

Client Alert

Special Matters; Government Advocacy and Public Policy Practice Group

February 7, 2018

For questions, please contact:

Richard H. Walker
+ 212 556 2290
rwalker@kslaw.com

Carmen Lawrence
+ 212 556 2193
clawrence@kslaw.com

Alec Koch
+ 202 626 8982
akoch@kslaw.com

J.C. Boggs
+ 202 626 2383
jboggs@kslaw.com

Dan Donovan
+ 202 661 7815
ddonovan@kslaw.com

Brian Michael
+ 213 443 4317
bmichael@kslaw.com

Ehren Halse
+ 415 318 1216
ehalse@kslaw.com

Jen DePalma
+ 650 422 6703
jdepalma@kslaw.com

Matthew Hanson
+ 202 626 2904
mhanson@kslaw.com

Jacob Gerber
+ 212 556 2186
jgerber@kslaw.com

King & Spalding
www.kslaw.com

Dividing Up the Sandbox: Recent Actions and Public Statements Demonstrate How the SEC and CFTC Are Dividing up the Cryptocurrency and Crypto-Token Enforcement Landscape

EXECUTIVE SUMMARY

Following testimony February 6th before the U.S. Senate, as well as a series of recent enforcement actions, it is clear that both the SEC and CFTC are picking up steam in their efforts to command a presence in the fast-developing world of virtual currencies.

Testifying before the Senate Committee on Banking, Housing & Urban Affairs, the Chairs of both the SEC and the CFTC described cooperation among their agencies and other federal financial regulators as they sort through how existing jurisdictional lines and enforcement authority apply to cryptocurrencies, cryptocurrency exchanges, initial coin offerings, and other aspects of virtual currencies. CFTC Chairman Christopher Giancarlo described a newly-formed working group in which regulators have discussed the scope of their respective jurisdictions. SEC Chairman Jay Clayton referenced ongoing consultation with fellow regulators concerning whether additional regulation is needed to bolster federal oversight of the virtual currency marketplace.

Both Giancarlo and Clayton also pointed to recent enforcement actions by their respective agencies as deterrents to those who might attempt to circumvent securities laws or to defraud investors caught up in the current heightened interest in virtual currencies and blockchain technology.

In one such recent case, on January 30, 2018, the SEC announced an emergency asset freeze and appointment of a receiver against AriseBank and related parties in connection with an unregistered initial coin offering (“ICO”) purported to have raised more than \$600 million.¹ In addition to the unregistered sale of securities, the SEC alleged numerous fraudulent misstatements by AriseBank’s promoters. If initial reports are confirmed, this would be the largest cryptocurrency enforcement action to date by either the SEC or CFTC.

This significant enforcement action comes at the end of a two-month period in which the SEC and CFTC both were very active in bringing enforcement

actions. This recent activity, when coupled with recent statements by the two Commission's Chairmen and other senior staff, presage continuing aggressive enforcement in this area as federal regulators further define their respective roles. As the Commissions distinguish between their roles, the SEC and CFTC Chairmen's remarks have generally separated digital assets into two overarching regulatory categories – cryptocurrencies (or virtual currencies), which capture Bitcoin and other mediums of exchange most readily analogized to traditional currencies, and crypto-tokens, which regulators use to discuss coins and tokens sold in ICOs. Indeed, this jurisdictional dividing line has played out in each Commission's enforcement actions, with the SEC generally focusing on unregistered ICOs based on fraudulent claims, and the CFTC focusing on fraudulent schemes involving Bitcoin or other virtual currencies.

While recent enforcement actions evidence each Commission's attempt to separate jurisdiction over the different forms of cryptocurrencies and crypto-tokens, the underlying conduct in several of these actions is very similar, with the primary distinguishing factor being whether the defendants were marketing a virtual currency or crypto-token. The CFTC's recent enforcement action against My Big Coin, Inc. is one such example, in that the underlying conduct in that matter was very similar to recent enforcement actions by the SEC. Expect aggressive enforcement by both Commissions to continue while each seeks to establish their respective jurisdictional roles.²

THE SEC

The SEC has jurisdiction over key participants in the securities markets, including those engaged in issuing, buying, and selling securities. A threshold requirement for SEC jurisdiction is the existence of a "security." Under one important definition, a security is an investment of money in a common enterprise with an expectation of profits solely from the efforts of others.³ Although the SEC has not asserted that Bitcoin or any other cryptocurrency is a security, it has stated that crypto-tokens sold in ICOs frequently are investment contracts and therefore fall within the definition of a security. Bitcoin and other cryptocurrencies are generally described as digital stores of value meant to facilitate exchange on a universal scale, like U.S. dollars or Euros, without sovereign backing.⁴ In contrast, crypto-tokens from ICOs are generally digital tokens sold to raise funds for a private enterprise or development of a blockchain-based ecosystem and meant to have a more limited scope of commercial use.⁵ The SEC's recent enforcement efforts have been focused on ICOs that the Commission classifies as unregistered securities offerings, especially cases alleging fraudulent misstatements and omissions to investors.

SEC GUIDANCE

Recent comments from SEC Chairman Jay Clayton have emphasized that unregistered ICOs that do not comply with exemptions from registration requirements specifically, are a key area of enforcement interest for the Commission.⁶ In an exchange during his Senate testimony, Chairman Clayton emphasized the fact that, to date, no ICO has been registered with the SEC. He further stated that every ICO that he has evaluated has resulted in the sale of securities. Chairman Clayton added that he believes the SEC has been clear on what it believes the law is in this area and that the SEC relies on gatekeepers, such as lawyers who help arrange ICOs and related disclosures, to appropriately counsel their clients regarding when federal securities laws apply.⁷

The Commission's momentum in this area began to build last summer after it issued a 21A report concluding that crypto-tokens known as "DAO tokens" were securities.⁸ In September 2017, the SEC launched a new Cyber Unit to focus its regulatory and enforcement efforts in this area.⁹ As the SEC brought additional enforcement actions in December 2017, Chairman Clayton issued a public statement warning investors and market professionals about cryptocurrencies and ICOs.¹⁰ Notably, in this public statement, Chairman Clayton acknowledged that the CFTC has designated Bitcoin as a commodity and that the CFTC has anti-fraud and anti-manipulation authority over trading of Bitcoin. This statement offered a potential explanation as to how the SEC and CFTC were dividing the cryptocurrency and ICO regulatory landscape (i.e., with the SEC focusing on fraud associated with ICOs offering crypto-tokens, and

the CFTC focusing on fraud associated with virtual currencies).¹¹ Chairman Clayton has emphasized that the SEC is focused on unregistered ICOs and does not claim direct regulatory authority over Bitcoin or other prominent cryptocurrencies.¹²

SEC CRYPTOCURRENCY ENFORCEMENT ACTIONS

The SEC's recent emergency action against AriseBank highlights some consistent themes in the SEC's recent enforcement in this developing area – actions against fraudulent, unregistered ICOs.¹³ In its September 2017 action against REcoin Group Foundation, LLC, the SEC alleged that defendants made false statements in connection with the unregistered sale of two classes of crypto-tokens purportedly linked to investments in real estate and in diamonds, respectively.¹⁴ In the SEC's action against PlexCorps in December 2017, the Commission alleged false statements by “a recidivist securities law violator” in connection with an unregistered ICO for PlexCoin tokens.¹⁵

The SEC's emergency action against AriseBank's ICO continues these themes. The defendants were allegedly promoting a token, AriseCoin, to help create what they advertised as a “decentralized” bank.¹⁶ According to the SEC's complaint, AriseBank claimed that it would employ an automated trading system to generate profits for customers using the money in their accounts. The defendants allegedly announced acquisition of an FDIC-insured bank and an agreement to issue a widely-accepted credit card. According to the Commission, these claims were all fraudulent.¹⁷

THE CFTC

The CFTC also has regulatory jurisdiction over some parts of the cryptocurrency marketplace. Over some markets – commodity futures, commodity options, and swaps – the CFTC has broad authority. The CFTC has more narrow anti-fraud and anti-manipulation authority over commodity spot transactions and forward markets. At the Senate Banking Committee hearing, Chairman Giancarlo emphasized that the CFTC has no regulatory authority over spot transactions that take place on cryptocurrency exchanges, and that these exchanges are not subject to the important custody, capital, and cybersecurity requirements that apply to CFTC-regulated platforms.¹⁸ The Commodities Exchange Act defines a commodity as “all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.”¹⁹ The CFTC first determined that Bitcoin and other cryptocurrencies were commodities in the *Coinflip* enforcement action in 2015.²⁰ This interpretation permitted the CFTC to bring enforcement actions alleging fraud or manipulation in connection with the purchase or sale of Bitcoin.²¹

CFTC GUIDANCE

Recently, CFTC Chairman Giancarlo joined with SEC Chairman Clayton in a Wall Street Journal Op-Ed about the promise of distributed ledger technology, the current threats in the virtual currency marketplace, and the importance of the investor protection schemes created by the two Commissions. They argued that investor protection regulations do not hamper innovation – they ensure a fair marketplace so that the most innovative companies can thrive.²²

Chairman Giancarlo also spoke at length at a recent ABA conference, explaining the CFTC's role in regulating Bitcoin and other cryptocurrencies.²³ He articulated the CFTC's responsibility to bring enforcement actions in order to prevent “fraud, abuse, manipulation or false solicitation in markets for cryptocurrency derivatives and underlying spot trading.”²⁴ Beyond enforcement, he also highlighted the CFTC's role in coordinating with the SEC and other regulators and its role in educating the public.²⁵ In his Senate testimony, Chairman Giancarlo said the CFTC has undertaken more extensive investor education efforts for virtual currencies than it has with any other asset class.²⁶

CFTC CRYPTOCURRENCY ENFORCEMENT ACTIONS

In the last six months, the CFTC's has brought three cryptocurrency enforcement cases that have targeted alleged Ponzi schemes with some connection to the purchase or sale of Bitcoin or other cryptocurrencies.²⁷ The CFTC has generally not brought enforcement actions against ICOs, although one recent action may come closer to this line.²⁸

On January 16, 2018, the CFTC brought suit against My Big Coin Pay, Inc. in connection with the company's marketing of a virtual currency called My Big Coin ("MBC").²⁹ According to the CFTC, the defendants marketed MBC as an easy-to-use cryptocurrency and falsely claimed MBC was backed by gold so that customers would believe it was safe to purchase. Defendants also allegedly claimed that MBC was trading on multiple exchanges, which the CFTC alleges was not true. The CFTC alleged that the defendants reported arbitrary, unilateral increases or decreases in the price of MBC on their website, but no actual trading of MBC ever took place and that users had no way of withdrawing MBC from the defendant's website. According to the complaint, MBC did not exist on a blockchain as Bitcoin and other cryptocurrencies do; MBC existed only on the defendants' website.

This case shows the difficulty regulators such as the CFTC and SEC face as they try to apply traditional definitions of "commodity" and "security" (which as a general matter, give each Commission its enforcement jurisdiction) to cryptocurrency and crypto-token related products and events. In bringing this case against My Big Coin Pay, Inc., it appears that the CFTC has reasoned that the definition of commodities under the Commodities Exchange Act covers *all* virtual currencies, and not just specific virtual currencies traded in (or likely to be traded in) futures contracts. This interpretation appears significant to the CFTC's jurisdiction because it seems unlikely that the virtual currency in this case, MBC, would ever have been the subject of contracts for future delivery, in part because there were few buyers and MBC did not actually exist as a virtual currency.

In fact, the CFTC's action against My Big Coin Pay, Inc. has very similar facts to an earlier case brought by the SEC. In *SEC v. SG Ltd.*, the defendants operated a "fantasy investment" website where customers could deposit funds and invest them in certain "stocks" listed on the website.³⁰ In reality, the defendants operating the website would unilaterally decide the prices of each "stock" from day-to-day. In this case and in the CFTC's case against My Big Coin, Inc., the defendants both allegedly operated websites that took customer or investor funds and provided in return non-existent digital products with arbitrary values set by the defendants.³¹ On these facts, it appears that the SEC may also have had jurisdiction to bring a case against My Big Coin Pay, Inc. under the securities laws – SEC and CFTC jurisdiction is not mutually exclusive. The fact that the CFTC pursued My Big Coin Pay, Inc., rather than the SEC, is consistent with the enforcement priorities both Chairmen have announced for their Commissions.

CONCLUSION

Given the uptick in recent enforcement actions and public statements from each Commission's leadership, aggressive cryptocurrency and crypto-token enforcement efforts from the SEC and CFTC are likely to continue. The SEC's emergency action against AriseBank fits a consistent pattern of enforcement from the securities regulator, focusing on unregistered ICOs, especially those collecting substantial investor funds based on false statements and other fraud. The CFTC's enforcement activity has focused on Ponzi schemes and similar frauds with some connection to Bitcoin or other cryptocurrencies. Although the underlying facts relevant to recent enforcement actions by both regulators have prominent similarities, the jurisdictional lines being developed by the SEC and CFTC appear to be consistent.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

¹ Press Release, SEC Halts Alleged Initial Coin Offering Scam (Jan. 30, 2018), available at <https://www.sec.gov/news/press-release/2018-8>.

² The SEC and CFTC coordinate their enforcement efforts related to cryptocurrencies and ICOs as shown by a recent joint statement from the heads of enforcement at both Commissions. Public Statement of SEC Co-Enforcement Directors Stephanie Avakian and Steven Peikin and CFTC Enforcement Director James McDonald, Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions (Jan. 19, 2018), available at <https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors>.

³ *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

⁴ *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. 1 (2018) (statement of J. Christopher Giancarlo, Chairman, U.S. Commodity Futures Trading Commission); *id.* at 4 (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission).

⁵ *Id.* at 6 (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission).

⁶ Speech of SEC Chairman Jay Clayton, Opening Remarks at the Securities Regulation Institute (Jan. 22, 2018), available at <https://www.sec.gov/news/speech/speech-clayton-012218>.

⁷ Chairman Clayton previously made this point in a December 2017 speech. Public Statement, SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

⁸ DAO tokens were digital tokens that entitled holders to vote on how proceeds from the DAO token sale should be used and also entitled holders to a portion of any profits or earnings from projects that were funded by the DAO. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Securities and Exchange Commission, Release No. 81207 at 5 (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

⁹ Press Release, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), available at <https://www.sec.gov/news/press-release/2017-176>.

¹⁰ Public Statement, SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

¹¹ *Id.* at fn.2.

¹² *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. (2018) (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission).

¹³ Earlier actions by the SEC targeted Ponzi schemes that related to Bitcoin and other cryptocurrencies. See Complaint, *SEC v. Bitcoin Savings and Trust*, 4:13-cv-00416 (E.D. Tex. July 23, 2013) (SEC alleged Ponzi scheme where operator of Bitcoin Savings and Trust promised Bitcoin depositors a 7% weekly return, but in fact withdrawals were being paid from investor funds); Complaint, *SEC v. GAW Miners, LLC*, 3:15-cv-01760 (D. Conn. Dec. 1, 2015) (SEC alleged Ponzi scheme where defendants sold computing power to mine virtual currencies and promised profits, but where defendants lacked adequate computing equipment). It is unclear if the SEC will continue to bring actions like these. It may be that such actions will be primarily brought by the CFTC in the future.

¹⁴ Complaint, *SEC v. REcoin Group*, 1:17-cv-05725 (E.D.N.Y. Sep. 29, 2017).

¹⁵ Complaint, *SEC v. PlexCorps*, 1:17-cv-07007 (E.D.N.Y. Dec. 1, 2017). The SEC also has a recent settled action in connection with an unregistered ICO where there was no allegation of fraud. *In re Munchee Inc.*, Securities and Exchange Commission, Release No. 10445 (Dec. 11, 2017).

¹⁶ Complaint, *SEC v. AriseBank*, 3:18-cv-00186 (N.D. Tex. Jan. 25, 2018).

¹⁷ *Id.*

¹⁸ *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. (2018) (statement of J. Christopher Giancarlo, Chairman, U.S. Commodity Futures Trading Commission). At the same hearing, SEC Chairman Clayton voiced strong concerns about unregulated Bitcoin and cryptocurrency exchanges and the risks posed to consumers. *Id.* (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission).

¹⁹ 7 U.S.C. § 1a(9). This catchall provision is publicly cited by the CFTC in justifying its jurisdiction. See *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. 3 (2018) (statement of J. Christopher Giancarlo, Chairman, U.S. Commodity Futures Trading Commission).

²⁰ *In re Coinflip, Inc.*, Commodity Futures Trading Commission, Docket No. 15-29 (Sep. 17, 2015) (citing catchall provision of commodities definition under the Commodities Exchange Act), available at <http://www.cftc.gov/ide/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

²¹ The CFTC also has narrow authority over retail commodity transactions with retail investors where some leverage is involved and where actual delivery does not occur within 28 days. Such transactions must take place on a registered futures exchange. Previously, the CFTC held that that a specific trading platform did not actually deliver Bitcoin to its customers where the Bitcoin purchased by customers were held in wallets owned and controlled by the platform. Under the new guidance, actual delivery takes place where the purchaser can “take possession and control” of the commodity and “use it freely in commerce,” not just on the platform where purchased. Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60335 (proposed Dec. 20, 2017) (to be codified at 17 C.F.R. pt. 1).

²² Jay Clayton and J. Christopher Giancarlo, *Regulators are Looking at Cryptocurrency*, WALL ST. J. (Jan. 24, 2018), available at <https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363>.

²³ Speech of CFTC Chairman J. Christopher Giancarlo, Remarks to the ABA Derivatives and Futures Section Conference, Naples, Florida (Jan. 19, 2018), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo34>.

²⁴ *Id.* This is consistent with a guidance document issued by the CFTC in early January confirming its authority to bring anti-fraud and anti-manipulation enforcement actions in connection with Bitcoin and other cryptocurrencies. Policy Guidance Document, CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets (Jan. 4, 2018), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

²⁵ In October of last year, the CFTC issued a primer explaining basic information about Bitcoin and other virtual currencies, the CFTC role overseeing virtual currency markets, the Commission’s prior efforts, and also explaining the risks faced by consumers buying and selling virtual currencies. Policy Guidance Document, A CFTC Primer on Virtual Currencies (Oct. 17, 2017), available at http://www.cftc.gov/idc/groups/public/documents/file/labefc_primercurrencies100417.pdf.

²⁶ See *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. (2018) (statement of J. Christopher Giancarlo, Chairman, U.S. Commodity Futures Trading Commission).

²⁷ Previously, in September 2017, the CFTC brought suit against Gelfman Blueprint, Inc. alleging a Ponzi scheme where the defendant solicited investments in a pooled fund that would buy and sell Bitcoin under the direction of a trading program called “Jigsaw.” According to the complaint, investors were told to expect 7-9% returns per month. Complaint, *CFTC v. Gelfman Blueprint, Inc.*, 1:17-cv-07181 (S.D.N.Y. Sept. 21, 2017). The CFTC brought two additional enforcement actions in January 2018 that were comparable, each targeting an alleged Ponzi scheme. Complaint, *CFTC v. CabbageTech, Corp.*, 1:18-cv-00361 (E.D.N.Y. Jan. 18, 2018) (alleging fraudulent claims of trading expertise and promises to provide expert advice, and further alleging fraudulent promises to invest Bitcoin and other cryptocurrencies on behalf of customers); Complaint, *CFTC v. Entrepreneurs Headquarters Limited*, 2:18-cv-00345 (E.D.N.Y. Jan. 18, 2018) (allegedly accepting Bitcoin investments with false promise to earn profits trading binary options).

²⁸ Complaint, *CFTC v. My Big Coin Pay, Inc.*, 1:18-cv-10077 (D. Mass. Jan. 16, 2018).

²⁹ Complaint, *CFTC v. My Big Coin Pay, Inc.*, 1:18-cv-10077 (D. Mass. Jan. 16, 2018). CFTC Chairman Giancarlo mentioned this case twice during his appearance before the Senate Banking Committee as an important example of the kind of anti-fraud cases the CFTC is pursuing. *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. (2018) (statement of J. Christopher Giancarlo, Chairman, U.S. Commodity Futures Trading Commission).

³⁰ 265 F.3d 42 (1st Cir. 2001).

³¹ Further comparison could be made to another SEC case. In *SEC v. Bitcoin Savings and Trust*, investors allegedly interfaced through the defendants website, which reported investor balances. Complaint, *SEC v. Bitcoin Savings and Trust*, 4:13-cv-00416 (E.D. Tex. July 23, 2013). The defendant was not earning the returns he claimed and could not pay back investors the balances shown on the defendant’s website. In this case and in the CFTC’s case against My Big Coin, Inc., the defendants provided investors with website access to their accounts, but the account information did not match reality.