separate, licensed entity in fiat for the purchase. The second letter indicated Michigan, Missouri, Mississippi, Texas, Georgia, and Kentucky had reached the same conclusion. In May 2020, the Department issued a third letter, stating that a company that buys and sells cryptocurrency from its own inventory for fiat currency is not required to obtain a license. Moreover, the letter applied to a platform that stored a user’s cryptocurrency (although the letter did not specify whether the wallet was hosted, multi-signature, or had other characteristics). |
| California | The California Department of Business Oversight (DBO) has issued several opinion letters in which it concludes that various entities in the cryptocurrency industry did not require a license. In almost every letter, the DBO indicates that it “has been studying the cryptocurrency industry closely. Whether Bitcoin and other cryptocurrencies are a viable form of money or a speculative non-money asset is widely debated. Given this ongoing debate, the Department has not concluded whether Bitcoin and other cryptocurrencies are a form of money. Likewise, the Department has not determined whether exchange and wallet services trigger the application of California’s banking laws or money transmission laws.” In April 2020, a DBO regulator informally told us that the “DBO does not regulate virtual or cryptocurrency activities/businesses.” A high-level summary of the services the DBO has concluded do not require a license:  
  - A platform that gives consumers the ability to purchase, store, and sell virtual currencies through registered broker-dealers. Customers will be able to purchase virtual currency directly from the entity, store the virtual currency in an entity-controlled wallet, and liquidate their holdings by selling the virtual currency back to the entity. |

Not for a cryptocurrency exchange (as detailed in the 2018 no-action letter) or for entities selling cryptocurrency from their own inventory. No, because the DBO has not determined whether cryptocurrencies are a form of money.
<table>
<thead>
<tr>
<th><strong>Description</strong></th>
<th><strong>Details</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>A provider of an escrow account controlled by a third party who transfers funds between counterparties in the event of default on a contract and a prime broker that holds clients’ cryptocurrency in its own account with a custodial digital exchange.</td>
<td>A cryptocurrency exchange that offers custodial wallets.</td>
</tr>
<tr>
<td>A provider of an escrow account controlled by a third party who transfers funds between counterparties in the event of default on a contract and a prime broker that holds clients’ cryptocurrency in its own account with a custodial digital exchange.</td>
<td>A cryptocurrency exchange that offers custodial wallets.</td>
</tr>
<tr>
<td>A platform that allows customers to load U.S. dollars from an external bank account into a custodial bank account maintained by an entity and titled in the customer’s name for the sole purposes of purchasing digital assets from, and paying fees to, the entity. Customers can buy and sell digital assets in direct transactions with the entity only, and they can store their digital assets in a custodial wallet managed by the entity.</td>
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</tr>
<tr>
<td>A Bitcoin ATM through which an entity dispenses its own inventory of cryptocurrency. (Similar letters here, here, here, here, and here.)</td>
<td>A Bitcoin ATM through which an entity dispenses its own inventory of cryptocurrency. (Similar letters here, here, here, here, and here.)</td>
</tr>
<tr>
<td>A platform that enables customers to buy, sell, and trade digital assets with other customers. Each customer may load virtual currency onto a custodial digital wallet and U.S. dollars into a custodial account with a federally insured financial institution.</td>
<td>A platform that enables customers to buy, sell, and trade digital assets with other customers. Each customer may load virtual currency onto a custodial digital wallet and U.S. dollars into a custodial account with a federally insured financial institution.</td>
</tr>
<tr>
<td>A platform that allows a customer to purchase and sell decentralized cryptocurrency in exchange for fiat currency or by exchanging one cryptocurrency for another. If a customer wishes to purchase cryptocurrency at a stated price and another customer wishes to sell that cryptocurrency at the same price, there will be a respective purchase and sale between each of the customers and the entity to complete each such customer’s order. Alternatively, if a customer wishes to purchase cryptocurrency and there is not another customer on the platform that will sell that cryptocurrency for that price, the entity will find a matching order from an external source, such as another exchange, and facilitate the transaction. Exchanges of cryptocurrency occur in a similar manner.</td>
<td>A platform that allows a customer to purchase and sell decentralized cryptocurrency in exchange for fiat currency or by exchanging one cryptocurrency for another. If a customer wishes to purchase cryptocurrency at a stated price and another customer wishes to sell that cryptocurrency at the same price, there will be a respective purchase and sale between each of the customers and the entity to complete each such customer’s order. Alternatively, if a customer wishes to purchase cryptocurrency and there is not another customer on the platform that will sell that cryptocurrency for that price, the entity will find a matching order from an external source, such as another exchange, and facilitate the transaction. Exchanges of cryptocurrency occur in a similar manner.</td>
</tr>
<tr>
<td>A digital asset dealer and financial platform offering three specific trading pairs: (1) fiat-to-crypto; (2) crypto-to-fiat; and (3) crypto-to-crypto. The entity acts solely as the intermediary to execute the trades and deliver electronic funds for transfer; it does not hold customer funds beyond the time required to execute the exchange transaction.</td>
<td>A digital asset dealer and financial platform offering three specific trading pairs: (1) fiat-to-crypto; (2) crypto-to-fiat; and (3) crypto-to-crypto. The entity acts solely as the intermediary to execute the trades and deliver electronic funds for transfer; it does not hold customer funds beyond the time required to execute the exchange transaction.</td>
</tr>
<tr>
<td>An entity that offers a mobile payments app and a merchant-payment-network that permits customers to use their digital assets to pay for goods and services.</td>
<td>An entity that offers a mobile payments app and a merchant-payment-network that permits customers to use their digital assets to pay for goods and services.</td>
</tr>
<tr>
<td>A membership-based online platform that enables non-profit organizations to receive cryptocurrencies as donations from individuals by providing tools to generate non-custodial</td>
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</tbody>
</table>
cryptocurrency wallets, associate noncustodial existing wallets, and provide interfaces for placement on members’ websites to allow donors to easily initiate cryptocurrency donations.

- **An exchange** that offers (1) a two-party transaction where an entity, as a seller, transfers its own virtual currency directly to the customer’s digital wallet in exchange for fiat currency transferred by the customer to the entity’s bank account via a third-party payment processor, and (2) a two-party transaction where the entity, as a buyer, transfers its own fiat currency to the customer’s bank account via a third-party money transmitter in exchange for virtual currency transferred directly by the customer to the entity’s digital wallet. The entity never takes possession of virtual currency or fiat currency as a custodian for customers, and the entity does not offer any wallet services.

- **A platform** that facilitates the exchange of fiat currency and digital assets with other users. Each user may load fiat currency into an account, segregated from other users’ accounts, with a third-party bank custodian. Users may also load digital assets into a multi-signature wallet segregated from other users’ wallets where the keys are held by the user, a third party, and the entity.

- **A currency exchange service** offered by an entity and a trust company. Users load virtual currency into a custodial digital wallet maintained by the entity and U.S. dollars into a bank account held by the trust for the benefit of its users. These amounts, associated with each user’s account, can be used only to exchange digital currency or U.S. dollars through the entity with third-party exchanges, over-the-counter counterparties, or the entity’s own inventory.

- **A crypto exchange** platform need not obtain a license to provide its users a hosted wallet, P2P crypto exchange services, or to provide instructions to a customer’s bank directing the movement of fiat.

Additional opinions are available [here](#).

(Note: the foregoing provides only summary descriptions of the services described in each letter. Reference to the actual letter is necessary to fully understand each service.)

<table>
<thead>
<tr>
<th>Colorado</th>
<th>In September 2018, the Colorado Department of Regulatory Agencies (Department) issued guidance that cryptocurrency is not money because it is not legal tender. Therefore, transmission of cryptocurrency, and only cryptocurrency, between two consumers does not require a license. Neither does transmission of cryptocurrency between two consumers through a third party, when no fiat currency is involved in the transmission. However, “the presence of fiat currency during a transmission may be subject to licensure.” Specifically, the guidance says a license is required if an entity (1) “engage[s] in the business of selling and buying cryptocurrencies for fiat currency;” (2) “[a] Colorado customer can transfer cryptocurrency to another customer within the exchange;” and (3) “[t]he</th>
<th>Yes, license required for at least some cryptocurrency activity</th>
</tr>
</thead>
</table>
The guidance also suggests contacting the Department for a licensing determination if a “business model has the ability to transfer fiat currency through the medium of cryptocurrency.”

| Connecticut | The Connecticut Money Transmission Act requires a license “to engage in the business of money transmission.” Conn. Gen. Stat. § 36a-597. The phrase money transmission is defined as “issuing or selling payment instruments or stored value” or “receiving money or monetary value for current or future transmission.” The phrase monetary value is defined as “a medium of exchange, whether or not redeemable in money;” virtual currency is defined, in part, as “any type of digital unit that is used as a medium of exchange or a form of digitally stored value or that is incorporated into payment system technology.” The Act also requires applicants and licensees to specify whether their activities will involve the transmission of monetary value in the form of cryptocurrency. The Commissioner may take certain actions, such as denying an application or imposing additional restrictions, if cryptocurrency transmission will occur. Id. § 36a-600. The Connecticut Department of Banking (Department) has specifically concluded that at least the following services require a money transmitter license: (1) digital currency exchanges which hold or transmit fiat or virtual currency on behalf of Connecticut residents; (2) a company offering custody and related transaction services for institutional clients, which holds or transmits virtual currency on behalf of Connecticut residents; and (3) an out-of-state trust company offering custodial and exchange related services, including holding cash and bitcoin as agent and facilitating the trading of virtual currency and fiat currency on behalf of Connecticut residents, is engaging in money transmission and requires a license, specifically noting that it does not recognize an exemption from licensure for trust companies. The Department also has concluded that bitcoin ATMs limited to depositing cash into the bitcoin ATM and receiving bitcoin from the machine’s inventory in return, not utilizing an exchange or other payment system, do not require licensure. |

| Yes, license required for at least some cryptocurrency activity |

| Delaware | According to Delaware’s application for a money transmitter/check seller license, “virtual currency exchanging and trading services” are authorized under a money transmission license. Moreover, the application states that “[Delaware] does not regulate trading [of virtual currency].” |

| No, although the scope is not entirely clear |

| Florida | In September 2014, the Florida Office of Financial Regulation (OFR) issued a consumer alert on cryptocurrency. The alert noted that “[v]irtual currency and the organizations using them are not regulated by the OFR.” The alert, however, is no longer posted, and the regulator has not provided further guidance. However, in January 2019, an intermediate appellate court held that the state’s money transmitter law applies to a business engaged in the sale of Bitcoin because Bitcoin is a “payment instrument.” |

<p>| Yes, at least for certain activities |</p>
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<th>Region</th>
<th>Information</th>
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<tr>
<td><strong>The OFR has issued various declaratory opinions advising on whether certain virtual currency business models are subject to licensure. The OFR has concluded that an exchange that controls customers’ fiat and cryptocurrency (including control of fiat currency via a custodial account with a financial institution) and purchases/sells cryptocurrency (at least where a customer must sell her crypto to the exchange to withdraw fiat) must be licensed. However, OFR also has concluded that cryptocurrency-only transactions between two parties do not constitute money transmission. For various statements, see here, here, here, here, here, and here.</strong></td>
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<tr>
<td><strong>Georgia</strong></td>
<td>Effective July 1, 2016, Georgia added the term virtual currency as a defined term in its Money Transmitter Law and defined it as “a digital representation of monetary value that does not have legal tender status as recognized by the United States government.” Ga. Code Ann. § 7-1-680(26). A license is required under the law to, inter alia, receive “money or monetary value for transmission.” Yes, license required for at least some cryptocurrency activity</td>
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<tr>
<td><strong>Hawaii</strong></td>
<td>In private discussions that have since been made public, the Hawaii Division of Financial Institutions indicated that cryptocurrency businesses must be licensed under the state’s Money Transmission Act and must meet the Act’s permissible investments requirement with cash reserves. Previously, the Hawaii Division of Financial Institutions stated that the “DFI licenses money transmitters in Hawaii and has not licensed any crypto-currency companies to do bitcoin exchanges, wallets or ‘mining’ activity. If companies are offering to transmit bitcoins, they are doing so in violation of Hawaii’s money transmitter laws.” Hawaii Department of Commerce and Consumer Affairs, State Warns Consumers on Potential Bitcoin Issues (February 26, 2014). Yes, license required for at least some cryptocurrency activity</td>
</tr>
<tr>
<td><strong>Idaho</strong></td>
<td>On its website, the Idaho Department of Finance has noted that “[i]f you act as a virtual/digital currency exchanger and accept legal tender (e.g., government backed/issued ‘fiat’ currencies) for later delivery to a third party in association with the purchase of a virtual currency, then you must be licensed as a money transmitter with the Department of Finance.” The Department also has issued a substantial number of no-action letters relating to cryptocurrency detailing the circumstances under which licensure is (or is not) required. Maintaining custody of a digital asset requires licensing, whereas selling cryptocurrency from one’s own inventory does not. Arranging buy/sell orders on behalf of a customer with a third party and transmitting funds from one party to the other would require a license, however. Yes, license required for at least some cryptocurrency activity</td>
</tr>
<tr>
<td><strong>Illinois</strong></td>
<td>In June 2017, the Illinois Department of Financial and Professional Regulation issued a guidance document explaining its view on how the state’s Transmitters of Money Act applied to cryptocurrency. The guidance distinguishes “centralized virtual currencies” from “decentralized.” For centralized virtual currencies, the guidance concludes that the department will have to make individual licensing determinations. For decentralized currencies, however, the guidance concludes that the Transmitters of Money Act does not apply to the transmission of decentralized cryptocurrencies. The guidance provides No, for decentralized cryptocurrencies; individual determinations required for centralized cryptocurrencies</td>
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additional examples explaining when the Act would apply. Illinois has issued a couple of non-binding interpretations to cryptocurrency companies (see [here](#), [here](#), [here](#), and [here](#)).


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<tr>
<th>State</th>
<th>Status</th>
<th>Description</th>
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<tr>
<td>Indiana</td>
<td>No</td>
<td>According to the Indiana Department of Financial Institutions’ FAQs, “a money transmitter license does not cover virtual currency transactions.”</td>
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<tr>
<td>Kansas</td>
<td>No</td>
<td>In June 2014, the Kansas Bank Commissioner issued a guidance document explaining its view on how the state’s Money Transmitter Act applied to cryptocurrency. The guidance distinguishes “centralized virtual currencies” from “decentralized.” For centralized virtual currencies, the guidance concludes that the department will have to make individual licensing determinations. For decentralized currencies, however, the guidance concludes that the Money Transmitter Act does not apply to the transmission of decentralized cryptocurrencies. The guidance provides additional examples explaining when the Act would apply. <a href="#">Kansas Office of the State Bank Commissioner, Guidance Document MT 2014-01</a> (June 6, 2014).</td>
</tr>
<tr>
<td>Maryland</td>
<td>No</td>
<td>In April 2014, the Maryland Commissioner of Financial Regulation issued an <a href="#">advisory notice on cryptocurrency</a>. The advisory states that “[c]urrently, Maryland does not regulate virtual currencies.”</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>No</td>
<td>In December 2017, the Secretary of the Commonwealth of Massachusetts issued a <a href="#">warning about Bitcoin</a>. The warning noted that “Bitcoin and other virtual currencies are not regular money, as they are not backed by the United States or any other government or central bank.” While Secretary Galvin did not mention whether the Commonwealth intends to regulate cryptocurrency, he noted the “unregulated . . . nature of Bitcoin . . . .”</td>
</tr>
<tr>
<td>Nevada</td>
<td>Yes</td>
<td>In August 2019, the Nevada Financial Institutions Division issued a <a href="#">press release</a> indicating that it would require licensing of some entities engaged in activities involving cryptocurrency, depending on the specific business model. “Generally, an entity engaged in the business of selling or issuing checks or of receiving for transmission or transmitting money or credits is required to have a license under NRS 671. However, if an entity proposes to serve as a digital custodian for any form of digital currency, then the business may be regulated as a trust company under NRS Chapter 669. Any entity that facilitates the transmission of or holds fiat or digital currency by way of brick-and-mortar, kiosk, mobile, internet or any other means, should contact the NFID to request a licensure determination.”</td>
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<tr>
<td>New Hampshire</td>
<td>No</td>
<td>In 2015, New Hampshire amended its Money Transmitter Act to include cryptocurrency. Under the law, a license is required to act as a “money transmitter,” which was, in turn, defined to include</td>
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However, effective August 1, 2017, a new bill went into effect that, although it does not alter the 2015 changes, provides a cryptocurrency exemption to the Act. Under the new law, the Money Transmitter Act does not apply to “[p]ersons who engage in the business of selling or issuing payment instruments or stored value solely in the form of convertible virtual currency or receive convertible virtual currency for transmission to another location. Such persons shall be subject to the provisions of RSA 358-A.” Chapter 358-A regulates unfair business practices.

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<tr>
<th>State</th>
<th>Description</th>
<th>Requires licensing</th>
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<tr>
<td>New Mexico</td>
<td>The Division of Financial Institutions of New Mexico’s Regulation and Licensing Department posted FAQs on its website that address cryptocurrencies. For “virtual currency exchanges or other businesses engaged in the exchange of crypto currency for monetary value,” the FAQs state that “any entity engaged in the business of providing the exchange of virtual currency for money or any other form of monetary value or stored value to persons located in the State of New Mexico must be licensed by the FID as a money transmitter.” However, the “exchange of crypto currencies, such as Bitcoin,” does not require an entity to obtain a “currency exchange” license (as opposed to a money transmitter license). Monetary value is defined as “a medium of exchange, whether or not redeemable in money.” N.M. Stat. § 58-32-102(N). Money is defined as “a medium of exchange that is authorized or adopted by the United States or a foreign government. Money includes a monetary unit of account established by an intergovernmental organization or by agreement between two or more governments.” Id. § 58-32-102(O).</td>
<td>Yes, license required for at least some cryptocurrency activity</td>
</tr>
<tr>
<td>North Carolina</td>
<td>A license is required to engage in money transmission, which is defined to include “maintaining control of virtual currency on behalf of others.” N.C. Gen. Stat. § 53-208.42(13). Virtual currency is defined as a “digital representation of value that can be digitally traded and functions as a medium of exchange, a unit of account, or a store of value but only to the extent defined as stored value under [the Money Transmitter Act], but does not have legal tender status as recognized by the United States Government.” Id. § 53-208.42(20). The North Carolina Commissioner of Banks also has provided detailed guidance on cryptocurrency in the form of FAQs, which describe the varying licensing treatment of cryptocurrency businesses.</td>
<td>Yes, license required for at least some cryptocurrency activity</td>
</tr>
<tr>
<td>North Dakota</td>
<td>The North Dakota Department of Financial Institutions has indicated in an FAQ that it “does not consider the control or transmission of virtual currency to fall under the scope of” the state’s money transmitter law, so long as the company does not also hold or transmit fiat currency. The FAQs also state that the “purchase, sale, or exchange of virtual currency does not in and of itself require a money transmitter license,” nor does “[u]sing a digital wallet to store fiat currency for the purpose of</td>
<td>Potentially yes; certain fiat-denominated stablecoins may trigger licensure</td>
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purchasing virtual currency.” However, “the transmission of fiat currency-denominated assets to third parties” may require a license.

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<th>Ohio</th>
<th>The Ohio Money Transmitter License application (available here) includes the following (however, no further written clarification or requirements have been identified):</th>
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<td></td>
<td>“Virtual Currency: If the applicant will engage in the transaction of virtual currency in the course of money transmission activities, provide a current third party security audit of all relevant computer and information systems.”</td>
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| Oregon     | A license is required to engage in *money transmission*, which is defined as “selling or issuing payment instruments or engaging in the business of receiving money for transmission, or transmitting money within the United States or to locations abroad by any and all means, including but not limited to payment instrument, wire, facsimile or electronic transfer.” ORS 717.200(10). Oregon defines *money* as “a medium of exchange that: (a) The United States or a foreign government authorizes or adopts; or (b) Represents value that substitutes for currency but that does not benefit from government regulation requiring acceptance of the medium of exchange as legal tender.” ORS 717.200(11). |
|            | In its *Spring 2018 newsletter entitled Common Ground*, the Department of Consumer and Business Services (Oregon Division of Financial Regulation) stated that “[c]urrently, cryptocurrency is not regulated by the federal government or by the State of Oregon.” It went on to state, however, that “Oregon law requires companies that transfer digital currency from one person to another to be licensed as money transmitters. Digital currency exchange companies that only turn cash into digital currency are not required to be licensed.” In addition, the Department encouraged consumers wishing to “transmit cryptocurrency to someone else, [to] use a digital currency exchange that is licensed with the state.” |
|            | The Oregon Secretary of State has published a [webpage](#) stating that virtual currency falls within the definition of “money” under the state’s money transmitter law. |

| Pennsylvania | Pennsylvania amended the Money Transmitter Act (MTA) in 2017 and now defines *money* as “currency or legal tender or any other product that is generally recognized as a medium of exchange.” In January 2019, the Department issued new [guidance](#) stating that only fiat currency or currency issued by the U.S. government is money under the MTA; therefore, virtual currency is not money under the MTA. The guidance clarifies that virtual currency platforms that facilitate the purchase or sale of virtual currency in exchange for fiat currency are not money transmitters, provided they do not handle the fiat currency itself. The guidance noted that such platforms do not directly handle fiat currency because “any fiat currency paid by or to a user is maintained in a bank account in the Platform’s name at a depository |
|            | No, in most cases |
Institute.” Moreover, virtual currency ATMs, kiosks, and vending machines are not money transmitters because the consumer “merely exchanges fiat currency for virtual currency and vice versa.”

| Rhode Island | In July 2019, Rhode Island amended its money transmitter law to include “currency transmission,” which is defined as “engaging in the business of any of the following: sale or issuance of payment instruments or stored value primarily for personal, family, or household purposes, or receiving money or monetary value for transmission or holding funds incidental to transmission within the United States or to locations abroad by any and all means, including payment instrument, stored value, wire, facsimile, or electronic transfer, primarily for personal, family, or household purposes. This includes maintaining control of virtual currency or transactions in virtual currency on behalf of others.” (emphasis added). “Monetary value” is defined as “a medium of exchange, whether or not redeemable in fiat currency.” “Control” is defined as “the power to execute unilaterally or prevent indefinitely a virtual currency transaction.”

“Virtual Currency” is defined as a “digital representation of value that is used as a medium of exchange, unit of account or store of value and is not legal tender, whether or not denominated in legal tender, and does not include a transaction in which a merchant grants, as part of an affinity or rewards program, value that cannot be taken from or exchanged with the merchant for legal tender, bank credit, or virtual currency; a digital representation of value issued by or on behalf of a publisher and used solely within an online game, game platform, or family of games sold by the same publisher or offered on the same game platform; native digital token used in a proprietary blockchain service platform; or a gift certificate, store gift card, general use prepaid card or loyalty, award, or promotional gift card, as these terms are defined” under Regulation E “without giving effect to any exception as specified in title 31 C.F.R. § 1010.100(kkk) or any card, code or device, or other device that can add funds to those products.” Currency transmission essentially replaces the former regulations of “electronic money transfer.”

Entities that only provide data storage or security services for a business engaged in virtual currency business activity and do not otherwise engage in virtual currency business activity on behalf of others, or provide virtual currency as an enterprise solution used solely among each other and have no agreement or relationship with a resident that is an end-user of virtual currency, or obtaining, creating, investing, buying, or selling virtual currency as payment for goods or services on their own behalf or for academic purposes or for consumer purposes, are exempt. Moreover, entities that do not engage in the ordinary course of business in virtual currency business activity with or for others in addition to maintaining securities accounts or commodities accounts and are regulated as a securities or commodities intermediary under federal law also generally are exempt. Other exemptions apply. Yes, license required for at least some cryptocurrency activity |
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<th>State</th>
<th>Details</th>
<th>Notes</th>
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<tr>
<td>South Carolina</td>
<td>In 2016, South Carolina enacted the South Carolina Anti-Money Laundering Act (the “Act”), and the regulations implementing the Act became effective in May 2018. According to the Attorney General’s FAQ on the law, “virtual currencies alone do not qualify as monetary value. However, to the extent that virtual currency transactions also involve the transfer of fiat currency, they may be subject to money transmission regulation under the Act.” The Attorney General set out this standard in an interpretive letter in December 2018. According to an order by the Attorney General issued in September 2019, virtual currency transactions that also involve the transfer of fiat currency may be subject to money transmission regulation, specifically that exchanging virtual currency for fiat currency through an ATM that acts as a third-party exchanger that facilitates contemporaneous exchange so that the ATM operator receives the buyer’s fiat currency in exchange for a promise to make the fiat available to the seller of the cryptocurrency, requires a license. However, no license is needed for an ATM that only facilitates a sale or purchase of virtual currency between itself and a customer directly.</td>
<td>Yes, for ATM exchanges where ATM exchanges make fiat currency available to a third-party seller of cryptocurrency</td>
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<td>South Dakota</td>
<td>The Division of Banking issued a memorandum in May 2019 stating that virtual currencies constitute “monetary value” under the state’s money transmitter act. Therefore, entities must be licensed to receive virtual currency for transmission to a location within or outside of the United States.</td>
<td>Yes</td>
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<td>Tennessee</td>
<td>In December 2015, the Tennessee Department of Financial Institutions issued a memorandum concluding that the transmission of cryptocurrency is not subject to regulation under the State’s Money Transmitter Act if the transmission does not also involve sovereign currency. The memorandum also discusses other common scenarios. Tennessee Department of Financial Institutions, Memorandum (Dec. 16, 2015).</td>
<td>No</td>
</tr>
<tr>
<td>Texas</td>
<td>In April 2014, the Texas Department of Banking issued guidance on the application of the Money Services Act to cryptocurrency activities. The guidance distinguishes between (a) centralized cryptocurrencies, which it explains are created and issued by a specified source and rely on an entity with some form of authority or control over the currency, and (b) decentralized cryptocurrencies, which are not created or issued by a particular person or entity, have no administrator, and have no central repository. For centralized cryptocurrencies, the guidance concludes that the Department will have to make individual licensing determinations. For decentralized currencies, however, the guidance concluded that some, but not all, cryptocurrency activities are subject to the Money Services Act. The Department revised its guidance in January 2019. The revised guidance still takes the position that individual licensing determinations must be made for centralized cryptocurrency activity. As for decentralized cryptocurrency activities, exchanging cryptocurrency for sovereign currency is not currency exchange or money transmission. Decentralized cryptocurrencies (which the guidance defines to include Ripple’s XRP) are not money or monetary value, except for stablecoins (cryptocurrencies that are pegged to a sovereign currency) to which there is a redemption right. Therefore, activities</td>
<td>No, for decentralized cryptocurrencies, unless it is a sovereign-backed stablecoin; individual determinations required for centralized cryptocurrencies</td>
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Involving only decentralized cryptocurrency do not trigger money transmission licensing requirements unless a sovereign currency is involved. Selling cryptocurrency for fiat currency is not money transmission; selling cryptocurrency for cryptocurrency is not money transmission. However, exchanging sovereign currency for cryptocurrency via a third party is money transmission because the third party receives the sovereign currency in exchange for a promise to make it available to the seller. Cryptocurrency ATMs are not money transmission if the ATM sells the proprietor’s cryptocurrency. If the ATM receives the buyer’s fiat in exchange for a seller’s cryptocurrency, the ATM conducts money transmission.

In April 2019, the Department revised its guidance. The Department states there are no substantive changes, but the guidance eliminates its prior reference to Ripple’s XRP.

### Utah

Effective May 14, 2019, Utah will exempt from its Money Transmitter Act a “blockchain token.” The phrase *blockchain token* is defined as “an electronic record that is: (a) recorded on a blockchain; and (b) capable of being traded between persons without an intermediary.” The term *blockchain* is defined as “an electronic method of storing data that is: (a) maintained by consensus of multiple unaffiliated parties; (b) distributed across multiple locations; and (c) mathematically verified.”

### Vermont

Effective May 2017, Vermont amended its Money Transmitter Act. The new law defines *virtual currency* as “stored value that: (A) can be a medium of exchange, a unit of account, or a store of value; (B) has an equivalent value in money or acts as a substitute for money; (C) may be centralized or decentralized; and (D) can be exchanged for money or other convertible virtual currency.” A license is required to “engage in money transmission;” *money transmission* is defined as engaging “in the business of selling or issuing payment instruments, selling or issuing stored value, or receiving money or monetary value for transmission.” The law also contains provisions regarding cryptocurrency and the permissible investment requirement.

Effective May 2019, Vermont amended its Money Transmitter Act to define *virtual currency* as “a digital representation of value” rather than as “stored value.” The term “stored value” has been eliminated and replaced with the term “prepaid access,” which is defined as “funds or monetary value represented in digital electronic format, including virtual currency, whether or not stored specially encrypted, that are stored or capable of storage on electronic media and are retrievable and transferable electronically.” Entities that sell or issue prepaid access engage in “money transmission.”

### Virginia

The Virginia Bureau of Financial Institutions (Bureau) does not currently regulate cryptocurrency; however, to the extent cryptocurrency transactions also involve the transfer of fiat currency (currency declared by a government to be legal tender), they may be regulated under Chapter 19 of Title 6.2 of the Code of Virginia (Money Order Sellers and Money Transmitters), § 6.2-1900, et seq. “Monetary value” means a medium of exchange, whether or not redeemable in money. *Id.* § 6.2-1900.

No for blockchain tokens
Yes, license required for at least some cryptocurrency activity
No
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<th>State</th>
<th>Action</th>
<th>License Required</th>
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<tr>
<td>Washington</td>
<td>Effective July 23, 2017, the Washington legislature amended the Washington Uniform Money Services Act (WUMSA). The new law amends the definition of “money transmission” to include “receiving money or its equivalent value (equivalent value includes virtual currency) to transmit . . . .” R.C.W. § 19.230.010(18). The term virtual currency is defined as “a digital representation of value used as a medium of exchange, a unit of account, or a store of value, but does not have legal tender status as recognized by the United States government,” but it “does not include the software or protocols governing the transfer of the digital representation of value.” Id. § 19.230.010(30). The new law amends other WUMSA provisions based on an entity’s cryptocurrency activities. (Because of the statutory amendments, Washington regulators withdrew guidance they previously had issued in December 2014 relating to cryptocurrency.) Effective August 1, 2018, the Washington State Department of Financial Institutions (DFI) finalized regulations to implement the changes to WUMSA, along with accompanying guidance. Most of the changes mirror those found in the statute. Notably, the regulations clarify that the following does not require licensing: “storage of virtual currency by a person when the virtual currency is owned by others and the person storing the virtual currency does not have the unilateral ability to transmit the value being stored.”</td>
<td>Yes, license required for at least some cryptocurrency activity</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>The Wisconsin Department of Financial Institutions (WDFI) has indicated it does not have the authority to regulate cryptocurrency, and it therefore is unable to license or supervise companies whose business activities are limited to those involving cryptocurrency. However, should the transmission of cryptocurrency include the involvement of sovereign currency, it may be subject to licensure, depending on how the transaction is structured. See Agreement between the WDFI and CoinX Inc.; see also Agreement between the WDFI and Circle Internet Financial Inc. In both instances, the WDFI issued “a Wisconsin seller of checks license to sell or issue checks or receive fiat currency for transmission,” and the licensee agreed that it shall “not use its Wisconsin seller of checks license to transmit virtual currency” and shall “not state, imply, or infer that it is licensed by the division to transmit virtual currency.” In each instance, the license applicant indicated that it was applying for a license to provide traditional money transmission of fiat currency, as well as the transmission of cryptocurrency.</td>
<td>No</td>
</tr>
<tr>
<td>Wyoming</td>
<td>In 2018, the Governor signed into law House Bill 19, which amended Wyoming’s Money Transmitters Act to exempt from the Act “[b]uying, selling, issuing, or taking custody of payment instruments or stored value in the form of virtual currency or receiving virtual currency for transmission to a location within or outside the United States by any means.” Wyo. Stat. § 40-22-104(vi). The bill defines virtual currency as “any type of digital representation of value that: (A) Is used as a medium of exchange, unit</td>
<td>No</td>
</tr>
<tr>
<td>Proposed Cryptocurrency Legislation/Regulation</td>
<td>Would License Be Required?</td>
<td></td>
</tr>
<tr>
<td>----------------------------------------------</td>
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<td></td>
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<tr>
<td><strong>California</strong></td>
<td>Yes, license would be required for at least some cryptocurrency activity</td>
<td></td>
</tr>
<tr>
<td><strong>Hawaii</strong></td>
<td>Yes, license would be required for at least some cryptocurrency activity</td>
<td></td>
</tr>
<tr>
<td><strong>Indiana</strong></td>
<td>No, the bill would exempt virtual currency</td>
<td></td>
</tr>
<tr>
<td><strong>Iowa</strong></td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td><strong>New Jersey</strong></td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

**California**

Assembly Bill 1489 would provide that issuing, transferring, or storing a virtual currency, as defined, on behalf of a consumer is money transmission.

**Hawaii**

HB 70 would adopt the Uniform Regulation of Virtual Currency Businesses Act.

SB 250 would adopt the Uniform Regulation of Virtual Currency Businesses Act.

SB 1364 would amend the Money Transmitters Act to govern the transmission of virtual currency.

**Indiana**

2019 Senate Resolution 9 urges the Indiana Legislative Council to assign a committee the task of determining whether to consider the enactment of the Uniform Regulation of Virtual Currency Businesses Act or other cryptocurrency regulation.

**Iowa**

House File 240 would exempt certain virtual currency activities from Iowa’s security and money transmission laws.

**Maryland**

A Maryland bill before the House and Senate would extend the money transmitter statutes to expressly apply to persons engaged in the transmission of virtual currency.

**New Jersey**

New Jersey Assembly Bill 1392 would require anyone engaging in digital currency business activity to complete a registration. Digital currency business activity is defined as “(1) receiving digital currency for transmission or transmitting digital currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of digital currency; (2) storing, holding, or maintaining custody or control of digital currency on behalf of others; (3) buying or selling digital currency as a customer business; (4) performing exchange services as a customer business; (5) controlling or issuing a digital currency.”

New Jersey Assembly Bill 2891 prohibits any person from engaging in any digital asset business activity or holding itself out as engaging in digital asset business activity with or on behalf of a resident without being licensed.

On February 20, 2020, the Assembly introduced the “Digital Asset and Blockchain Technology Act,” which if enacted would regulate the virtual currency and blockchain industry. The Act states that a person or entity engaging in digital business activity must be licensed by the New Jersey Department of Banking and Insurance.