SEC, NASAA, AND STATE REGULATORS CAUTION ON CRYPTOCURRENCIES AND ICOS

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If 2017 was the year that cryptocurrencies came to the forefront of public attention, 2018 will be the year that this emerging medium of exchange enters a new phase of regulatory scrutiny. As an example, on January 4, 2018, the North American Securities Administrators Association ("NASAA") circulated a release (the "Release") (found here) warning investors to approach cryptocurrencies, initial coin offerings ("ICOs"), and other cryptocurrency-related investment products with caution. The Release specifically cites common cryptocurrencies such as Bitcoin, Ethereum, and Litecoin, and states that "[u]nlike traditional currency, these alternatives have no physical form and typically are not backed by tangible assets. They are not insured or controlled by a central bank or other governmental authority, cannot always be exchanged for other commodities, and are subject to little or no regulation."

The Release also mentions a survey of state and provincial securities regulators demonstrating that "94 percent believe there is a 'high risk' involving cryptocurrencies" and a unanimous viewpoint that more regulation is needed. Joseph P. Borg, NASAA President, states in the Release that "[c]ryptocurrencies and investments tied to them are high-risk products with an unproven track record and high price volatility. Combined with a high risk of fraud, investing in cryptocurrencies is not for the faint of heart."

Coincident with the Release, the three commissioners of the Securities and Exchange Commission ("SEC"), Chairman Jay Clayton and Commissioners Kara Stein and Michael Piwowar, issued a joint public statement (the "SEC Statement") (found here) commending NASAA on its Release. The SEC Statement, reflecting bipartisan views, also attempts to dispel analogies of cryptocurrencies to traditional currencies:

The [Release] recognizes that cryptocurrencies, while touted as replacements for traditional currencies, lack many important characteristics of traditional currencies, including sovereign backing and responsibility, and now are being promoted more as investment opportunities than efficient mediums for exchange.

The SEC Statement further asserts that the Release serves as a reminder that when investors:

are offered and sold securities, they are entitled to the benefits of state and federal securities laws, and that sellers and other market participants must follow these laws. Unfortunately, it is clear that many promoters of ICOs and others participating in the cryptocurrency-related investment markets are not following these laws. The SEC and state securities regulators are pursuing violations. . . .

Also, on the same date that the SEC Statement and the Release were issued, the Texas State Securities Board entered an Emergency Cease and Desist Order against BitConnect (the "BitConnect Order") to halt several of its multiple investment programs. BitConnect is a prominent "cryptocurrency ecosystem" that describes itself as a "self regulated Financial system . . . designed to provide multiple investment opportunities with cryptocurrency education." BitConnect's services include a news portal for cryptocurrency matters and various lending-based investment programs. Central to the ecosystem is BitConnect's own cryptocurrency called the "BitConnect Coin." Per the BitConnect Order, investors could lend their BitConnect Coins to others for returns of up to 40% per month and to "stake" their BitConnect Coins for a return of up to 120% per year. (BitConnect Coin may be purchased only with Bitcoin.)

Per the Texas State Securities Board's press release, the BitConnect Coin has a market cap of US$4.1 billion. The BitConnect Order cites registration violations of the lending program and the staking program under Texas securities law, including (i) the failure to register those programs for qualification, notification, or coordination and the sale of those programs in Texas without registration; (ii) the failure of BitConnect to register with the Securities Commissioner of the State of Texas as a securities dealer or agent; and (iii) the recruitment of sales affiliates who are not registered as dealers or agents. The BitConnect Order also concludes that BitConnect is engaging in fraud in connection with the offer for sale of securities and making offers for the sale of securities containing statements that are materially misleading or otherwise likely to deceive the public. The BitConnect Order, however, does not explicitly identify the BitConnect Coin as a security.

Also, on January 4, 2018, Idaho's Department of Finance issued a cautionary statement (found here) as did Alaska's Division of Banking and Securities (found here).

TAKEAWAYS

The Release, the SEC Statement, and various announcements from state regulators on the same day are the latest examples of heightened regulatory attention and perhaps cross-regulatory coordination regarding the cryptocurrency marketplace.

The SEC Statement and Release follow closely on the heels of SEC Chairman Jay Clayton's December 11, 2017 public statement on cryptocurrencies and ICOs, where he cautioned on the risks of the cryptocurrency markets and, in bold font, reminded market intermediaries such as lawyers, accountants, and consultants that they are gatekeepers of investor protection. For a fuller discussion of Chairman Clayton's public statement, please see our analysis here.

The SEC Statement makes issue of how some ICO market participants have touted certain cryptocurrencies as replacements for traditional fiat currencies. On this point, beyond the aforementioned cautions of NASAA and the SEC, it should be noted that cryptocurrencies are subject to Internal Revenue Service ("IRS") taxation as property under IRS Notice 2014-21. Such posture could frustrate the objectives of certain currencies such as Bitcoin that were originally designed as payment systems by subjecting each Bitcoin transaction as either a capital gain or loss.

Unlike traditional fiat currencies, it also should be noted that cryptocurrencies can be susceptible to significant scalability issues that have made transactions on certain cryptocurrency networks increasingly difficult and expensive to accomplish. These issues have on occasion motivated efforts to solve scalability through "hard forks" to separate certain cryptocurrencies into new forms of cryptocurrencies. Further, some cryptocurrency networks have shown themselves to be subject to hacking attacks and technical errors.

The BitConnect Order also serves as a significant reminder of the federalized system of securities regulation within the United States. The SEC is the securities regulator applicable to federal law, but many states have their own securities regulators. A state regulator may express views as to whether a particular token is a security under state law independent of any action or interpretation by the SEC under federal law. Token sponsors who issue tokens not registered under the Securities Act of 1933, as amended (the "Securities Act"), or are not exempt from registration under Regulation D of the Securities Act, do not have the benefit of state blue sky law preemption and may expose themselves to regulatory actions and private litigation under various state laws.

In the coming year, we expect that we will see additional regulatory actions addressing risks and problematic practices surrounding the cryptocurrency markets. Private litigants also will make allegations sounding in federal and state laws in various jurisdictions. Remediation of certain token offerings that violate securities laws will likely become a topic of much discussion. There may be uncertainty around how a rescission offer would be accomplished, particularly in the context of an offering conducted using Bitcoin or Ether as consideration, in light of the appreciation of the Bitcoin and Ether.

Notwithstanding the present risks and uncertainties in the cryptocurrency marketplace, those who are serious about building cryptocurrency-based businesses can and should view increased regulatory focus as a necessary and important step in the growth of the industry. Clearer "rules of the road" should facilitate capital raising while deterring some of the more problematic practices.

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