

CLIENT ALERT

Cryptocurrency in Small Bytes: Who's in Charge Here Anyway Part II – The Regulators Speak Up

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The Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have taken early action to assert their jurisdiction over cryptocurrency transactions and initial coin offerings (ICOs), and they have been working together to define their respective jurisdiction and attempt to clarify whom and what will be regulated. The Chairman of the CFTC, Christopher Giancarlo, and the Chairman of the SEC, Jay Clayton, recently testified before the Senate Banking Committee and shed more light on their views regarding jurisdiction and the steps the agencies are taking to police the cryptocurrency and ICO space. While these efforts do add some clarification to the CFTC's and the SEC's role in virtual currency transactions, the authority of each regulator is far from clear, emphasizing the need for a more effective and unified regulatory approach.

"Patchwork" Jurisdiction

The CFTC's jurisdiction is laid out in the Commodity Exchange Act (CEA), which defines commodity quite broadly. The agency has found virtual currency to meet this definition and therefore the CFTC has regulatory and enforcement power over traded derivatives for virtual currency. The one major exception to the authority of the CFTC is "spot" markets. The agency can use subpoenas and other methods to bring civil enforcement actions when fraud or manipulation occurs in those markets and has used these methods in the past, but it does not have the authority to require any specific disclosures with respect to spot transactions or to require spot transactions to be traded on regulated markets.

The CFTC is working to coordinate regulatory efforts with other agencies that have claimed separate jurisdictions over virtual currency. The SEC is stepping up its own enforcement efforts. The SEC has authority over anything classified as a security according to the Securities Act of 1933. SEC Chairman Clayton has often stated that a fact-based analysis of most virtual currencies would find them to be securities. He stated that "by and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws."

The SEC's authority is broader than the CFTC's in that the SEC has jurisdiction over "spot" transactions in securities, including issuances of securities. Thus, under Chairman Clayton's interpretation, ICO issuers are all subject to SEC regulation. This would mean that issuers must either register their tokens with the SEC or use one of the available exemptions from registration, and in either case must make specific disclosures to investors. In addition, this would also mean that securities must be traded on registered platforms such as national securities exchanges or alternative trading systems. Currently there are no securities exchanges or alternative trading systems that list virtual currencies, although there are platforms that are working to develop this functionality.

And the States Too?

Chairman Giancarlo recognized this regulatory gap in his testimony, acknowledging that in addition to federal regulations, there is also a patchwork of state laws and regulators that have attempted to address virtual currencies. New York was the first to implement virtual currency-specific regulation, although many view New York's rules as cumbersome and expensive to comply with, which has led some virtual currency businesses to leave the state entirely. The Uniform Law Commission has drafted a proposed regulatory system, which Nebraska and Hawaii have moved to adopt. And many states have confirmed that their money transmission regulations apply to transactions in virtual currencies, requiring issuers as well as exchangers to register at the state as well as the federal level.

At the same time, there are some moves to standardize regulation at the state as well as the federal level. For example, the state regulators of Georgia, Illinois, Massachusetts, Tennessee, Texas, Kansas, and Washington have agreed to recognize each others' money services licensing schemes, making it easier to apply to do business in multiple states. These regulators have said that they expect more states to join the initiative. Meanwhile, Chairmen Clayton and Giancarlo voiced support for the concept of a federal money transmitter license that would supersede the requirement for state-by-state registration.

Bringing All the Elements Together

Both Chairmen agreed the most important thing to do right now is improve guidance for investors, issuers, and other market participants. They each want to work between agencies and with Congress to more clearly define which agencies have jurisdiction over virtual currency transactions. Both have requested more funding and authority from Congress for their regulatory efforts. Chairman Clayton advocated for all the federal financial regulators to come together to draft a coordinated plan to address virtual currency markets. Chairman Giancarlo noted that any proposed federal regulation should be carefully tailored to enhance efforts to prosecute fraud and manipulation.

The problem is that virtual currency is not like what has come before. It can be used for investment, as a medium of exchange, and in the case of most ICOs, for other functionality as well. While this makes virtual currencies fall by definition under the jurisdiction of multiple regulators at the federal and state level, subjecting virtual currency businesses to the licensing requirements of manifold regulators is not an answer that will foster innovation. Instead of just treating virtual currency as part of an existing asset class, hopefully the regulators' testimony before Congress will start a discussion of how to best create a more finely tailored, and more appropriate, regulatory system.

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