

Smart Start on Cryptocurrency-- A Current Road Map to Regulation

Carnegie Mellon University
Swartz Center for Entrepreneurship

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Michael Philipp
michael.philipp@morganlewis.com

Morgan, Lewis & Bockius, LLP

Cryptocurrency Innovation--

Characteristics That Make It Useful

- Quasi-Anonymous
- Electronic
- Fast
- Cross-Border
- No Intermediaries

The Imperative To Regulate Cryptocurrencies

- Criminal Uses
 - Money Laundering
 - Ransomware
 - Terror Financing
- Tax Evasion
- Money Laundering
- Investment Fraud
 - Ponzi Schemes
 - ICOs
- Market Manipulation
- Hacks/Theft

Factors That Affect the Extent of Regulation

Categories of Attributes Of Cryptocurrency

- Digital Currency (“Spot”)
- Derivatives
- ICO
- Utility
- Record of Real Assets

How It Is Used And By Who

- Miners
- Issuers/Administrators
- Consumers/Merchants
- Exchangers
- Custodians
- Transmitters
- Intermediaries (Brokers, Investment Advisors, Fund Managers)

How Regulators View Cryptocurrency

- A Commodity (CFTC)
- A Medium Of Exchange That Operates Sort of Like a Currency (FINCEN and State Banking Regulators)
- A Security or Investment Contract (SEC)
- Property (IRS)

CFTC Jurisdiction—Commodity Derivatives

- Exclusive Jurisdiction Over Commodity Derivatives
 - Futures
 - Options
 - Swaps
- Public Interest
 - Promotion of Risk Management
 - Price Discovery
 - Prevention of Manipulation
 - Prevention of Fraud
 - Promotion of Financial Integrity
 - Promotion of Responsible Innovation

Commodity Definition

- Commodity Defined
 - Enumerated Agricultural Commodities
 - Metals
 - Energy
 - Foreign Currency
 - Interest Rates
 - Stock Indices
 - “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in”
 - Credit indices
 - Macroeconomic indices
 - Weather
 - Environmental
- Not a Commodity
 - Onions!
 - Movie Box Office Receipts
 - Political Events/Sporting Events

Cryptocurrencies Are Commodities

- CFTC *Coinflip Order*
- CFTC *Bitfinex Order*—Leveraged Retail Contracts
- TeraExchange -- CFTC Approved swap exchange
- LedgerX—CFTC Approved option exchange
- CME/CFE—CFTC Approved futures exchanges
- CFTC Intermediary Registration -- FCMs/IBs, CPOs, CTA
- CFTC Regulatory Regime—Regulatory Capital, Disclosure, Reporting, Recordkeeping, Customer Protection
- CFTC Anti-manipulation and Antifraud Jurisdiction

FINCEN

- Views Cryptocurrency as Money
- Protect Financial System From Criminals, Money Launderers, Sanctions Evaders, Hostile Foreigners
- Promote Financial Innovation
- Three Groups of Virtual Currency Actors: Users, Administrators and Exchangers
- Money Services Businesses (MSB) Requirements: Registration, KYC/CIP, AML, SAR, Currency Transaction Reporting, Cybersecurity

State Regulation

- Money Transmitter Licences—Parallel to FINCEN Requirements
- New York BitLicence
 - Virtual Currency Business Activity
 - Receiving or Transmitting
 - Storing, Holding, or Maintaining Custody or Control For Others
 - Buying and Selling As A Customer Business
 - Exchanger for Customers
 - Administering or Issuing
 - Not Included
 - Software Developers and Miners

NY DFS BitLicense Requirements

- Registration—background checks
- AML Program
- Cybersecurity Program/BCP/DR
- Regulatory Capital
- Risk Disclosure Requirements
- No Exemption For Otherwise Regulated Entities Except For NY State Chartered Banks, and Merchants That Utilize VC Solely For Purchase and Sale of Goods Or For Investment Purposes
- No Reciprocity With Other States

Uniform Law Commission (State Laws)— Uniform Regulation of Virtual-Currencies Business Act

- Uniform Regulation of Virtual-Currencies Business Act
Adopted in July 2017
- Not self-executing—needs to be adopted state by state
- Similar to NY DFS BitLicense definition of virtual currency business
- Similar requirements to NYS DFS BitLicense requirements
- Numerous exceptions for otherwise regulated entities
- Provides for State reciprocity

SEC Jurisdiction

- Regulatory Mission is to Protect Investors, Maintain Fair, Orderly and Efficient Markets, and Facilitate Capital Raising
- Security Definition is Very Broad
- SEC has Never Claimed That Virtual Currency Such as Bitcoin is a Security
- But...instruments issued by entities that own virtual currencies or that provide returns based on virtual currency assets are likely securities
 - ETFs
 - Indexed Notes
 - Many ICOs

“Howey Test” for Investment Contracts

- *Howey* Investment Contract Test=Security
 1. An investment of money
 2. In a common enterprise
 3. With a reasonable expectation of profits
 4. From the entrepreneurial or management efforts of others
- *The DAO*
- *Munchee* (Failed as a “Utility Token”)

SEC Regulation and Enforcement

- If an ICO is the offer of Security, then it must either be registered, or exempt under a Reg A+ limited public offering, a Reg D Private offering under 3(c)(1) or 3(c)(7), or Reg S for only non-US investors
- Secondary Trading of Securities ICOs on Exchanges Requires Exchange Registration
- Intermediaries—Brokers and Advisors Must Be Registered
- Ponzi Schemes—*Shaver*
- ICO Fraud --*Zaslavsky, Lacroix, Centra Token*
- Mining Schemes—*GAW Miners/ZenMiner*

IRS-Tax Regulation

- IRS views virtual currency as property
- Each sale or exchange is a taxable event and related gain or loss must be reported on annual tax return
- IRS John Doe subpoena on Coinbase
- IRS may treat non-reporting of virtual currency gains/losses the same way as unreported offshore income

Conclusion

- Try to reconcile promotion of innovation with regulatory imperatives
- Existing regulatory regime is fractured—no single regulator with exclusive jurisdiction and no uniform regulation
- Develop Industry voluntary best practices?
- Regulatory “Sandbox” approach?
- New Federal regulator?
- Strategically embrace regulation

THANK YOU!