Cryptocurrencies: What is the applicable regulatory framework in the United States?

According to the unknown person or persons who "invented" cryptocurrencies, cryptocurrencies are "[a] n electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need of a trusted third party." This definition sheds very little light on whether they should be regulated and how they should be characterized for purposes of regulation. Any serious discussion of regulation of cryptocurrencies does not start with the premise that they are completely unregulated but with the question of what they are and to what extent they should be regulated. The possible candidates for regulatory categories are securities, money, commodities and swaps/futures. As with most questions of legal characterization, the answer does not depend upon abstract or theoretical concepts but context and a "facts and circumstances" test, which is used frequently by lawyers to articulate a test which relies upon "I know it when I see it." Relevant facts that could be important in this analysis are the motivation or intent of those creating or using the cryptocurrency and their manner of use — in other words, what are they being used for and how are they being used. Applying these factors leads to a conclusion that cryptocurrencies can, depending, upon the context, be all of the above, namely securities, monies, commodities and swaps.

Securities

The Securities and Exchange Commission (**SEC**) has examined the issue of whether and when cryptocurrencies are securities through reports, statements of commissioners and enforcement, particularly in the context of initial coin offerings (**ICOs**). The SEC has used the analytical framework first set forth by the U.S. Supreme Court in SEC v. W. J. Howey Co. (**Howey**) to assess whether an investment in a cryptocurrency is a security. In Howey, the Supreme Court was called to determine whether "an offering of units of a citrus grove development, coupled with a contract for cultivating, marketing, and remitting the net proceeds to the investor" is an "investment contract" and therefore a "security" for purposes of the Securities Act of 1933. The Supreme Court in Howey articulated a four-part test to determine whether an investment is a "security", namely whether there is (a) an investment of money; (b) in a common enterprise; (c) with a reasonable expectation of profits; (d) from the entrepreneurial efforts of others.

In the "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO", issued July 25, 2017, the SEC indicated that cryptocurrencies can be categorized as securities offerings, and that the DAO, a decentralized autonomous organization, further described as "a 'virtual' organization embodied in computer code and executed on a distributed ledger or blockchain", was a securities offering because it resembled an investment company. The DAO sold so-called "DAO Tokens" to investors in exchange for Ether cryptocurrency, with the proceeds of such sales being used to fund "projects." Investors could vote on what to do with the revenue generated by the "projects" – either to use it to fund new "projects" or to distribute it to the investors as a return on investment. The investors were also able to sell their DAO Tokens in the secondary markets by using electronic platforms. About one-third of the assets of the DAO were stolen in a cyberattack.

Similarly, in the In re Munchee Inc. administrative proceeding, in which the SEC issued an order in December 2017, a business that created an iPhone app for people to review restaurants offered and then sold digital tokens to be issued on the Ethereum blockchain via an "initial coin offering" to the general public. Munchee Inc. described to investors how the tokens would be expected to increase in value and stated that they would be traded on secondary markets. Munchee Inc. started selling the tokens on October 31, 2017, but ceased sales the following day after being contacted by SEC staff. The SEC applied the Howey test in the context where the proceeds of the token offering were used to promote general corporate purposes of the issuer rather than held in escrow or invested in a hedging transaction to provide the good or service that a

buyer can exchange for the token in the future. In such situations, where investors may be motivated more by an appreciation in the tokens rather than their use with respect to a good or service, the tokens are more likely to be deemed a "security."

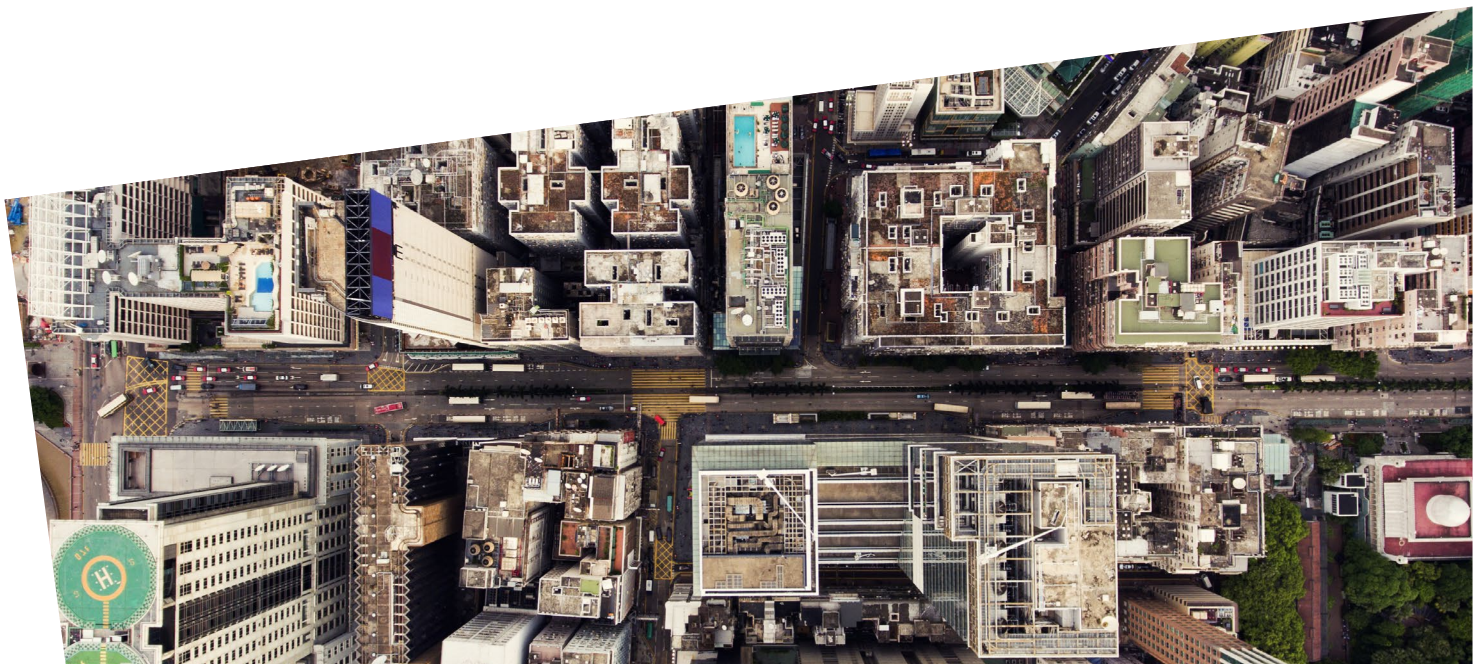
Furthermore, SEC commissioners have issued official statements highlighting their views on whether cryptocurrency products are securities. For example, in a December 2017 statement, SEC Chairman Jay Clayton stated that "[m]erely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security. Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law."

DAO and Munchee did not have an immediate direct connection with the purchase of goods and services, and in DAO included a cyber-attack, and accordingly their characterization as securities were not close calls. Less clear, however, are situations where a cryptocurrency token may have dual purposes, i.e., the promotion of general purposes as well as a method of exchange or where the use may change over time from a "security token" to exclusively a "utility token".

Money

Money transmitters are regulated by both federal and state regulation. The U.S. Department of Treasury Financial Crimes Enforcement Network (**FinCEN**), pursuant to its implementation of the Bank Secrecy Act and the USA PATRIOT Act, requires that "money transmitters" comply with registration, monitoring, reporting and other requirements. Under FinCEN regulations, a "[m]oney transmitter" means "[a] person that provides money transmission services" or "[a]ny other person engaged in the transfer of funds." "Money transmission services" is defined 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." Virtually every state has licensing and/or registration requirements that parallel those of FinCEN.

FinCEN has also issued specific guidance (**FinCEN Guidance**) on the application of its money transmission regulations with respect to cyptocurrencies. According to the FinCEN Guidance, a "user" of cryptocurrencies, i.e., one who uses virtual currency to purchase goods or services on the user's own behalf, is not a money transmitter, while "exchangers" or "administrators" are



properly classified as money transmitters. Further, according to the FinCEN Guidance, an "exchanger" is a person or entity "engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency," while an administrator of virtual currency is a person or entity "engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency." In looking at the questions of motivation and manner of use, therefore, FinCEN focuses on whether the person is engaged in a business (whether as an issuer of virtual currency or as an exchanger) and the manner of use — on an exchange.

Commodities

The term "commodity" is defined broadly in the relevant statute, the Commodity Exchange Act (**CEA**), to mean:

"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 . . . 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."

This definition encompasses both physical commodities, like agricultural products or natural resources, as well as financial assets, which are included within the definition of "all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in." The Commodity Futures Trading Commission ("CFTC") has taken the view that cryptocurrencies are within the scope of this definition of "commodity."

At least one federal court has agreed with the CFTC. The court in CFTC v. McDonnell held that the CEA has non-exclusive authority to investigate and enforce the CEA as to both virtual currency spot transactions and futures transactions. In McDonnell, the defendant was accused of operating CabbageTech, Corp., doing business as Coin Drop Markets, for the stated purposes of soliciting funds from customers in exchange for providing advice about trading virtual currencies and for trading on behalf of the customers under the defendant's direction. Instead, the defendant was alleged to have misappropriated customer funds. The court examined whether the CFTC had standing to sue the defendant. It should be noted, however, that the defendant in McDonnell was pro se and did not raise available arguments against the court's ultimate interpretation, and accordingly this may not be the final word on this analysis.

Whether cryptocurrency is a commodity or not, however, is only part of the question in assessing the scope of CFTC jurisdiction. Other than anti-fraud enforcement authority, the CFTC and the CEA do not generally regulate "cash" or spot transactions involving commodities such as cryptocurrencies (but they do with respect to "commodity interests" – swaps and futures).

One key exception is if the cryptocurrency transactions utilize margin, leverage or financing – if the transaction does utilize margin or leverage then it is subject to CFTC and CEA oversight in addition to anti-fraud enforcement. Section 2(c)(2)(D) of the CEA grants explicit jurisdiction to the CFTC over "any agreement, contract, or transaction in any commodity that is . . . entered into with, or offered to (even if not entered into with)" a person that is neither an "eligible contract participant" nor an "eligible commercial entity" "on a leveraged or margined basis, or financed by

the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis."

An important factor in determining whether cryptocurrencies utilize margin or leverage and the resultant scope of CFTC authority is whether there has been "actual delivery" of the cryptocurrency. Pursuant to Section 2(c)(2)(D)(ii)(III) of the CEA , known as the "Actual Delivery Exception", CFTC authority does not extend to any contract of sale that "results in actual delivery within 28 days or such other longer period as the [CFTC] may determine by rule or regulation based upon the typical commercial practice in cash or spot markets for the commodity involved."

In the context of cryptocurrencies, however, this definition begs the question of the meaning of "actual delivery" in the context of an environment where payments are based upon cryptographic proof reflected on a distributed ledger. The CFTC has attempted to provide guidance on this issue through the issuance of a proposed interpretation (**Proposed Interpretation**) for public comment in December 2017, which has not yet been finalized and which has thus far received more than 90 comments. The Proposed Interpretation defines actual delivery as having occurred when a customer has the ability to "(i) [t]ake 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) use it freely in commerce (both within and away from any particular platform) no later than 28 days from the date of the transaction" and "[t]he 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) not retaining any interest in 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."

The Proposed Interpretation sets forth four examples of the presence and absence of "actual delivery" in the context of virtual currencies:

Example 1: Actual delivery: within 28 days of entering into an agreement:

- there is a record on the relevant public distributed ledger network or blockchain of the transfer of virtual currency, whereby the entire quantity of the purchased virtual currency, including any portion of the purchase made using leverage, margin, or other financing, is transferred from counterparty seller's blockchain wallet to purchaser's blockchain wallet;
- counterparty seller retains no interest in or control over the transferred commodity; and
- counterparty seller has transferred title of the commodity to purchaser.

When a matching platform or other third party offeror acts as an intermediary, the virtual currency's public distributed ledger must reflect the purchased virtual currency transferring from counterparty seller's blockchain wallet to

the third party offeror's blockchain wallet and, separately, from third party offeror's blockchain wallet to purchaser's blockchain wallet, provided that purchaser's wallet is not affiliated with or controlled by counterparty seller or third party offeror in any manner.

Example 2: Actual delivery: within 28 days of entering into a transaction:

- counterparty seller has delivered the entire quantity of the virtual currency purchased, including any portion of the purchase made using leverage, margin, or financing, into the possession of a depository (i.e., wallet or other relevant storage system) other than one owned, controlled, or operated by counterparty seller (including any parent companies, partners, agents, affiliates, and others acting in concert with counterparty seller) that has entered into an agreement with purchaser to hold virtual currency as agent for purchaser without regard to any asserted interest of offeror, counterparty seller, or persons acting in concert with offeror or counterparty seller on a similar basis;
- counterparty seller has transferred title of the commodity to purchaser;
- purchaser has secured full control over the virtual currency (i.e., the ability to immediately remove the full amount of purchased commodity from depository); and
- no liens (or other interests of offeror, counterparty seller, or persons acting in concert with offeror or counterparty seller on a similar basis) resulting from the use of margin, leverage, or financing used to obtain the entire quantity of the commodity purchased will continue forward at the expiration of 28 days from the date of the transaction.

Example 3: No actual delivery: within 28 days of entering into a transaction, a book entry is made by offeror or counterparty seller purporting to show that delivery of the virtual currency has been made to the purchaser, but counterparty seller or offeror has not, in accordance with the methods described in Example 1 or Example 2, actually delivered the entire quantity of the virtual currency purchased, including any portion of the purchase made using leverage, margin, or financing, and transferred title to that quantity to purchaser, regardless of whether the agreement between purchaser and offeror or counterparty seller purports to create an enforceable obligation to deliver the commodity to purchaser.

Example 4: No actual delivery: within 28 days of entering into a transaction, the agreement, contract, or transaction for the purchase or sale of virtual currency is rolled, offset against, netted out, or settled in cash or virtual currency (other than the purchased virtual currency) between purchaser and offeror or counterparty seller (or persons acting in concert with offeror or counterparty seller).

The CFTC's focus on possession in the Proposed Interpretation, however, has been cast into doubt in another context by a recent U.S. District Court decision that resulted in the dismissal of an enforcement action against a company offering precious metals to customers on a leveraged basis and where the court held that the CFTC lacked regulatory jurisdiction as to alleged commodity fraud under the Actual Delivery Exception. In this case, which does not relate to cryptocurrencies, the defendants offered precious metals on a leveraged, margined, or financed basis, meaning that retail customers purchased the metals by paying a part of the purchase price, with the balance financed. The trading did not take place on a regulated exchange or board of trade, and the defendant was the counterparty to, and set the price for, every trade. The metals were stored at third-party depositories, and customers could only request physical possession of metals upon full payment. The CFTC alleged fraud in violation of the CEA and that these precious metal trades are off-exchange transactions in violation of the CEA. Defendants argued that the CFTC lacked jurisdiction due to the Actual Delivery Exception, and the court agreed. The CFTC is expected to appeal or file an amended complaint.

Since certain cryptocurrencies can only be used on specific platforms, it is difficult to see how the second prong of the Proposed Interpretation with respect to actual delivery — requiring the commodity to be used freely in commerce both within and away from any particular platform — can be satisfied.

Whether there has been "actual delivery" is not just an academic question; rather, absent a new statute, the scope of federal commodities jurisdiction will depend upon how this exception is applied in the commodities context. Accordingly, as with respect to the securities and money transmitter discussion, commodity regulation will depend upon the manner of use — in other words, whether through actual delivery or future delivery.

Swaps/Futures

It is possible, however, that "delivery" or physical settlement of the cryptocurrency will never occur; in other words, that the change in value of a cryptocurrency will be cash-settled in U.S. dollars or another fiat currency. In that case, the cryptocurrency product could be a "swap" or "futures" contract. The definition of "swap" in the CEA is likewise very broad – it includes any contract "that provides on an executory basis for the exchange, on a fixed or contingent basis, of [one] or more payments based on the value or level of [one] or more interest or 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."

Under this portion of the definition it is possible that contracts for future sale of cryptocurrencies (i.e., ICO pre-sales) that provide the purchaser with a right to transfer the right of future purchase, to book-out or to monetize that right may be considered to be a "swap" and therefore subject to CFTC regulation as a swap. In addition, lack of clarity around the meaning of the phrase "without also conveying a current or future direct or indirect ownership interest" in the context of cryptographic proof or distributed ledger technology where ownership and control have different meanings than in a traditional context may prove problematic and

requires different applications than those based upon exclusive possession and control. If classified as swaps, these products could be subject to a litany of federal swaps regulation, such as reporting, central clearing and recordkeeping requirements, each of which may prove difficult to apply in the context of a distributed ledger.

Conclusion

We are still in the early stages of obtaining clarity with respect to the scope of regulation regarding cryptocurrencies. Part of that may be due to the fact that the early cases testing these issues are usually fraud cases; part of this may be due to the still somewhat limited scope of the use of cryptocurrencies and the fact that it will take some time before more complicated test cases are "ripe" for regulatory review. In any case, it is clear that the regulatory tools for supervision and enforcement exist — and a legislative solution is not necessary — although the application of these tools may require some different approaches in order to take into account technological changes.

Contact

Evan Koster
Partner, New York
T +1 212 918 8260
evan.koster@hoganlovells.com