

The Regulatory Adventures of a Crypto Startup

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NoDoubt Crypto LLC (NoDoubt Crypto) – a fictitious Delaware limited liability company with its principal place of business in New York, N.Y. – is an innovative new FinTech startup in the digital assets or blockchain/distributed ledger technology (DLT) space. One thing NoDoubt Crypto wants – aside from revolutionizing the way financial markets operate and making a profit – is regulatory clarity. And regulatory simplicity. Okay, two things. NoDoubt Crypto, however, is unlikely to get either. Why? Let us take a look at regulatory developments in 2018.

Starting From the Top

Absent legislative action by Congress, the regulation of digital assets and DLT appears to be under the concurrent jurisdiction of several federal regulatory agencies, departments and bureaus, primarily, the Financial Crimes Enforcement Network (FinCEN), Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC).

FinCEN was the first to issue guidance on virtual currencies in 2013 and since then has issued several administrative rulings clarifying the impact of the guidance on different business models in the virtual currency space. CFTC defined cryptocurrencies as commodities in 2015 and therefore subject to its anti-fraud and anti-manipulation enforcement authority. The CFTC’s jurisdiction was confirmed by two federal courts in 2018, as discussed below.

The SEC made a number of crypto-related pronouncements, including, notably, SEC Director Hinman’s [speech](#) “Digital Asset Transactions: When Howey Met Gary

(Plastic),” remarking that Bitcoin and Ether are not securities. These, however, are staff views, not official SEC rules and regulations, and therefore are nonbinding and unenforceable. In September 2018, SEC Chairman Clayton reiterated this as the Commission’s longstanding position. See <https://www.sec.gov/news/public-statement/statement-clayton-091318>.

I See, You Say. How About an ICO?

As NoDoubt Crypto is moderately comforted by regulators affirming the idea that they embrace new technologies and do not want to stifle innovation, and awaits clear regulatory guidelines, why not raise capital through an Initial Coin Offering (ICO)? Not so fast. At least not until NoDoubt Crypto determines if its token might be considered a security and therefore subject to federal securities laws, including registration with the SEC, or whether it qualifies for an exemption from registration. More on ICOs below.

Lawmakers on the Crypto Side

NoDoubt Crypto, still hopeful, begins to lose patience. As do members of Congress. Following an ICO Summit on Capitol Hill in late September 2018, where representatives of the cryptocurrency and traditional financial industry met to discuss the lack of regulatory clarity, 15 lawmakers sent a letter to the SEC asking it to clarify its position on what makes an ICO a security. See [Letter to Jay Clayton](#), Chairman, U.S. Securities and Exchange Commission (Sept. 28, 2018); see also Kate Rooney, [“Congress members ask SEC chairman for clarity on cryptocurrency regulation,”](#) CNBC.com (Sept. 28, 2018).

If the fog obscuring the cryptocurrency regulatory landscape is not lifted soon, businesses, like NoDoubt Crypto, will likely continue to explore more crypto-friendly foreign jurisdictions.

Malta, anyone? Or, Switzerland, perhaps?

Taking a Bite Out of the Big Apple

The grass may be greener elsewhere, but as NoDoubt Crypto awaits legislative or federal regulatory action, it may confidently proceed with its business operations in New York, correct? Not exactly.

If NoDoubt Crypto engages in a “virtual currency business activity” involving New York or New York residents, it has to comply with the New York State Department of Financial Services (DFS) [licensing regulatory framework](#) that became effective in June 2015.

Known as the BitLicense, the regulations involve a rigorous and lengthy application process and impose substantial operational and regulatory requirements. Effective Oct. 1, 2018, DFS transitioned the BitLicense applications and ongoing regulation to the Nationwide Multistate Licensing System and Registry.

Considered by many a regulatory overreach, the onerous BitLicense requirements, coupled with the high cost of compliance, led a number of crypto-businesses to leave New York, an outcome termed the “Great Bitcoin Exodus” and “Bit-exodus” by journals and online publications.

See, e.g., Michael del Castillo, “[The ‘Great Bitcoin Exodus’ has totally changed New York’s bitcoin ecosystem](#),” New York Business Journal (Aug. 12, 2015); see also Evander Smart, “[Escape from New York: Kraken & Paxful Join ‘Bit-Exodus,’](#)” Coin Telegraph (Aug. 10, 2015).

Wait! More Is Happening in New York

While fully compliant with the BitLicense, NoDoubt Crypto is also eagerly anticipating a BitLicense reform to potentially lower the regulatory and compliance burdens it imposes, as discussed in early 2018, when New York state lawmakers held a roundtable with the cryptocurrency industry. See Stan Higgins, “[New York Lawmakers Open to Revisiting the BitLicense](#),” Coin Desk (Feb. 25, 2018).

Next year, maybe? NoDoubt Crypto hopes.

But that is not all.

In April 2018, the New York State Office of the Attorney General (the OAG) launched the [Virtual Markets Integrity Initiative](#) seeking disclosure on the business and trading operations of 13 trading platforms/crypto-exchanges. In September 2018, it published the [Virtual Markets Integrity Initiative Report](#) detailing certain of its findings.

Though participation was voluntary, the OAG referred several exchanges that declined to participate to the DFS for potential regulatory violations.

FinHub to the Rescue?

NoDoubt Crypto begins to doubt that it will ever be on the right side of all regulations that apply to it. Could the SEC's [Strategic Hub for Innovation and Financial Technology](#) (FinHub) be the silver lining? Launched on Oct. 18, 2018, FinHub is an online portal for the FinTech, digital assets and blockchain/DLT industry and the public to engage with the SEC by completing an online form to request a meeting with the regulators and submit white papers, offering documents and other supporting materials. It "provides a central point of focus for [the SEC's] efforts to monitor and engage on innovations in the securities markets that hold promise, but which also require a flexible, prompt regulatory response to execute [the SEC's] mission."

Weighing the pros and cons of a prospective meeting request with the SEC, NoDoubt Crypto reviews recent SEC and CFTC cryptocurrency related actions to better understand their jurisdiction over its operations.

Federal Courts Confirm CFTC's Jurisdiction

NoDoubt Crypto takes notice of two recent federal court opinions.

A New York federal judge sided with the CFTC finding that the CFTC had jurisdiction over a trader of virtual currency. In ruling that virtual currencies are commodities, the court stated that “[u]ntil Congress clarifies the matter, the CFTC has concurrent authority, along with other state and federal administrative agencies, and civil and criminal courts, over dealings in virtual currency.” See *CFTC v. McDonnell et al.*, Memorandum & Order, 18-CV-361 (E.D.N.Y. March 6, 2018).

Similarly, a Massachusetts federal judge confirmed the CFTC’s authority to prosecute an operator of a fraudulent virtual currency scheme holding that the currency was a “commodity” under the Commodity Exchange Act. See *CFTC v. My Big Coin Pay*, Memorandum of Decision, 18-10077-RWZ (D. Mass. Sept. 26, 2018).

With a better understanding of CFTC’s jurisdiction, NoDoubt Crypto turns its attention to the SEC’s approach to ICOs.

Federal Judge Rules That ICOs Fall Under Federal Securities Laws

A New York federal judge declined to dismiss a criminal indictment, ruling that federal securities laws may apply to an ICO and virtual currency frauds. Finding that a reasonable jury could conclude that cryptocurrency is a security, the court left the ultimate answer to the jury. See *U.S. v. Zaslavskiy*, Memorandum & Order, 17 CR 647 (E.D.N.Y. Sept. 11, 2018).

While the SEC seems reluctant to provide a clear regulatory framework regarding cryptocurrencies, it is decidedly clear that investor protection is a high priority and it has cracked down on fraudulent ICOs.

Recent SEC Firsts in ICO Fraud Enforcement Actions

This year, the [SEC obtained a receiver](#) for the first time over the assets of an ICO that claimed to fund the world’s first decentralized bank. Though a receiver is not a novel

remedy, the SEC sought such relief, in part, due to the egregious nature of the claimed fraud including the bank defendant's false statement that it had acquired an FDIC insured bank and intended to generate \$1 billion.

A hedge fund manager settled an enforcement action with the SEC that claimed it operated a company investing in digital assets, but failed to register as an investment company, despite marketing itself as the “first regulated crypto asset fund in the United States.” *Matter of Crypto Asset Management and Timothy Enneking*.

For the first time since its [2017 DAO Report](#), warning sellers of digital securities to comply with securities laws, the SEC charged a company and its owners for selling digital tokens on their self-described “ICO Superstore” website, but failing to register as broker-dealers. *Matter of TokenLot, Lenny Kugel and Eli L. Lewitt*.

What About Private Party Lawsuits?

NoDoubt Crypto is risk averse and questions whether it may be exposed to lawsuits from ICO investors.

Yes! Investor federal class actions against ICOs are on the rise. Twelve were filed by mid-2018 compared to five in 2017. See Cornerstone Research, “[Securities Class Action Filings: 2018 Midyear Assessment](#).”

This increase coincides with the overall increase in class action securities lawsuits with over 750 filed since mid-2016. *Id.* In addition, investors are filing lawsuits against celebrity endorsers who allegedly solicited investor purchases in unregistered security tokens. See, e.g., *Rensel et al. v. Centra Tech et al.*, 1:17-cv-24500-JLK (S.D. Fla. Oct. 9 2018).

Key Takeaway

Given the evolving regulatory landscape, enforcement actions and civil litigation, with likely more to come in 2019, being proactive and staying abreast of regulatory and legal

developments should be a top priority for NoDoubt Crypto and other businesses in the crypto/digital asset space.

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